TAX MANAGEMENT

The Tax Reform Act of 1984

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The Tax Reform Act of 1984

DETAILED ANALYSIS

Prepared By

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FOREWORD

Despite the magnitude of the material which follows, we are eager to assure our readers that the content of this comprehensive analysis of the Tax Reform Act of 1984 represents much more than a testament to the growing complexity of the Internal Revenue Code and, more generally, to the federal taxing process in the United States. The enactment of these wide-ranging tax amendments by the Congress in mid-1984, itself an extraordinary legislative feat, reflects the relentless momentum of global economic and social tensions, and, at the same time, the intense sensitivity of tax rules to these dynamics.

In this volume, Tax Management has sought to produce commentary with substance which will extend beyond mere recitation and outline of the new rules as enacted by the Congress and elaborated by the tax-writing congressional committees. To the extent feasible (given the time demands of the profession for delivery of this material and the inevitable complexities of production and distribution), we have sought to analyze the implications of each of the provisions and to indicate, wherever possible, their application in practical business settings. Certain of the new provisions represent major statutory changes. Materials relating to time value of money (sections 1273-1274), to the new foreign international sales corporation (sections 921-927), to changes in the tax treatment of fringe benefits (sections 125(d), 132, 4977), and to the treatment of divorce and separation (sections 71, 215, 1041) illustrate a few, but by no means all, of the important areas which have been revised. Certainly, problems respecting tax compliance, as reflected *inter alia* in changes in partnership tax treatment and penalty provisions are critical parts of the new law which must be understood by all professionals.

We are, of course, keenly aware of the fact that, as time passes and the implications of the new provisions become clearer (or modified as ever-changing economic conditions continue to alter), new interpretations will become appropriate. Doubtless also, our many readers will observe areas in which additional commentary is appropriate. These and other additional input will be reflected in direct revisions to our portfolios and/or in ongoing materials reflected in changes and additions which will continuously appear.

Tax Management stands ready, as a genuinely cooperative professional effort, to welcome constructive comments from our many qualified contributors. We hope that each of you will continue to play a part in this process.

The task of creating this volume represents the work of a multitude of persons at Silverstein and Mullens and at Tax Management, Inc., without whose intense dedication this effort could not have been completed.

Leonard L. Silverstein
Chief Editor
September 1984

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ACKNOWLEDGMENT

The assistance of the following practitioners who prepared this portfolio is gratefully acknowledged.

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DETAILED ANALYSIS

CHAPTER 1

AMENDMENTS AFFECTING SECTION 72: DISTRIBUTIONS FROM ANNUITY CONTRACTS AND FROM EMPLOYEE-FUNDED PENSION PLANS

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I. Distributions from Annuity Contracts

A. Introduction

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress made a number of changes in the tax treatment of annuity contracts to limit the perceived attractiveness of such products as short-term investment vehicles. First, changes were made in the rules of Code §72(e) to provide that amounts received under an annuity contract before the "annuity starting date" would first be viewed as withdrawals of income credited to the contract to the extent of such investment income (a "LIFO" rule). Also, any loan against the cash value of an annuity contract, or an assignment or pledge of such a contract, was to be treated as an amount "not received as an annuity" and thus subject to the LIFO rule governing withdrawals. These provisions applied with respect to contracts entered into, and amounts allocable to investments made, after August 13, 1982. The pre-TEFRA rules continued to apply to withdrawals of any earnings on investments from contributions made before August 14, 1982, and to contracts purchased in connection with qualified plans.

Second, Congress added Code §72(q), which imposed a penalty tax on certain "premature" distributions from an annuity contract. The penalty, which was effective for distributions after December 31, 1982, is equal to 5 percent of the amount includible in income, to the extent such amounts are allocable to an investment made within 10 years before the receipt of the distribution (the so-called "10 year look-back rule"). This penalty does not apply, however, to a distribution that is (1) made after the policyholder reaches age 59½; (2) made to a beneficiary on or after the death of the annuitant; (3) attributable to the policyholder becoming disabled; (4) one of a series of substantially equal periodic payments for life or at least five years; (5) from a qualified pension plan; or (6) allocable to an investment before August 14, 1982.

B. Analysis of the TRA Changes

Section 222 of the Act amends §72 of the Code by (1) eliminating the 10-year look-back rule under §72(q) and (2) creating a new §72(s) which specifies what provisions a contract must contain in order to be treated as an annuity contract for purpose of §72.

Act §222 amends Code §72(q) to eliminate the 10-year look-back rule.[1] Thus, the 5 percent penalty tax will be applicable to the amount of any distribution to a policyholder before age 59½ that is includible in income, whether or not the amount is allocable to an investment made during the preceding 10 years. The other exceptions to the application of the penalty tax fashioned in TEFRA, however, will continue to apply. For example, distributions made after the policyholder attains age 59½, or made in a series of substantially equal periodic payments for life or at least 5 years, will not be subject to the 5 percent penalty tax.

The new law also makes a "technical" modification to Code §72(q) for purposes of applying the 10-year look-back rule; under this modification, an investment in a multiple premium annuity contract (entered into before January 19, 1985) will be deemed to have been received on January 1 of the year of the investment.[2]

Further, Act §222 adds Code §72(s) which provides that, for an annuity contract to be treated as such under the Code, it must contain language specifying certain methods of distribution in the event of the contractholder's death.[3] Under this new rule, the contract must provide that, if the contractholder dies before the annuity starting date, the entire interest will be distributed within five years after the date of death of the contractholder. However, if any portion of the contractholder's interest is payable to a designated beneficiary and such portion will be distributed (commencing within one year after the date of death) over a period equal to the life of the designated beneficiary (or over a period not exceeding the life expectancy of such beneficiary), such portion will be deemed to have satisfied the post-death required distribution rule.[4] In the event that the contractholder dies after the annuity starting date but before the entire interest in the contract has been distributed, the contract must provide that the remaining portion of such interest will be distributed at least as rapidly as the distribution method in effect as of the time of the contractholder's death. The new distribution requirements of Code §72(s) do not apply, however, in the case of a spousal

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beneficiary who, in effect, steps into the shoes of the deceased contractholder.[5]

Observation: In a case where the contractholder dies before the annuity starting date and a beneficiary has been designated to receive distributions, the regulations prescribing rules for distributions over the designated beneficiary's life will presumably require that the beneficiary's life expectancy be determined only once — when payments commence. This is the rule that regulations must adopt for purposes of the qualified plan required distribution provisions,[6] and, since the annuity and qualified plan provisions are comparable, the regulations implementing the two should also be comparable. Thus, it will likely not be possible to prolong distribution by recomputing life expectancy after payments have begun.

Comment: The exception in §72(s)(2) for distributions over the life of a designated beneficiary technically applies for purposes of the requirement that distributions be completed at least as rapidly as under the method in effect for a deceased contractholder in payment status as well as for purposes of the rule that distributions be made within five years of death where the contractholder dies before the annuity starting date.[7] Section 72(s)(2) provides that the portion of the contractholder's interest payable to a designated beneficiary in accordance with the §72(s)(2) conditions will be "treated as distributed on the day on which such distributions begin." Thus, if a contractholder dies after the annuity has commenced and he has designated a beneficiary to receive the remaining portion, and if this portion is treated as completely distributed on the commencement date under §72(s)(2), then the requirement that this portion be distributed at least as rapidly as under the method in use prior to death has arguably been satisfied. However, based on language in the Conference Report,[8] and the rules that apply to qualified plan distributions,[9] it is questionable whether this result was intended.

C. *Effective Date*

Code §72(q), as amended, and Code §72(s) apply with respect to an annuity contract issued after the day which is six months after the date of enactment of the new law (*i.e.*, a contract issued after January 18, 1985).[10] In contrast to TEFRA, the new law generally does not permit an annuity contract received in a tax-free exchange under Code §1035 to retain the character of the contract given up in the exchange for purposes of applying the new rules. However, the Conference Report does provide that the grandfather provisions granted in TEFRA for amounts invested in or credited to investments in annuity contracts prior to August 13, 1982, continue in effect for purposes of applying the distribution of income-first rules applicable to annuity contracts.[11]

II. Distributions from Employee Funded Plans

One of the principal exceptions to the TEFRA revision of §72(e) treating withdrawals from annuity contracts as first attributable to income was provided for qualified plans and other qualified retirement arrangements. Since nondeductible employee contributions to such qualified arrangements must be 100-percent vested when made and freely withdrawable, financial institutions began promoting qualified plans funded entirely by employee contributions, under which employees would have free access to their contributions yet enjoy a tax-free accumulation of income for the period the contributions were deposited in the plan.

Perceiving this to be an abuse of the qualified plan exception, Congress amended §72(e) in the TRA to subject a qualified plan (or other qualified arrangement) funded 85-percent or more by employee contributions to the TEFRA rules. For a full analysis of the TRA changes, *see* Chapter 49, III, A, *infra*.

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[1] Act §222(a), amending §72(q) of the Code.

[2] Act §222(c)(2) creating a transitional rule for contracts issued before the effective date of the 1984 Tax Reform Act. This modification is intended to simplify the accounting requirements of the 10-year-aging rule in TEFRA for the penalty on early distributions from annuity contracts. Conference Report (Conf. Rep.) H.R. Rep. No. 861, 98th Cong., 2d Sess. 1078 (1984).

[3] Code §72(s) thus applies to both qualified and nonqualified contracts. Act §222(b) redesignates subsection (s) as subsection (t) and creates a new subsection (s).

[4] Regulations may provide for the commencement of distributions to a designated beneficiary on a date later than one year after death. These distribution rules generally conform to the rules applicable to qualified pension plans and IRAs. *See* Conf. Rep. at 1077. The Senate amendment, which was not adopted, created specific distribution rules depending upon the beneficiary's relationship to the contractholder in the following categories: (1) nonspousal beneficiary, (2) spousal beneficiary, (3) dependent minor child and (4) dependent handicapped individual. S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 580-581 (1984).

[5] Code §72(s)(3). If a spousal beneficiary exists at the contractholder's death, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder. Conf. Rep. at 1077.

[6] *See* discussion in Chapter 49, I, D, 1, b, *infra*.

[7] Section 72(s)(2) states the exception is applicable "for purposes of paragraph (1)," which contains the required distribution rules for post-death distributions both before and after the annuity starting date.

[8] *See, supra*.

[9] *Cf.* §401(a)(9)(B)(ii) and (iii). *See also* Chapter 49, I, D, 1, b, *infra*.

[10] For contracts issued before January 19, 1985, and for investments made after January 18, 1985, on contracts existing as of that date, the 10-year look-back rule (as modified) will continue to apply.

[11] H.R. Rep. No. 861, *supra*, at 1077-1078.

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Chapter 2

PROVISIONS RELATING TO THE TIME VALUE OF MONEY

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I. Introduction

The present value of an obligation to make payments in the future is measured in the marketplace by discounting such payments at a rate of interest appropriate to the market rate and the debtor's creditworthiness. Interest is computed on a compounded semiannually basis for most corporate and governmental obligations. Thus, applying an interest rate of 12 percent, the present value of an obligation to pay $10,000 in 20 years is $3,118. This fact of commercial life was not reflected in the Code provisions relating to transactions involving debt instruments and deferred payments until the reforms enacted by TEFRA to the original issue discount (OID) provisions (§§1232A and B). While §483, enacted in 1963, did accord partial recognition to the time value of money, its provisions did not, in most cases, provide an accurate measurement of the true economic consequences of deferred payment transactions. The TEFRA reforms partially remedied the Code's deficiencies in this respect. In the 1984 TRA, an effort was made to complete the TEFRA reforms and to make such amendments as were necessary to make the Code provisions in this area consistent with economic reality.

II. Brief Outline of 1984 TRA Provisions

A. OID Rules

Section 41(a) of the TRA added new §§1271 - 1275 to the Code. Sections 1232, 1232A and 1232B, being superseded by the new provisions, are repealed. The most significant of these provisions is §1274 which provides rules for determining the issue price of any debt instrument issued for property. Prior to the TRA, the issue price of a debt instrument issued for property, where neither the instrument nor the property was traded on an exchange, was the redemption price at maturity, *i.e.*, there was no OID. Under §1274, applicable only where the sum of all payments to be made under a debt instrument exceeds $250,000 (this includes both principal and interest), the sum of the present values of such payments is discounted using 110 percent of the average yield of marketed U.S. obligations having a similar maturity (the "applicable Federal rate"(AFR)). If this amount is not at least equal to the instrument's stated principal amount (the purported sales price), the payments are then discounted at 120 percent of the AFR to obtain an "imputed principal amount" which is treated as the instrument's issue price. OID is then computed using such issue price and is currently included in the income of the holder, and deducted by the issuer, under §1272 (similar to former §1232A).

The OID rules, other than §1274, contain a number of important changes:

(i) OID rules apply to instruments issued by individuals after March 1, 1984.

(ii) The computation of OID currently accruable is based on a 6 month "accrual period," rather than a 1 year "bond period."

(iii) OID rules apply to instruments whether or not they are capital assets in the hands of the holder.

(iv) The formula for reducing OID accruals by the purchaser of an OID instrument at an acquisition premium is changed to yield a value no greater than 1.

B. Section 483 Amendments

Section 483, as amended by TRA §41(b), applies to deferred payments for the purchase of property in any case to which §1274, *supra,* is inapplicable. The same 110 and 120 percent of AFR test and interest imputation rates apply. Imputed ("unstated") interest is computed with respect to any payment on a constant interest rate basis (*i.e.*, semiannual compounding). Instruments issued to purchase a personal residence are excepted from §1274 altogether. Section 483 will apply to such instruments, however, where total payments do not exceed $250,000, the test and imputation rates as in effect prior to the TRA (*i.e.*, 9 percent simple interest and 10 percent compounded semiannually) are to be used. Also, these lower rates are to be applied to the sales of farms where the sales price is less than $1,000,000. Sales in excess of this amount are subject to §1274.

C. Effective Dates of Sections 1274 and 483

The provisions of §§1274 and 483 apply to sales or exchanges after December 31, 1984.

D. Market Discount

Where any debt instrument issued after July 18, 1984 is purchased from its holder for a price less than the amount payable at redemption, the market discount must be accrued for each day the instrument is held and, to the extent of any gain realized on the disposition of the instrument, is treated as ordinary income in the year of disposition. These provisions (and provisions deferring interest on indebtedness attributable to the acquisition of market discount bonds) are contained in new §§1276-1278 enacted by TRA §41(a).

E. Short-Term Obligations

No OID is currently includible with respect to short-

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term (maturity date not more than one year from date of issue) obligations. Under §§1281-1283, added by TRA §41(a), accrual basis taxpayers, dealers, banks, and certain other holders, are required to include currently in income any discount on short-term obligations acquired after July 18, 1984. This includes both governmental (*e.g.*, Treasury bills) and non-governmental (*e.g.*, certificates of deposit) obligations.

F. Tax-Exempt Obligations

Holders of tax-exempt obligations issued after September 3, 1982 and acquired after March 1, 1984 must adjust their basis in such obligations by accruing discount on a constant interest basis (rather than ratably). This is required by §1288, added by TRA §41(a).

G. Deferred Payments for the Use of Property and Services

Neither the OID provisions nor amended §483 apply to payments for the use of property or services (leases and compensation arrangements). Under §467, added by TRA §92, payments of rent deferred for more than one year are currently includible in income on a present value basis, as is any interest on such amounts until they are paid.

In the case of a rental agreement providing for increases in the rent payable, where such agreement is a leaseback, or long-term agreement (for more than 75 percent of the property's statutory recovery period), the rents are leveled and currently taken into income based on this amount. Leveling is required, however, only where it is determined that the rental arrangements have as a principal purpose the avoidance of tax. Property subject to such a stepped rental agreement under a leaseback or long-term agreement is subject to recapture in the same manner as §1245 or §1250 property where the rentals have not been leveled.

These provisions are effective, generally, to agreements entered into after June 8, 1984.

H. Below-Market Interest Loans

Under §7872, added to the Code by §172 of the TRA, where certain types of loans are made at a rate of interest which is not at least equal to the AFR, the transaction is treated as if the lender charged such interest and transferred to the borrower the funds with which to pay it. The borrower in the case of a gift or demand loan is treated as having retransferred the funds to the lender as interest. In the case of a loan which is not a gift loan or a demand loan, the lender is considered as having transferred to the borrower of a below-market interest loan an amount equal to the difference between the amount loaned and the present value of the debt instrument (using the AFR), OID. De minimis exceptions and a $100,000 principal amount exception for certain gift loans are provided. In addition to gift loans, this section applies to compensation related loans, corporation-shareholder loans, and tax avoidance loans.

These provisions apply to term loans made after June 6, 1984 and to demand loans outstanding after that date. However, where a demand loan is repaid by September 16, 1984, it is excepted from these rules.

I. Detailed Analysis Cross Reference

TRA §§41-44 (OID, market discount, short-term obligation, tax-exempt obligation, and §483 provisions) are analyzed in detail in Chapter 21, infra. The provisions enacted by §92 (deferred payments for the use of property and services) and 172 (below-market interest loans) of the Act are analyzed in detail in Chapter 22, *infra.*

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CHAPTER 3

MISCELLANEOUS ITEMS OF INCLUSION

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I. Certain Amounts with Respect to Nuclear Decommissioning Costs [Act §91(e)] — Code Section 88

A utility must also include in its income the amount of any nuclear decommissioning costs which are included in its cost of service for ratemaking purposes.

For a more complete discussion of this change, *see* Chapter 23 (III).

II. Interest-Free and Below-Market Loans Give Rise to Gross Income [Act §172]

Effective as to loans made after July 18, 1984, new Code §7872 provides the following rules for interest-free and below-market loans.[1]

In the case of a loan all of which is repayable upon the demand of the lender (a demand loan) made during any calendar year, there will be computed as of December 31 of such year the amount of interest which would have been payable by the borrower had interest been charged at the AFR [2] (the AFR is compounded semiannually) for any period during the year in which the demand loan was outstanding. If the interest charged on such loan (if any) was less than the amount thus computed, it is known as "foregone interest." Where there is foregone interest the amount thereof is treated as if it had been transferred by the lender to the borrower and retransferred by the borrower to the lender on December 31 as interest. Where the demand loan is a gift loan (*i.e.*, the foregoing of interest is treated as a gift under gift tax principles) the deemed transfer to the borrower is includible as a gift for gift tax purposes (subject to the special exemptions explained below). Otherwise, the deemed transfer will have tax consequences depending on the relationship of the parties.

Where the loan is other than a demand loan, it is a "term loan." In this case, where the loan is a gift loan, for income tax purposes (but not for gift tax purposes) the loan is treated in the same manner as a demand loan. That is, interest is computed at the AFR on the principal amount of the loan as if it had been charged (where interest less than the AFR was charged as determined by discounting all payments to be made under the loan terms at the AFR) and such foregone interest is deemed paid by the lender to the borrower on December 31, and retransferred by the borrower to the lender on the same date as interest.

Where the loan is a term loan, and is not a gift loan, the payments to be made are discounted at the AFR. The sum of their present values is the principal amount of the loan. Where the amount actually loaned exceeds this amount (*e.g.*, where the lender has loaned, say, $38,000 to be repaid in installments over a 2 year period without interest or with interest below the AFR, and the sum of the present value of all payments discounted at the AFR is $32,000) there is deemed transferred by the lender to the borrower on the date of the loan an amount equal to the difference between the amount loaned and the principal amount of the loan as computed by discounting the payments at the AFR ($6,000 in the example set forth above). In such a case, the borrower is treated as having issued a debt instrument having original issue discount (OID) in an amount equal to the deemed transfer. The OID rules of §§1272 and 1273 will apply to this deemed debt instrument (*see* Chapter 21 for a discussion of the OID rules as amended by the Act). Where such below-market interest term loan was a gift loan, the amount of the deemed transfer ($4,000 in the example) is treated as a gift. The income tax consequences are as described in the preceding paragraph.

Exceptions to these rules are provided where the outstanding balance of the below-market interest loan (including all loans between the lender and borrower) does not exceed $10,000. Also, for any day on which the outstanding balance of a gift loan made directly between individuals does not exceed $100,000, the amount treated as retransferred from the borrower to the lender as of the last day of the year is not to exceed the borrower's net investment income (a de minimis amount of $1,000 is ignored) for the year. "Net investment income" is defined, generally, in §163(d).

These rules apply to: (1) all gift loans, (2) loans from (by) an employer to (from) an employee, (3) loans from (by) a corporation to (from) a shareholder, (4) any loan a principal purpose of which the interest arrangements of which is tax avoidance, and (5) other types of loan as will be provided by regulations where the interest arrangements have a significant effect on the tax liability of either the lender or borrower.

Below-market interest loans are discussed in detail in Chapter 22 of this portfolio. The OID rules are discussed in Chapter 21.

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[1] §1274(d).

[2] Beginning after July 18, 1984, the Secretary of the Treasury will announce the average yields of U.S. Government obligations in 3 categories: short-term (not more than 3 years from date of issue to maturity), mid-term (not more than 9 years) and long-term (more than 9 years) on March 31 and September 30 of each year based on the previous 6 months' trading. These will be known as the "applicable Federal rate (AFR)" and such AFR will become effective on July 1 and January 1 respectively.

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Chapter 4

EXCLUSION RULES FOR TAX BENEFIT ITEMS REVISED

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The Act expands the statutory tax benefit rule to exclude from income recoveries of any deduction taken in a prior year to the extent that the deduction did not reduce income subject to tax. This is intended to reverse the result in Revenue Ruling 79-15. Section 111 now will increase income taxes by the amount of income tax credits previously allowed (other than the investment tax credit and the foreign tax credit) when there is a downward price adjustment which would have affected the amount of the credit. A price adjustment which affects a credit which did not reduce income taxes will not increase income taxes, however.

An increase in a carryover which has not expired before the beginning of the taxable year in which a recovery takes place is treated as a reduction of income tax as under prior law. The exceptions to the tax benefit rule as previously applied to the accumulated earnings and personal holding company taxes are preserved in new §111.

For a more complete discussion of this change, *see* Chapter 16.

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CHAPTER 5

MISCELLANEOUS AMENDMENTS AFFECTING EXCLUSIONS FROM GROSS INCOME

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I. Net Interest Exclusion Repealed [Act §16]

A. *Introduction*

The Economic Recovery Tax Act of 1981 repealed the $200 ($400 in the case of a joint return) interest and dividend exclusion for taxable years beginning after 1981. For subsequent years, the $100 dividend exclusion previously in effect was reinstated, amended to permit an exclusion of up to $200 to be claimed on a joint return without regard to which spouse actually received the dividend.[1]

Congress also enacted §128, which established a temporary program of tax exemption certificates generally known as "all-saver certificates".[2] These were issuable by qualified savings institutions from September 30, 1981, through December 31, 1982. A lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on qualified tax exempt certificates was provided.

For taxable years beginning after December 31, 1984 (one year after the expiration of the all-saver certificate program), ERTA enacted a new Code §128, which provided for an exclusion of 15 percent of "net interest" received up to $3,000 of net interest ($6,000 in the case of a joint return).[3]

For purposes of §128, net interest is generally defined as eligible interest received by the taxpayer in excess of the amount of interest payments by the taxpayer for which an income tax deduction is allowed. Eligible interest generally includes any interest paid on deposits in banks and thrift institutions, corporate debt in registered form or in a form generally sold to the public, United States, State, or local government debt, certain federally-sponsored participation trusts, and certain amounts held by life insurance companies.[4]

Mortgage interest and trade or business interest are not taken into account to reduce eligible interest income.[5] For this purpose, mortgage interest is interest paid on debt incurred to acquire, construct, reconstruct, or rehabilitate property the taxpayer uses primarily as a dwelling.

B. *Overview*

1. *TRA Amendment*

The Act repeals the net interest exclusion enacted in ERTA.

2. *Effective Date*

The provision applies to taxable years ending after December 31, 1983.[6]

C. *Detailed Analysis*

Section 16 of the TRA of 1984 repeals subsections (a) and (c) of §302 of the Economic Recovery Tax Act of 1981, thereby preventing §128 from becoming effective, as originally enacted, for taxable years beginning after December 31, 1984.

A conforming amendment revises paragraph (1) of §57(a) of the Code, relating to items of tax preference, to provide that excluded interest under the now inoperable §128 is not a tax preference item.[7]

II. Foreign Earned Income Exclusion — Scheduled Increases Postponed

The Economic Recovery and Tax Equity Act of 1981 (ERTA) repealed §913 and enacted an amended version of §911 providing liberal rules for the exclusion of foreign earned income of U.S. citizens and resident aliens.

Under §911(a), a qualified individual may elect to exclude from gross income for any taxable year: (i) the foreign earned income of such individual, and (ii) the housing cost amount of such individual.

Section 911(b)(2), as originally enacted by ERTA, however, provided certain limits on the maximum amount of foreign earned income that a qualified individual could claim as an exclusion for any particular taxable year. This maximum amount of exclusion was $75,000 for the taxable years beginning in 1982; $80,000 for taxable years beginning in 1983; and was further scheduled to increase by $5,000 yearly until it reached $95,000 for taxable years beginning in 1986 and thereafter.

Section 17 of the Tax Reform Act of 1984 (P.L. 98-369) postpones the scheduled increases for 1984 and later years with respect to the maximum amount of foreign earned income exclusion that a qualified U.S. citizen or resident alien may exclude from gross income until 1988. Thus, the maximum amount of foreign earned income exclusion under §911(b)(2) remains at $80,000 for taxable years beginning in 1984, 1985, 1986 and 1987. For taxable years beginning in 1988, the maximum limit will increase to $85,000. This limit will further increase to $90,000 for taxable years beginning in 1989, and to $95,000 for taxable years beginning in 1990 and thereafter.

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III. Amendments to the Exceptions for Cancellation of Indebtedness Income

Effective for transfers of stock after July 18, 1984, §59(a) of the 1984 TRA adds new §108(e)(10)(A) to the Code providing that, where a debtor corporation issues stock in exchange for the extinguishment of any of its debt, the debtor corporation is treated as having satisfied the debt with an amount of cash equal to the fair market value of the stock issued. In other words, the difference between the face amount of the debt so extinguished less the fair market value of the stock issued therefor constitutes gross income realized.

Because any debt so satisfied is by definition debt issued by a corporation, it will be "qualified business indebtedness" within the meaning of Code §108 and thus the debtor corporation may elect to reduce the basis of its depreciable assets, defined to include real property held for sale to customers in the ordinary course of business and interests in partnerships holding depreciable property, rather than take the forgiven debt into income. For a more detailed discussion of this provision, *see* Chapter 33, VIII, *infra.*

IV. Changes in Rules Relating to Fringe Benefits

A. Introduction

Section 61 of the Internal Revenue Code of 1954, as amended (hereinafter referred to as the "Code"),[8] defines gross income as including "all income from whatever source derived" and includes "compensation for services." On several occasions, the United States Supreme Court has held that §61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." [9] In addition, for purposes of Social Security and Unemployment Insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding, the Code defines wages as all remuneration for employment, including the cash value of remuneration not paid in cash.[10] The regulations issued pursuant to these sections indicate that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item.[11]

As a practical matter, the economic benefit test set forth by the Supreme Court, generally has not been followed. Rather, the treatment of in-kind compensation has been governed by statutory provisions, regulations, and administrative rulings and practices. Before the Act, for example, many fringe benefits had been statutorily excludable from an employee's gross income. Among these so-called "statutory" fringe benefits were: (1) qualified pension, profit-sharing, and stock bonus plans; (2) group-term life insurance (under $50,000); (3) accident or health benefits; (4) up to $5,000 of death benefits; (5) legal services; (6) dependent care assistance; (7) certain benefits provided to members of the Armed Services; and (8) parsonage allowances.[12]

In recent years, the erosion of the tax base through the expanding use of so-called "nonstatutory" fringe benefits led the Treasury Department in 1975 to issue a discussion draft of proposed regulations containing rules for determining whether various fringe benefits constitute taxable compensation. The proposed rules would have codified many of the then-existing exclusions of nonstatutory fringe benefits that were based on judicial authority or administrative practice. However, the rules would have required the taxation of certain employee fringe benefits that had not been taxed previously. The proposed regulations were withdrawn in 1976 following considerable controversy.

Because of its inability to agree on how to approach the controversy, beginning in 1978, Congress enacted a series of moratoriums prohibiting the Treasury Department from issuing regulations under §61 relating to the tax treatment of fringe benefits.[13] The last moratorium, enacted as part of the Economic Recovery Tax Act of 1981, expired on December 31, 1983. In December, 1983, the Treasury provided assurances to Congress that it would not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits before January 1, 1985.[14] This assurance gave Congress an opportunity to enact legislation it had been considering in earnest for over a year.[15]

During the moratorium on the issuance of regulations, the taxation of nonstatutory fringe benefits was determined on a case by case basis and as a result of a lack of guidance to the field, taxation of such benefits was nonuniformly applied depending on the policy of the particular Internal Revenue Service district in which the taxpayer filed.

Dissatisfied with existing practices and mindful of the dangers involved in allowing the tax base to erode, Congress considered several pieces of legislation during the course of a year-and-a-half and then adopted as part of the Act provisions that specifically treat the income tax aspects (as well as the Social Security and unemployment insurance tax and income withholding) of nonstatutory fringe benefits.

B. Overview

1. Provisions

Sections 531 and 532 of the Act provide for the exclusion of certain fringe benefits from a recipient employee's gross income for Federal income tax purposes and from the wage base for purposes of income tax withholding, FICA, FUTA, and the Railroad Retirement Tax Act. The excluded fringe benefits are those that qualify under categories defined in the bill including (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, and (5) qualified tuition reductions. The Act also contains rules for parking or eating facilities provided to employees, athletic facilities, and the demonstration use of an employer-provided automobile to automobile salespeople. Some exclusions apply to benefits provided not only to the employee but also to the spouse and dependent children of a current employee, or to former employees who left employment due to retirement or disability, and to their widows and dependent children. In the case of several of the categories of fringe benefits, a nondiscrimination rule is applied so that if benefits are provided to the owners or highly compensated employees on

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a discriminatory basis, the exclusion will not be available to such individuals.

The Act clarifies that where a benefit does not qualify for exclusion under the provisions of the Act, the benefit will be considered taxable to the recipient under §61 and §83 (and will be includable in wages for employment tax purposes) at the excess of its fair market value over any amount paid by the employee for the benefits.

2. Effective Date

For the most part, the provisions of the bill take effect on January 1, 1985. The tuition reduction exclusion however, applies with respect to education furnished after June 30, 1985, in taxable years ending after that date.

3. Cross-reference

For a detailed analysis of the fringe benefits provisions *see* Chapter 46, section I, *infra*.

V. Interest on Certain Loans to ESOPs Excluded

Section 133 of the Code, enacted in Act §543, permits banks, insurance companies and other corporate commercial lenders to exclude from gross income 50 percent of the interest received on loans to ESOP companies, provided the loan proceeds are used to finance an ESOP's acquisition of company stock.

Section 133 is analyzed in depth in Chapter 48 of this Portfolio.

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[1] P.L. 97-34, §302(b), August 13, 1981.
[2] P.L. 97-34, §301(a), August 13, 1981.
[3] P.L. 97-34, §302(a), August 13, 1981.
[4] §128(c)(1).
[5] §128(c)(2).
[6] TRA §18(a).
[7] TRA §16(b).
[8] All section references are to the Code unless otherwise indicated.
[9] *Comr. v. Smith*, 324 U.S. 177, 181 (1945).
[10] Sections 3121(a), 3306(b), and 3401(a). The Railroad Retirement Tax Act also applies to any form of money remuneration (Section 3231(e) of the Railroad Retirement Act).
[11] *See*, for example, §31.3121(a)-1(i).
[12] Educational benefits provided under a nondiscriminatory plan were among the excludable benefits until the provision, §127, expired on December 31, 1983.
[13] Public Law 95-427; Public Law 96-167; and Public Law 97-34.
[14] Treasury Department News Release R-2461, December 20, 1983.
[15] Of particular note was H.R. 3525, "The Permanent Tax Treatment of Fringe Benefits Act of 1983," introduced by Congressmen Stark and Conable in the 98th Congress, 1st Session, and S. 1817, "The Fringe Benefits Tax Act of 1983," introduced by Senator Symms in that same session of Congress. H.R. 3525 was not favorably received by many members of the business community because of its limitations on existing practices. Nevertheless, it provided the basis for much of the language adopted in the Act.

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CHAPTER 6

CHANGES AFFECTING ACRS, DEPRECIATION, AMORTIZATION, AND EXPENSING *

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I. Extension of the ACRS Recovery Period for Real Estate

A. Introduction

The Accelerated Cost Recovery System (ACRS) of §168, enacted by the Economic Recovery Tax Act of 1981,[1] classifies most real property placed in service after 1980 as 15-year real property.[2] As the classification implies, the cost of 15-year real property can generally be recovered over 15 years using tables prescribed by the Treasury.[3] These tables employ the 175-percent declining balance method (200-percent in the case of low-income housing), switching to the straight-line method when that method yields a greater deduction.[4] In general, the ACRS tables for both the accelerated and straight-line methods for 15-year real property round the cost recovery percentages to the nearest whole number.

The amount of cost recovery deductions allowable on 15-year real property for the year such property is placed in service or is disposed of depends on the number of months the property is in service for such year. Provided the taxpayer places 15-year real property in service by the last day of the month, the taxpayer obtains a full month's worth of cost recovery deductions under the tables.[5] On the other hand, when 15-year real property is disposed of, the disposition is deemed to occur as of the last day of the month preceding the month in which it is withdrawn from service.[6]

Section 168(f)(1) generally provides that components of 15-year real property must be depreciated in the same manner. An exception is provided in §168(f)(1)(C) for substantial improvements to real property. Moreover, under a transitional rule in §168(f)(1)(B), a component of a building placed in service after 1980 will qualify as 15-year real property even though the building itself does not so qualify.

For purposes of the alternative minimum tax imposed on noncorporate taxpayers under §55 and the add-on minimum tax imposed on corporate taxpayers under §56, §57(a)(12)(B) treats accelerated cost recovery deduction on 15-year real property, to the extent they exceed the amount of deductions that would have been obtained if the straight-line method had been used over 15-years, as a preference item.

B. Analysis

1. General

The TRA [7] lengthens the recovery period for real property from 15 to 18 years. The recovery period for low-income housing, however remains at 15 years.[8] The accelerated recovery percentages for what is now termed "18-year real property" will continue to be based on the 175-percent declining balance method with a switch, when appropriate, to straight-line percentages.

The TRA [9] also amends §168(b)(2)(A) and (B) to require the use of a mid-month convention for the year 18-year real property is placed in service or is disposed of. Under the mid-month convention, 18-year real property is considered to be placed in service, for purposes of computing the recovery allowance, in the middle of the month it was placed in service, regardless of the precise date such property was placed in service. Thus, one-half month's worth of cost recovery is obtained for the month 18-year real property is placed in service, in contrast to the present rule providing a full month's worth of cost recovery. Further, after the TRA, one-half month's worth of cost recovery deductions will be allowed in the year of disposition, in contrast to the pre-TRA rule allowing no cost recovery deductions for the month of disposition.

Note: Assuming that 18-year real property is in service for 12 months in the year it is first placed in service, the cost recovery deduction will be approximately 9.3 percent if the table to be prescribed using the 175 percent accelerated rate and mid-month convention does not round to whole numbers, and will be 9 percent if rounding is employed. Without the mid-month convention, the cost recovery deduction under these circumstances would be 9.7 percent without rounding and 10 percent with rounding. Under pre-TRA law for 15-year real property in service for 12 months in the first year, the accelerated recovery percentage is 12 percent.

The lengthening of the recovery period for real property to 18 years reflects Congress's concern that the 15-year recovery period, which was one-half the estimated economic life of real property prior to the ACRS, provided "overly generous depreciation." [10] Congress determined that this more rapid depreciation contributed to the growth of real estate tax-shelter partnerships and to the churning of existing real property through sales and leasebacks.[11] When combined with other tax breaks accorded real estate, such as high interest deductions, favorable recapture rules, and the availabilty of the installment sales method, a real estate shelter could achieve a low or even negative effective tax rate, thereby encouraging the growth of uneconomical real estate projects.[12] The lengthening of the recovery period was seen as reducing "the tax revenue cost associated with tax-motivated real estate shelters, depreciation-strips, and churning transactions without harming incentives for cap-

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ital formation in the most productive real property investments."

2. Components of Buildings

Under §168(f)(1)(B), as amended by the TRA,[13] building components that are placed in service after March 15, 1984 (generally, the effective date of the 18-year recovery period) with respect to a building in existence on March 15, 1984, are treated as a "separate building." Consequently, such components will be treated as 18-year recovery property even though the building to which they relate is 15-year real property.[14] For example, if a taxpayer places a building in service on March 15, 1984, the building is treated as 15-year real property. If a central air conditioning system is added to the building on June 15, 1984, the air conditioning system is treated as 18-year real property.

Under the §168(f)(1)(B) transitional rule for post-March 15, 1984 building components, cost recovery on all such components is to be computed in the same manner. Thus, if the straight-line method and 18-year recovery period is used with respect to the first component placed in service after March 15, 1984, the straight-line method and 18-year recovery period must be used for any subsequent components added to that same building.

Observation: As previously mentioned, the first post-March 15, 1984, component is treated as a separate building, thereby causing such component to be 18-year real property. Under §168(f)(1)(C), an exception is provided to the rule that a building and all of its components must be depreciated in the same manner under the ACRS. The exception provides that a "substantial improvement" is treated as a separate building, which means that a different ACRS method can be used with respect to the substantial improvement. Improvements qualify as substantial improvements if they are made at least three years after the building is placed in service and the total cost of the improvements (including any improvements during any 24-month period) equals or exceeds 25 percent of the adjusted basis of the building, determined without regard to adjustments for depreciation or cost recovery deductions.

Comment: The interaction between the TRA transitional rule and the substantial improvement rule is unclear. Since the first post-March 15, 1984 component is treated as a separate building, and the substantial improvement exception overrides the general rule that building components should be depreciated in the same manner as the building, the position can conceivably be taken that building components added at least three years after the first post-March 15, 1984 building component may themselves be treated as a separate building if they collectively fall within the substantial improvement exception.

3. Low-Income Housing

Neither the 18-year recovery period nor the mid-month convention applies to low-income housing. Thus, low-income housing continues to have a 15-year recovery period using the 200-percent declining balance percentages. The continued availability of the 15-year recovery period enhances the relative advantage for real property classified as low-income housing. As previously noted, 18-year real property in service for 12 months in the first year will generate a cost recovery deduction of approximately 9 percent. Low-income housing, in contrast, is assigned a 13 percent deduction under the current tables in comparable circumstances.

The definition of low-income housing continues to be made by reference to the definition found in §1250(a)(1)(B).

Comment: The definitions of low-income housing for various Internal Revenue Code purposes may not be uniform. Section 1250(a)(1)(B), for example, lists four categories of low-income housing, the most important of which classifies as low-income housing units held for occupancy by families or individuals eligible to receive housing subsidies under §8 of the United States Housing Act of 1937.[15] This category does not appear to require that dwelling units be held for families actually *receiving* §8 housing subsidies; only that the units be held for families eligible to receive such subsidies. Families are eligible to receive subsidies under §8 if they are "lower-income." Under 42 U.S.C. §1437a(b)(2), a lower-income family is, generally, a family having income of 80 percent or less of the median income within a locality. This 80-percent figure, however, is subject to adjustment for special circumstances, such as the existence of very high or very low income levels within a particular locality. In contrast, a somewhat different definition of low-income housing is provided for purposes of the tax-exempt bond provisions of §103(b)(4)(A). Under §103(b)(12)(C), the determination of low and moderate income for purposes of §103(b)(4)(A) financing is to be made in a manner consistent with determinations of lower-income families under §8 of the 1937 Housing Act. The percentage of median income qualifying as low or moderate income, however, is, in all cases, 80 percent under §103(b)(12)(C). No discretion is provided to adjust the 80-percent figure for special circumstances for purposes of the tax-exempt bond provisions. Consequently, it is conceivable that low-income housing acquired with tax-exempt financing may not qualify as low-income housing for purposes of the ACRS in localities where discretion has been exercised to establish eligibility for §8 housing subsidies at a median income that is less than 80 percent.

4. Minimum Tax Preference

In a conforming change, the TRA[16] amends §57(a)(12)(B) to provide that the preference amount in the case of 18-year real property for minimum tax purposes will be the excess of the ACRS deduction for the taxable year over the amount that would have been allowable if the property had been depreciated using the straight-line method over an 18-year recovery period. The computation of the preference for low-income housing remains the same.

C. Effective Dates

The 18-year recovery period generally applies to property placed in service after March 15, 1984.[17] The mid-month convention applies generally to property placed in service after June 22, 1984.[18]

The TRA changes do not apply to property placed in service by the taxpayer before January 1, 1987, if either the taxpayer or a "qualified person" entered into a binding contract to purchase or construct such property before March 16, 1984, (for purposes of the mid-month convention, the date is June 23, 1984), or construction of such

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property by or for the taxpayer or a qualified person began before March 16, 1984 (June 23, 1984, for the mid-month convention).[19]

For purposes of this exception, a qualified person is any person who transfers his rights in a qualifying contract or transfers his rights in qualifying property to the taxpayer, provided the person does not place in service the qualifying property before the rights are transferred to the taxpayer.

The Conference Report [20] provides two examples illustrating the application of the transitional rules:

> *Example 1*: Assume taxpayer A signed a binding contract on March 10, 1984, to have a building constructed and, on December 1, 1984, A assigned the contract to B. B assigned the contract to C on March 15, 1985. C placed the building in service on November 1, 1985. Since neither A nor B placed the property in service, C is entitled to use the 15 rather than the 18-year recovery period.
>
> *Example 2*: Assume a partnership commenced construction of, or signed a binding contract to acquire or construct, real property on or before March 15, 1984. Subsequently, but before time the property is placed in service, interests in the partnership are sold or exchanged. If, by reason of such sales or exchanges, the partnership terminates and a new partnership is deemed to be created under §708(b)(1)(B) (relating to sales or exchanges of 50 percent or more of the total interests in the partnership's capital or profits) the partnership is treated as having transferred its rights in its contract or the property to the new partnership (through its partners) for purposes of the transitional rule.

For purposes of the transitional rule, a person will not be treated as having placed property in service and, therefore, fail to be a qualified person, if (i) the person holds the real property primarily for sale to customers (such as a condominium project), (ii) the person disposes of the property before January 1, 1985, and (iii) prior to disposition, the person temporarily rents the property or holds the property for rental.

Note: A person seeking to utilize this rule will not be entitled to depreciation or amortization deductions with respect to the property. The Conference Committee states, however, that no inference is intended to be drawn as to whether property held as §1221(1) property by a taxpayer may be depreciated by that taxpayer.[21]

A contract is to be considered binding under the transitional rules only if it is enforceable under state law and does not limit damages to a specified amount that is relatively minor. A contract limiting damages to an amount equal to at least 5 percent of the total contract price will not be treated as calling for relatively minor damages. A contract subject to a condition not within the control of either party is considered binding. Moreover, a contract will not be treated as ceasing to be binding merely because any term is to be determined by a standard beyond the control of either party or there is a bilateral agreement to reduce the property's purchase price by no more than 20 percent or to change the financing terms.[22]

For purposes of the transitional rules, construction is considered to have commenced when land preparations and improvements, such as clearing, grading, excavation (including any significant required archaeological excavation), or filling, are undertaken.[23] The performance of drilling for determining soil conditions, the preparation of architectural plans, or the obtaining of a building permit, however, do not constitute construction.[24] Demolition to prepare a site for specific construction is considered the commencement of construction, but demolition not undertaken as a part of the plan for the construction of specific buildings or improvements does not commence construction.[25]

In the case of property to be constructed that is an integral part of an integrated facility, construction of such property is deemed to have begun on or before March 15, 1984 if construction of part of the facility began on or before March 15, 1984. An integrated facility is a multiproperty facility constructed as a single project on a single site which is to be operated as a single, unitary facility as described in a written plan (evidenced by the taxpayer's internal documents) existing on March 15, 1984. Property is an integral part of an integrated facility if: (i) the property is described as part of the same project in the taxpayer's written plans; (ii) the property is an integral part of the planned operation of the project when a significant part of the project will first be placed in service; and (iii) the property will be constructed during the same time as the rest of the project.[26]

> *Example:* Three separate apartment buildings are not an integrated facility if it is planned that only one building will be placed in service initially. A hotel and separate convention center, however, constitute an integrated facility. Parking lots, access roads, and utility hook-ups, although they may be part of an integrated facility, are not considered the start of construction of other property in the facility since they can be used in connection with any type of facility.[27]

One last transitional rule for components deserves mention.[28] If property which is placed in service after March 15, 1984 (but before January 1, 1987) is treated as 15-year real property under the foregoing transitional rules, components of such property placed in service after December 31, 1986 will be treated as 18-year real property pursuant to §168(f)(1)(B).

II. Applicability of ACRS to Movies, Films, and Sound Recordings

A. Introduction

The income forecast method has been held to be an appropriate method of depreciation for movies,[29] television films and video tapes,[30] and master sound recordings.[31] In fact, §280 mandates the use of the income forecast method by an individual, personal holding company, or S corporation for certain production costs of films, tapes, and sound recordings. Under the income forecast method, each year's depreciation deduction is computed by multiplying capitalized production costs by the ratio of the income derived from the property for the year to the total income that is reasonably expected to be derived from the property.

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It is not settled whether movies, tapes, and sound recordings qualify as recovery property under the ACRS. To be qualified, property must be tangible, depreciable property placed in service after 1980. The Service has taken the position for investment credit purposes that movies, tapes, and sound recordings are intangible property,[32] although the courts have generally rebuffed this position.[33] If such property qualifies as recovery property, it would be classified as five-year property under the ACRS.[34]

Property depreciated under the income forecast method, or any other method not expressed in terms of years, is excluded from classifcation as recovery property for ACRS purposes.[35]

Under §168(f)(2), personal property which is recovery property used predominantly overseas that was not assigned a present class life is deemed to have a recovery period of 12 years.

B. Analysis

1. Films and Tapes

The TRA [36] enacts §168(e)(5) to exclude any motion picture film or video tape from the definition of "recovery property." Section 168(e) is also amended [37] to provide that property within the exceptions listed in §168(e) to the definition of recovery property, including post-TRA §168(e)(5), will not be treated as recovery property for all purposes of the Internal Revenue Code, and not just for purposes of §168. The principal effect of this change is that taxpayers may no longer take the position that the 10 percent investment credit (6 percent credit in the case of three-year property) [38] provided for recovery property is available for property excluded under the §168(e) exceptions on the theory that those exceptions apply only for §168 purposes.

Comment: The enactment of §168(e)(5) and the clarifying amendment to §168(e) may not completely end the controversy as to the tangibility of films and tapes for depreciation purposes. The specific exclusion of films and tapes in §168(e)(5) does not necessarily relegate such items to the income-forecast method of depreciation. The depreciation methods of §167 remain available with respect to such property. The straight-line method can clearly be used with respect to films and tapes. More significantly, if such films and tapes have a useful life of at least three years and are *tangible* property,[39] the 200-percent declining balance method provided under §167(b)(2) or the sum-of- the-years-digits method provided by §167(b)(3) can be used. Although the Service takes the position that motion picture films do not qualify for the 200-percent declining balance method because such films are intangible,[40] §168(e)(5) does not address the tangibility of films and tapes. Thus, the court decisions holding films to be tangible property may still apply for purposes of using the accelerated §167 methods.[41]

Observation: The Senate Finance Committee Report [42] describes §168(e)(5) as a clarification that movies and video tapes cannot qualify as recovery property for either depreciation or investment credit purposes. If it is merely a "clarification," such property would not have been recovery property for depreciation purposes prior to the TRA only because it did not constitute tangible property. The Conference Committee clearly states, however, that no inference is intended as to the proper treatment under pre-TRA law for depreciation as well as investment credit purposes.[43]

2. Sound Recordings

The TRA [44] enacts in the investment credit provisions special rules that apply for depreciation purposes as well as investment credit purposes. Post-TRA §48(r) provides taxpayers with two alternatives with respect to sound recordings. Under §48(r)(1), if the sound recording is new property, the taxpayer is granted an election to treat such recording as three-year recovery property to the extent the taxpayer has an "ownership interest" in the recording. The election must be made separately with respect to each sound recording.[45] In addition, the election will not be effective unless all taxpayers having an interest in the sound recording make the election.[46]

Under §48(r)(2), if a taxpayer does not make an election with respect to any sound recording, the recording is not allowed an investment credit nor may it be treated as recovery property. Presumably, the same result follows as to a taxpayer who endeavors to elect §48(r)(1) as to a sound recording but where other taxpayers having an interest in that sound recording do not make the election.

Comment: The Conference Report [47] in fact, states that the second option will apply unless all taxpayers with an ownership interest in the recording elect the first option. The report further states [48] that, under the second option, the income-forecast method or similar method can be used to depreciate the sound recording. No mention is made, however, in the legislative history as to whether the accelerated depreciation methods of §167(b) are available with respect to sound recordings. As indicated in the comment above, if such property is tangible property, the accelerated depreciation methods may apply. Clearly, §48(r)(2) does not rule out the classification of sound recordings as tangible property. Note also that both the Conference Report [49] and the Senate Finance Committee Report [50] state that no inference is intended as to whether sound recordings qualify as tangible personal property.

Observation: Although it is not entirely clear in the statute,[51] it appears that a used sound recording will be subject to the second alternative since an election under §48(r)(1) is clearly denied for a used sound recording.

Presumably, a taxpayer's "ownership interest" in a sound recording is determined in accordance with his loss-sharing ratio in the production costs of the sound recording. For investment credit purposes, §48(r)(4) provides that ownership interests are determined according to loss-sharing ratios. The reason for specifically providing this rule for investment credit purposes is that the investment credit is ordinarily determined on the basis of profit-sharing ratios,[52] rather than on the basis of loss-sharing percentages.

Under §168(f)(14), added by the TRA,[53] the adjusted basis of a sound recording for §168 purposes is equal to the production costs as determined under §48(r)(6). Under §48(r)(6), production costs include:

(i) a reasonable allocation of overhead costs;

(ii) compensation to songwriters, artists, production personnel, directors, producers, and similar personnel;

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(iii) costs of "first" distribution of records or tapes; and

(iv) the costs of the material being recorded.

Production costs do not include contingent amounts, such as residuals payable under contracts with labor organizations or participations or royalties payable to songwriters, artists, *etc.*, unless such contingent amounts are "incurred" in the taxable year the recording is placed in service or in the ensuing taxable year.

Production costs, including contingent amounts incurred in the first year the recording is placed in service, are recovered under the rules applicable to three-year recovery property. Contingent amounts incurred in the subsequent taxable year are treated as a separate item of three-year property, the recovery periods of which begins in that second year.[54] Although foreign production costs are not counted for investment credit purposes,[55] foreign production costs are included within the cost recovery base.[56]

Contingent amounts incurred after the first two years are not treated as three-year property for cost recovery purposes, but they may continue to be deducted when paid or accrued to the extent deductible when paid or accrued under pre-TRA law.[57]

Under §48(r)(3)(A), the investment credit is not to be denied a sound recording because of overseas distribution; §48(a)(2) is specifically made inapplicable.

Observation: The Senate Finance Committee Report [58] provides that sound recordings are not to be treated as used overseas for purposes of the 12-year recovery period prescribed by §168(f)(2) by reason of distribution of the recordings outside the U.S. Section 168(f)(2), however, was not specifically amended to provide this result, and this subsection is not mentioned in §48(r)(3) as being rendered inapplicable. The regulatory authority provided in §168(f)(2)(D) for the issuance of rules similar to the rules under §48(a)(2), including the exceptions under §48(a)(2)(D), for determining whether property is used predominantly outside the U.S. may, however, provide a means for effectuating Congress's intent.[59]

Lastly, it should be noted that §168(j)(4)(B)(ii) specifically provides that sound recordings used by foreign persons are not to be treated as used by tax-exempt entities. No comparable exception is provided, however, for use by the U.S. or a state government or by a tax-exempt organization.

C. *Effective Dates*

1. *Films and Tapes*

The TRA provisions excluding films and tapes as recovery property apply to films and tapes placed in service before, on, or after July 18, 1984, (the TRA's enactment date).[60] Any qualified film placed in service by the taxpayer before March 15, 1984, however, will be treated as recovery property if the taxpayer treated such film as recovery property for purposes of §168 on a tax return filed before March 16, 1984. Also, a qualified film placed in service by a taxpayer before January 1, 1985, will be treated as recovery property if 20 percent or more of the production costs of such film were incurred before March 16, 1984, and the taxpayer treats such film as recovery property for purposes of §168. Note, however, in the latter case the investment credit can be claimed only to the extent provided in §48(k).[61]

For purposes of the exceptions, a qualified film is defined in §48(k)(1)(D) as any motion picture film or video tape created primarily for use as public entertainment or educational purposes. It does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.

The amendment to §168(e) providing that the exceptions listed in §168(e) to the definition of recovery property apply for all Code purposes applies as if included in the Economic Recovery Tax Act of 1981, so that it is effective for property placed in service after 1980.[62]

2. *Sound Recordings*

The TRA amendments for sound recordings apply to sound recordings placed in service after March 15, 1984, in taxable years ending after that date.[63]

III. Election of Depreciable Business Assets — Scheduled Increases Postponed

A. *Introduction*

Under §179 [64] a taxpayer that purchases certain qualifying depreciable property may elect to treat the cost of such property as a current expense not chargeable to capital account. Any cost so treated is allowed as a deduction for the taxable year in which the property is placed in service. No ACRS deductions or investment tax credits are available with respect to property subject to the election.

In general, property qualifying for the §179 election ("§179 property") is any recovery property which is §38 property acquired by purchase for use in a trade or business.[65] Thus, the election is generally not available for real property or property acquired for investment.

A limit is placed on the cost of qualifying property that may be expensed each year. Prior to the TRA, the aggregate cost which could be taken into account under the general §179 election could not exceed $5,000 per year for taxable years beginning in 1983. This limit was scheduled to increases to $7,500 for taxable years beginning in 1984 and 1985, and to $10,000 for taxable years beginning after 1985. The limit applicable to a married individual filing separately would be one-half the dollar amounts described above.[66]

B. *Overview*

1. *Summary of Amendment*

The Tax Reform Act of 1984 postpones for four years the scheduled increases in the maximum amount of property that may be expensed under §179. Thus, the $5,000 limit remains applicable to taxable years beginning before 1988, increases to $7,500 for taxable years beginning in 1988 and 1989, and increases to $10,000 for taxable years beginning after 1989.

2. *Effective Dates*

The provision is effective with respect to taxable years ending after December 31, 1983.[67]

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C. *Detailed Analysis*

Section 179(b)(1) relating to the dollar limit on the cost of qualifying property that may be expensed under §179 each year, is amended to retain the pre-TRA 1983 $5,000 ceiling for taxable years beginning before 1988. The limit becomes $7,500 for taxable years beginning in 1988 and 1989, and increases to $10,000 for taxable years beginning in 1990 and thereafter.[68] The maximum annual amount that a married individual filing a separate return may deduct remains 50 percent of the annual dollar limit that otherwise applies.

Note: As under pre-TRA law, component members of a controlled group of corporations are treated as one taxpayer for purposes of the annual dollar limit.[69] Additionally, in the case of partnerships, the dollar limit applies separately with respect to a partnership and with respect to each partner thereof. This provision also remains unchanged from pre-TRA law.[70]

Observation: Perhaps the primary negative consideration under pre-TRA law in deciding whether to elect §179 expensing was the fact that amounts so expensed were ineligible for the investment tax credit [71] With the additional postponement for four years of the scheduled increases in the maximum amount of property that may be expensed, the election to expense should generally be made only if the tax benefit to be derived from the immediate write-off exceeds the amount of the investment credit that would otherwise be allowed, plus the present value of the tax benefits that would be derived if accelerated cost recovery under §168 were used.[72]

IV. Changes Relating to Cost Recovery of Leased Property

Section 31 of the Act enacted a comprehensive set of rules limiting the ACRS deductions that may be claimed with respect to property leased to "tax exempt entities." The leasing rules vary in a number of critical respects depending upon whether the leased property is real property or personal property. For a detailed discussion of these rules, *see* Chapter 18.

V. ACRS and Depreciation Deductions for Luxury Automobiles, Computers and Other Listed Property Restricted

Section 280F, as added by the 1984 TRA, limits the ACRS and depreciation deductions which may be claimed with respect to a passenger automobile in any one year to $4,000 in the first year of service and $6,000 in any year thereafter until the cost of the automobile is recovered. This limitation precedes any reduction for personal use of the automobile. In addition, certain "listed property" (including passenger automobiles) may not use ACRS if the percentage of use in a trade or business fails to exceed 50 percent in any one year. Where ACRS is not available, the taxpayer must use the straightline method over the earnings and profits life. If the business use percentage initially exceeds 50 percent and thereafter declines to 50 percent or less, the excess of ACRS deductions over the amount which would have been deductible under the straight-line method over earnings and profits life is recaptured in the year of the decline.

The TRAS ACRS and depreciation provisions are discussed in detail in Chapter 40.

VI. Straight-Line ACRS for Property Financed with Tax-Exempt Bonds

A. *Introduction*

Under §168(f)(12), which was added by TEFRA,[73] ACRS deductions are generally limited to those available under the straight-line method to the extent property is financed with the proceeds of tax-exempt industrial development bonds (IDBs). The straight-line deductions are computed on IDB-financed recovery property over the property's regular recovery period unless a longer period has been elected under §168(b)(3).[74]

Section 168(f)(12)(A) requires the use of the straight-line method and regular recovery periods to compute depreciation allowances not only for IDB-financed recovery property but also as to any other IDB-financed property not eligible for ACRS.

The §168(f)(12) restrictions do not apply to any recovery property in the following categories:[75]

(i) Recovery property placed in service in connection with certain low-income multi-family rental projects, provided the projects qualify for IDB-financing under §103(b)(4)(A) or are exempt from restrictions on the use of IDBs for multi-family housing under the Mortgage Subsidy Bond Tax Act of 1980.[76]

(ii) Recovery property placed in service in connection with a facility providing sewage or solid waste disposal services for residents in part or all of one or more governmental units, and with respect to which substantially all of the sewage or solid waste processed is collected from the general public;

(iii) Recovery property placed in service as an air or water pollution facility installed in connection with an existing facility or in connection with a conversion of an existing facility which used oil or natural gas (or any product derived therefrom) as a primary fuel to a facility that uses coal as a primary fuel; or

(iv) Recovery property placed in service in connection with a facility with respect to which an urban development action grant equaling or exceeding 5 percent of the total capital expenditures on the facility is made.

B. *Analysis*

The TRA [77] amends §168(f)(12)(C) to eliminate all of the foregoing exceptions to the application of the straight-line rules for the IDB-financed property, with one exception. The retained exception is for property placed in service in connection with multi-family rental projects financed with the proceeds of obligations described in §103(b)(4)(A).[78] The straight-line requirements also will not apply with respect to multi-family housing projects exempt from the restrictions on the use of the IDBs under the Mortgage Subsidy Bond Tax Act of 1980.[79]

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Note: As described in I, above, the TRA lengthened the recovery period for real property from 15 to 18 years and imposed a mid-month convention for purposes of computing the recovery deduction in the year such property is placed in service or disposed of. In what was presumably a technical oversight, the TRA failed to amend §168(f)(12)(B) to conform the computation of straight-line recovery deductions on IDB-financed recovery property to these rules.

C. *Effective Dates*

The changes made by the TRA apply to property placed in service after December 31, 1983, to the extent financed by tax-exempt bonds (including a refunding obligation) issued after October 18, 1983.[80] To the extent the property is not financed with tax-exempt bonds or is financed with such bonds issued before October 18, 1983, the straight-line rules do not apply even though the property is placed in service after 1983.[81] If property is placed in service after 1983 and is financed by the proceeds of an obligation that is issued solely to refund another obligation issued before October 19, 1983, however, the straight-line method applies, but only with respect to an amount equal to the basis of such property that has not been recovered before the date the refunding obligation is issued.[82]

The TRA changes do not apply with respect to facilities the construction, reconstruction, or rehabilitation of which began before October 19, 1983, provided the original use commences with the taxpayer, or with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.[83] Also, the straight-line method will not apply with respect to facilities financed with the proceeds of a refunding obligation issued to refund an obligation issued before October 19, 1983, if significant expenditures were made before January 1, 1984, and the original use of the facilities commences with the taxpayer.[84]

The House Ways and Means Committee Report[85] states that no retroactive adjustments to cost recovery deductions previously claimed are required on refunding the pre-October 19, 1983 issue where no significant expenditures are made with respect to the facility after December 31, 1983.

VII. Reinstatement of Expensing Costs of Eliminating Architectural and Transportation Barriers to Handicapped

A. *Introduction*

Under §190, a taxpayer could elect to expense up to $25,000 of qualified architectural and transportation barrier removal costs that were paid or incurred in a taxable year. Architectural and transportation barrier removal costs are defined as expenditures for the purpose of making any facility or public transportation vehicle owned or leased by the taxpayer for use in connection with the taxpayer's trade or business more accessible and usable by handicapped and elderly individuals. These costs could be expensed under §190, however, only if it was established to the satisfaction of the Treasury that the barrier removal met the standards set by the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board.

Section 190 terminated effective with respect to taxable years beginning on or after January 1, 1983.[86]

B. *Analysis*

The TRA[87] reinstates §190 and increases the amount that may be expensed from $25,000 to $35,000. Under post-TRA §190(d), §190 applies to taxable years beginning after December 31, 1976, and before January 2, 1983, and to taxable years beginning after December 31, 1983, and before January 1, 1986. Thus, the §190 expensing deduction is extended to taxpayers having a calendar year beginning January 1, 1983, as well as to all other taxpayers for taxable years beginning after December 31, 1983.

Comment: Both the Senate and the Conference Reports[88] state that the maximum deduction allowed to a taxpayer (including an affiliated group of corporations filing a consolidated return) is $35,000. Nothing in §190, however, specifically limits a consolidated return group to a single $35,000 expensing deduction. Under Regs. §1.190-1(b), a consolidated return group was limited to a maximum of $25,000 as was a partnership and each partner. This regulation, however, was promulgated pursuant to the express authority in former §190(d) to issue such regulations as may be necessary to carry out the provisions of §190. The TRA[89] deleted former §190(a), thus arguably eliminating the Treasury's authority to issue legislative regulations that would preclude a consolidated return group from claiming more than one $35,000 amount.

C. *Effective Dates*

The TRA amendments apply to taxable years beginning after December 31, 1983.[90]

VIII. Extension of Rapid Amortization for Rehabilitating Low-Income Housing

A. *Introduction*

Section 167(k) provided an election with respect to rehabilitation expenditures incurred before January 1, 1984, on low-income rental housing to permit amortization of such expenditures on a straight-line basis over 60 months. The aggregate amount of rehabilitation expenditures eligible for this rapid amortization could not exceed $20,000 with respect to any dwelling unit unless certain requirements were met, in which case up to $40,000 of expenditures per dwelling unit were eligible for rapid amortization.

For purposes of §167(k), "low-income rental housing" is defined as any building the dwelling units in which are held for rental to families and individuals of low and moderate income, as determined by the Treasury in a manner consistent with the §8 housing program of the United States Housing Act of 1937.

B. *Analysis*

The TRA[91] extends the rapid amortization of §167(k) for three years.

C. *Effective Dates*

The extension is effective with respect to rehabilitation expenditures incurred after December 31, 1983, and before January 1, 1987. Moreover, under what the Senate Finance

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Report terms the "affirmative commitment rule" of §167(k)(3)(D), the extension also applies: (i) to rehabilitation expenditures incurred after 1986 that are incurred pursuant to a binding contract entered into before 1987, if the contract is binding at all times on or after that date; and (ii) to rehabilitation expenditures incurred with respect to low-income rental housing, the rehabilitation of which begins before 1987.[92]

A binding contract will not be considered to exist before 1987 unless the property to be acquired or the services to be rendered are specifically identified or described before such date. Such a contract exists only with respect to property or services the taxpayer is obligated to pay for under the contract. If the taxpayer has an option to purchase additional items under the contract, the contract is binding only to the extent of those items or services that must be purchased. A contract may be binding even though the contract price is to be determined at a later date, the contract contains conditions the occurrence of which are under the control of a third party, or the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract. A contract with an option to acquire property is not considered binding under the affirmative commitment rule unless the amount paid for the option is forfeitable and is more than a nominal amount. Moreover, a rehabilitation is considered to have begun before 1987 only if actual physical work on the rehabilitation was begun such date. Physical work begun after 1987 must be significant when viewed in light of the entire rehabilitation project.[93]

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[1] P.L. 97-34, §201.

[2] §168(c)(2)(D) describes 15-year real property as §1250 class property not having a present class life of 12.5 years or less. This generally includes buildings, structureal components (incuding elevators, and escalators), and improvements to land that are not an integral part of manufacturing, production, farming, or the providing of transportation or utility services.

[3] §168(b)(2). All section references herein are to the Internal Revenue Code of 1954 as amended and the regulations promulgated thereunder, unless otherwise specified.

[4] *See* Prop. Regs. §1.168-2(b)(2) for the 15-year tables containing the accelerated rates. In leiu of using the accelerated rates, taxpayers may elect the straight-line method over 15, 35, or 45 years. §168(b)(3). *See* Prop. Regs. §1.168-2(c)(4) for the straight-line tables.

[5] *See* Prop. Regs. §1.168-2(c)(4)(iii).

[6] *See* Prop. Regs. §1.168-2(a)(3).

[7] Act §111(a), amending §168(b)(2).

[8] §168(b)(4).

[9] Act§111(d).

[10] S.Rep.No.98-169,98thCong.,2d Sess.460-461(1984).

[11] *Id.*

[12] *Id.*

[13] Act§111(c).

[14] *See also* S.Rep.No.98-169,supra.

[15] 42 U.S.C.§1437f.

[16] Act §111(e)(5),(6),and(7).

[17] Act §111(g)(1).

[18] Act §111(g)(5).

[19] Act §111(g)(2).

[20] H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1006 (1984).

[21] *Id.*at1007.

[22] *Id.*

[23] S.Rep. No. 98-169, *supra*, at 463. Clearing or grading, or the digging of drainage ditches, however, is not construction if undertaken primarily for the maintenance or preservation of raw land and existing structures.

[24] *Id.*

[25] *Id.* The Conference Report, H.R. Rep. No. 98-861, *supra*, states an intent that demolition is to be treated as the commencement of construction if both demolition and the formally approved plan of construction are consistent with recommendations of a feasibility study evidenced by a taxpayer's internal documents in existence when demolition commenced.

[26] S. Rep. No. 98-169, *supra*, at 463-64.

[27] *Id.*

[28] Act §111(g)(4).

[29] Rev. Rul. 64-273, 1964-2 C.B. 62.

[30] Rev. Rul. 60-358, 1960-2 C.B. 68,

[31] Rev. Rul. 79-285, 1979-2 C.B. 135.

[32] *See* Regs. §1.48-1(f), and PLR 7802004.

[33] *Walt Disney Productions v. U.S.*, 549 F. 2d 576 (9th Cir. 1977) (negatives of feature motion picture films); *EMI North America, Inc. v. U.S.*, 675 F. 2d 1068 (9th Cir. 1982) (master sound recordings).

[34] *See* §168(c)(2)(A) and (B). The three-year category would not apply since no "present class life" had ever been established for such property; *see* Rev. Proc. 83-35, 1983-1 C.B. 745.

[35] §168(e)(2).

[36] Act §113(b)(1).

[37] Act §113(b)(2)(A), deleting the word "section" and substituting the word "title" in §468(e) the matter preceding paragraph (i) in §168(e).

[38] *See* §46(c)(7).

[39] §167(c).

[40] PLR 7802004.

[41] See *Walt Disney Productions v. U.S., supra.*, footnote 33.

[42] S. Rep. No. 98-169, *supra*, at 468.

[43] H.R. Rep. No. 98-861, 1009-1010.

[44] Act §113(a).

[45] §48(r)(7).

[46] *Id.*

[47] H.R. Rep. No. 98-861, *supra*, at 1010.

[48] *Id.*

[49] *Id.*, at 1011.

[50] S. Rep. No. 98-169, *supra*, at 471.

[51] §48(r)(1) reads, "For purposes of this title, in the case of any sound recording, the original use of which commences with the taxpayer,. . . ." Conceivably, the original use requirement in §48(r)(1) can be viewed as a condition that must be met for §48(r), including §48(r)(2), to apply to "any sound recording."

[52] Regs. §1.46-3(f)(1).

[53] Act §113(a)(2).

[54] §48(r)(6)(C).

[55] §48(r)(3)(B).

[56] See H.R. Rep. No. 98-861, *supra*, at 1010.

[57] S. Rep. No. 98-169, *supra.*

[58] S. Rep. No. 98-169, *supra*, at 471.

[59] The Senate Finance Committee Report, *supra*, further states that no inference is intended as to pre-TRA law by the addition of the provisions relating to the foreign use of sound recordings.

[60] Act §113(c)(2)(A).

[61] *Id.*

[62] Act §113(c)(2)(B).

[63] Act §113(c)(1).

[64] §179(a).

[65] §179(d)(1).

[66] 179(b).

[67] Act §18(a).

[68] Act §13.

[69] §179(d)(6). A controlled group for this purpose includes parent and subsidiary corporations with 50 percent common ownership. §179(d)(7).

[70] §179(d)(8).

[71] 179(d)(9).

[72] For detailed analysis of the requirements of §179, *see* 62 T.M., *Depreciation—Basis, Useful Life, Salvage*; *see also* 129 T.M., *Depreciation Recapture—Section 1245—General.*

[73] TEFRA, §216.

[74] §168(f)(12)(E).

[75] §168(f)(12)(C).

[76] *See* TEFRA, §216(b)(3).

[77] Act §628(b).

[78] *See* §168(f)(12)(C).

[79] Act §631(d)(3) provides that the TRA amendments relating to IDBs do not apply to property described in TEFRA §216(b)(3).

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[80] Act §631(b)(1).
[81] H.R. Rep. No. 98-432, Part II, 98th Cong., 2d Sess. 1697 (1984).
[82] Act §631(b)(2)(B).
[83] Act §631(b)(2)(A).
[84] Act §631(b)(B)(ii).
[85] H.R. Rep. No. 98-432, *supra*.
[86] P. L. 96-167, §9(c), extended the effective date through December 31, 1982.
[87] Act §1062(a).
[88] S. Rep. No. 98-169, *supra*, at 895; H.R. Rep. No. 98-861, *supra*, at 1274-5.
[89] Act §1062(a).
[90] Act §1062(c).
[91] Act §1064.
[92] S. Rep. No. 98-169, *supra*, at 892.
[93] *Id.*

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CHAPTER 7

MODIFICATIONS TO THE CHARITABLE CONTRIBUTION DEDUCTION RULES

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I. Changes Affecting Percentage Limitations and Carryovers [Act §301]

A. Introduction

The principal federal tax incentive for charitable contributions has long been the charitable contribution deduction of §170. That deduction is subject to restrictions, which limit the total amount of contributions an individual can deduct in a single year.

Since the Tax Reform Act of 1969, there have been three separate limitations. The general limitation, applicable to contributions of cash by an individual to public charities, permits deductions up to 50 percent of the donor's contribution base (*i.e.*, adjusted gross income, computed without regard to net operating loss carryback.[1] Contributions of ordinary income property (*i.e.*, property which, if sold, would give rise to ordinary income) are treated in the same fashion as cash contributions for purposes of this rule. In addition to public charities, private operating foundations (as defined in §4942(j)(3)) are also subject to the 50 percent limit. Moreover, the 50 percent limit applies to contributions of cash or ordinary income property made to a private nonoperating foundation, but only if the donee foundation either redistributes all contributions within a specified period after receipt[2] or qualifies as a "pooled fund" foundation.[3]

Contributions of capital gain property to organizations otherwise qualifying for the 50 percent limit are generally deductible to the extent of 30 percent of an individual donor's contribution base.[4] In the case of contributions to private nonoperating foundations other than the two categories described above which qualify for the 50 percent and 30 percent limitation, the limitation is 20 percent of adjusted gross income.[5] The 20 percent limit also applies to contributions made "for the use of" charity rather than "to" charity.

If an individual taxpayer makes contributions which exceed the 50 percent or 30 percent limitations, the excess may be carried forward and deducted over the following five taxable years, subject to the same percentage limitations in those years.[6] Prior to the 1984 Act, no carryover of excess deduction amounts was available for amounts rendered nondeductible by the 20 percent limitation.

For corporations, the limitation for all charitable contributions is 10 percent of taxable income, and a comparable five-year carryover is available.[7]

Private nonoperating foundations as to which the 20 percent limit applies are subject to an additional limitation. Contributions of appreciated capital gain property to such entities are not deductible at the full fair market value of the contributed property, as is permitted for contributions of such property to other organizations. Instead, the amount of the deduction for such a contribution is the fair market value of the contributed property reduced by 40 percent of the unrealized appreciation (*i.e.*, by 40 percent of the amount by which the value of the property exceeds the donor's basis).[8] In the case of a contribution of tangible personal property to virtually any donee, a reduction of the deductible amount occurs if the donee's use of the property is not related to the purpose or function constituting the basis for its exemption under §501(c)(3).[9] Moreover, the deduction in the case of any charitable contribution of property, regardless of the nature of the donee, is reduced by any amount which would not be taxed as long-term capital gain if the property were sold by the donor for its fair market value on the date of the contribution.[10]

B. Overview

1. Carryover of Excess Contributions

The Act extends the five-year carryover for contributions by individuals in excess of the applicable percentage limitations to apply to contributions to private nonoperating foundations and contributions "for the use of" charity.

2. Percentage Limitations

The Act increases from 20 to 30 percent the limit applicable to charitable contributions by individuals to private nonoperating foundations (as well as contributions "for the use of" charity). The expanded limit is available only for contributions of cash and ordinary income property. The pre-TRA 20 percent limit continues to apply for all gifts of capital gain property to the donees now qualifying for the TRA's 30 percent limitation.

Some of the most important changes Congress considered in this area were ultimately rejected. The Senate version of the 1984 Act would have increased the overall limit for contributions of cash and ordinary income property to public charities and comparable organizations as described above from 50 to 60 percent of adjusted gross income.[11] In addition, the Senate bill would have abolished the distinction between public charities and private foundations for purposes of the charitable contribution deduction, raised the 50 percent limit to 60 percent, and extended the carryover period for excess contributions from five to fifteen years.[12] These proposed liberalizations would have been offset by strict rules disallowing charitable contributions of appreciated property for which an excessive valuation was claimed. The Conference Committee considered deleting the proposed disallowance rule and substituting a three-year holding period requirement in its stead. Under

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such a rule, a donor's deduction for a charitable contribution of appreciated property would have been limited to the donor's basis in the property unless the property had been held for three full years. Eventually, the entire package (including the increased percentage limitation and carryovers) was deleted from the bill by the Conference Committee, largely in response to college and university opposition to the proposed three-year holding period.

3. Certain Contributions of Publicly-Held Stock

The Act permits deductions at full fair market value for contributions to private nonoperating foundations of certain qualified appreciated stock. The general rule whereby gifts of capital gain property to nonoperating foundations are subject to reduction (§170(e)(1)(B)(ii)) will not apply to these contributions. Stock which qualifies for this purpose means any stock of a corporation (1) for which market quotations are readily available on an established securities market on the date of the contribution, and (2) which is capital gain property for purposes of the charitable contribution deduction rules (§170(b)(1)(C)(iv)). The increased deduction is available only to the extent that the cumulative total of donations by a donor to all private nonoperating foundations of stock in a particular corporation amounts to less than 10 percent of the value of all outstanding stock of that corporation. Attribution rules apply for this purpose, treating a donor as making all contributions made by any member of his family as defined in §267(c)(4).

4. Effective Dates

The TRA's provisions concerning carryover of excess contributions and the increase in the percentage limitations apply to contributions made in taxable years ending after the date of enactment of the 1984 Act (*i.e.*, July 18, 1984). The rule providing full fair market value deductions for contributions of certain publicly-held stock applies to such contributions made after the date of enactment of the 1984 Act (July 18, 1984) and before January 1, 1995.

C. *Detailed Analysis*

1. Carryover of Excess Contributions

Section 301(a)(2) of the Act amends Code §170(b)(1)(B) to provide for the first time a five-year carryover of contributions to private nonoperating foundations in excess of the applicable percentage limitation (expanded as described below). This is accomplished by adding the following sentence to §170(b)(1)(B):

> "If the aggregate of such contributions exceeds the limitation of the preceding sentence, such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution (to which subparagraph (A) does not apply) in each of the five succeeding taxable years in order of time."

The "limitation of the preceding sentence" referred to is the newly-increased 30 percent limitation for contributions other than those to public charities. This carryover applies to contributions to private nonoperating foundations and all transfers "for the use of" charity. The latter category refers primarily to charitable lead trusts.

Contributions of capital gain property to private foundations and charitable lead trusts similarly qualify for a five-year carryover under the Act. This follows from post-TRA §170(b)(1)(D)(ii).

2. Percentage Limitations

Section 301(a)(1) of the Act amends Code §170(b)(1)(B)(i) to increase the limitation for contributions by individuals to private nonoperating foundations from 20 percent of adjusted gross income to 30 percent. The expanded limitation applies to contributions of cash and ordinary income property. The prior 20 percent limitation is continued for contributions of appreciated property to private foundations.

Both the post-TRA 30 percent limit for cash contributions and the post-TRA carryovers described above extend to contributions to charitable lead trusts and other transfers "for the use of" charity, as well as contributions to private nonoperating foundations. These changes will enhance the usefulness of the charitable lead trust, for they eliminate some of the major disincentives to creation of such trusts.

The TRA's 30 percent limit for cash contributions to private foundations is, strictly speaking, not a flat 30 percent. In fact, it can be considerably less. Under §170(b)(1)(B), such contributions are allowable only to the extent they do not exceed the *lesser of* (1) 30 percent of the taxpayer's contribution base,[13] or (2) the excess of 50 percent of contribution base over the amount of contributions allowable under §170(b)(1)(A) *determined without regard to §170(b)(1)(C)* (*i.e.*, determined without to the special 30 percent limit for contributions of capital gain property).

> *Example*: Assume a donor has a contribution base of $100,000 for the taxable year, and that his charitable contributions for the year consist of $50,000 of capital gain property given to a qualified university and $30,000 in cash given to a private foundation. The deduction for the contribution to the university is limited to $30,000 by virtue of §170(b)(1)(C), and the remaining $20,000 carries over to the following five taxable years. The $30,000 contribution to the private foundation is not deductible in the current year, but rather carries over to the following five taxable years under the TRA's carryover rule. The reason for disallowing the private foundation contribution is that, under §170(b)(1)(B), the deduction for that contribution is limited to the lower of (1) 30 percent of contribution base (*i.e.*, $30,000) or (2) the excess of 50 percent of contribution base (*i.e.*, $50,000) over the total contributions allowable under §170(b)(1)(A) determined without regard to the 30 percent capital gain limit of §170(b)(1)(C) (*i.e.*, $50,000). Thus, the limitation is the lower of (1) $30,000 or (2) $50,000 less $50,000 or zero. The zero amount is less, so foundation contributions in excess of zero are not deductible in the current year.

Note that, under post-TRA §170(b)(1)(D)(i), a similar effect is realized with respect to contributions of capital gain property to private nonoperating foundations and charitable lead trusts. Thus, contributions of capital gain property to public charities will, to the extent they exceed the 30 percent limitation of §170(b)(1)(C), effect a dollar-for-dollar reduction in the amount deductible for contribu-

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tions to private nonoperating foundations and contributions to charitable lead trusts.

The effect described above was realized under the law prior to the 1984 Act. Thus, in this respect, the 1984 Act changes are consistent with the rules of prior law. However, the percentage limitation structure created under the 1984 Act creates one anomaly not experienced under prior law. Under §170(b)(1)(C), both before and after its amendment by the 1984 Act, a 30 percent limit applies to contributions of capital gain property "to which subsection (e)(1)(B) does not apply." Section 170(e)(1)(B), referred to in this connection, is the provision which requires a reduction in the amount of a charitable deduction of capital gain property by 40 percent of the appreciation inherent in the property if (1) if the contribution consists of tangible personal property use of which by the donee is unrelated to the donee's basis for exemption, or (2) the donee is a private nonoperating foundation.[14] If the amount of donor's charitable contribution deduction is reduced pursuant to §170(e)(1)(B), the 30 percent limitation of §170(b)(1)(C) no longer applies, so that the general 50 percent limitation is applicable. The TRA rules with respect to private foundations do not extend this principle to the special 20 percent limit imposed by §170(b)(1)(D) upon contributions of capital gain property to donees other than public charities.

Example: Assume an individual donor with a contribution base of $100,000 contributes to a private foundation $10,000 in cash and closely-held stock with a basis of $10,000 and a fair market value of $20,000. Under §170(e)(1)(B)(ii), the amount of the donor's contribution is reduced by 40 percent of the appreciation of the property (*i.e.*, by $4,000) to $16,000. Despite this reduction, however, the 20 percent limitation of §170(b)(1)(D) continues to apply. The amount deductible by the donor would consist of the $10,000 cash contribution to the private foundation and $10,000 [15] of the $16,000 property contribution, with the remaining $6,000 carrying over to future taxable years. If, however, the donor had sold the property for $20,000, and contributed the $20,000 cash proceeds to his private foundation in addition to the $10,000 contribution already described, the entire $30,000 would have been deductible. Because the donor would have incurred a capital gains tax on the $10,000 gain realized, his net economic position would be the same but, by effecting the sale rather than contributing the property, he would have rendered his contribution subject to the 30 percent limit rather than the 20 percent limit. While the planning potential of this statutory gap is limited, it is something of which practitioners should be aware.

3. Certain Contributions of Publicly-Held Stock

Under §170(e)(1)(B)(ii), a contribution of appreciated property to or for the use of a private foundation is generally subject to reduction. Instead of being deductible at full fair market value, the deduction must be reduced or "scaled down" by 40 percent (28/46 in the case of a corporation) of the amount of capital gain that would have resulted if the property had been sold instead of contributed. This rule is continued under the 1984 Act. However, §301(b) of the Act enacts Code §170(e)(5), which makes the scale-down inapplicable to contributions of publicly-held stock for which market quotations are readily available. The deduction in these circumstances will be allowed at full fair market value for contributions of up to 10 percent of the stock of a given corporation by a single donor and the members of his family. Family members, for this purpose, refers to brothers and sisters, spouse, ancestors and lineal descendants.

Code §170(e)(5) provides an important incentive to the use of private foundations in tax and estate planning, even though it is limited to contributions made between July 18, 1984 and January 1, 1995. In enacting this rule, Congress departed somewhat from the policy of §4943, which limits the amount of stock a private foundation and its disqualified persons can hold (in the aggregate) in any business enterprise. In many cases, §4943 may limit the ability of a donee foundation to hold as much as 10 percent of the stock of even a publicly-held corporation. Thus, even though §170(e)(5) permits a full fair market value deduction, §§4943(c)(2) and 4943(c)(6) may continue to require the donee foundation to dispose of the stock within five years of its receipt, as under prior law.

II. New Substantiation Requirements for Charitable Contributions

A. Introduction

Historically, charitable contributions of property are generally deductible at their full fair market value, provided the donor has held them long enough to qualify for long-term capital gain treatment.[16] If a donor contributes listed securities, the value of the contributed property, and hence the amount of the deduction, can be readily determined by reference to published market quotations. For other items of property, however, value cannot be as readily determined and subjective considerations must be taken into account. There is sufficient room for reasonable individuals, and even knowledgeable appraisers, to disagree as to the precise value of such property as real estate, closely-held stocks, and works of art. Nevertheless, such items are frequently the subject of charitable contributions.

As a result, some donors have been tempted to claim deductions higher than the actual value of such contributed property. This has produced a growing enforcement problem for the Service. The situation is further complicated by the existence of tax shelter programs based upon aggressively-valued charitable contributions. One such plan was described in *Anselmo v. Comr.*,[17] which involved bulk purchases of low-quality gemstones from financial planners and subsequent contribution thereof to the Smithsonian Institution. As a result of these situations, and the attending publicity, the problem of overvalued charitable contributions was a major concern of Congress as it set to work on the Tax Reform Act of 1984.

The 1984 Act attacks overvalued property contributions on several fronts. To discourage overvaluation, the previously existing penalty in §6659 was strengthened and expanded. Contributions of property worth more than $5,000 ($10,000 in the case of closely-held stock) are, after the TRA, subject to detailed new appraisal requirements, and the charity which receives a property contribution and sells or otherwise disposes of it within two years must report the disposition to the Service and send a copy of that report

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to the donor. The net effect of these rules is to make it more difficult for a donor to justify an overly optimistic valuation for property, and to increase the cost to the donor of claiming a value which turns out to exceed the "correct" value.

B. Overview

1. Overvaluation Penalty

The Act expands and strengthens the existing penalty of §6659 for overvaluation of property producing an overstated charitable deduction. If the value claimed by the donor is more than 150 percent of the true value as ultimately determined, a flat penalty of 30 percent of the tax understatement will apply.

In addition, the application of the penalty is broadened. Under prior law, the §6659 overvaluation penalty did not apply to transfers of property held for more than five years. The 1984 Act repealed this exception. Moreover, the Service is authorized to waive the revised penalty only where the claimed value was based upon an appraisal and the donor made "a good faith investigation of value."

2. Independent Appraisals Required

Beginning with contributions made in 1985, donors claiming deductions for contributions of appreciated property to charity must comply with a new set of appraisal requirements. The rules apply to all forms of property other than publicly-traded securities, where the claimed value of the property (plus all similar items of property contributed during the year) exceeds $5,000. In the case of closely-held stock, these rules apply only if the claimed value of the stock is more than $10,000. Tangible property, such as art work and museum pieces, as well as intangible property and interests in real estate, are affected.

If the TRA requirements apply, the donor must obtain a "qualified appraisal" for the property contributed. This must be prepared by a qualified appraiser and must include specified categories of information. A qualified appraiser, for this purpose, means a person qualified to make appraisals of the type of property donated, and who is independent of both the donor and the donee. The appraisal may not be prepared by any party to the transaction in which the donor obtained the property, nor by any other person whose relationship to the donor would cause a reasonable person to question his or her independence.

The donor must attach a summary of the appraisal, signed by the qualified appraiser and acknowledged by the donee, to the return on which the deduction is claimed for the contribution. In addition, the return itself must include such additional information (including the cost basis and acquisition date of the contributed property) as regulations may require.

The TRA appraisal requirements are not included in the Code itself, but rather are to be set forth in regulations. The Treasury is directed to prescribe those regulations not later than December 31, 1984. Under §170(a)(1), the Service has long been authorized to disallow deductions for charitable contributions if those deductions are not properly substantiated. The TRA's appraisal regulations are to be promulgated under this provision and, as a result, donors who fail to comply will subject their deductions to disallowance.

3. Donee Reporting Requirement

A charitable organization which, after 1984, receives a contribution of property worth more than $5,000 will be required to file a notice with the Service if it sells the property or otherwise disposes of it within two years after its receipt. A copy of this report must be furnished to the donor as well. The report itself will resemble IRS Form 1099, and will include the name, address and tax identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.

An organization which fails to file the required report will be subject to a penalty of $10 per incident up to a total penalty of $25,000 per year. In addition, an organization which fails to supply a copy to the donor will be subject to a penalty of $10 per incident, up to a total penalty of $25,000 per year. These penalties may be excused if the donee establishes that its failure was due to reasonable cause and not due to willful neglect.

With this information in hand, the Service will easily be able to check the deduction claimed by the donor pursuant to the appraisal summary described above, and raise appropriate audit challenges if the amount received by the donee is substantially less than the deduction claimed.

4. Effective Dates

The modifications to the overvaluation penalty of §6659 apply to charitable contributions claimed on returns filed after December 31, 1984. Thus, for most individuals, the revised penalty will apply to all 1984 charitable contributions, including those made prior to the date of enactment of the 1984 Act (July 18, 1984). The appraisal requirements and the donee reporting requirement apply to contributions made after December 31, 1984, in taxable years ending after that date.

C. Detailed Analysis

1. Overvaluation Penalty

Prior to the 1984 Act, §6659 applied a penalty on a sliding scale from 10 to 30 percent upon any underpayment of tax attributable to overstatement of the value or adjusted basis of any property claimed on a return, according to the following scale:

If the valuation claimed is the following percent of the correct valuation —	The penalty is:
150% to 200%	10%
Over 200% but less than 250%	20%
Over 250%	30%

Under pre-TRA §6659(c)(2), the penalty did not apply to any property which, as of the close of the taxable year for which there was a valuation overstatement, had been held by the taxpayer for more than five years.

TRA §155(c) changes these provisions in several respects. First, §6659(c) was revised to delete the requirement that property be acquired within the last five years. Thus, a valuation overstatement exists whenever a value or adjusted basis of any property claimed on any return is 150 percent or more of the amount determined to be the correct valuation or basis. This is accomplished by deleting pre-

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TRA §6659(c)(2), and revising pre-TRA §6659(c)(1) to comprise the entire text of §6659(c). Although the legislative history implies that Congress' principal concern in this connection was with overvalued charitable contributions, the deletion of the five-year requirement applies for all purposes of §6659, including basis overstatements and other transactions not involving the charitable contribution deduction.

In addition, TRA §155(c)(2)(A) created a new penalty provision, §6660, imposing a penalty upon undervaluations for estate and gift tax purposes which corresponds to the overvaluation penalty of §6659. This penalty applies whenever the value of property claimed on an estate or gift tax return is 66-2/3 percent or less of the amount determined to be the correct valuation. There is no penalty if the underpayment is less than $1,000, and the Secretary's waiver authority corresponds to the waiver authority for non-charitable contributions. The estate and gift tax penalty is applied on a sliding scale:

If the valuation claimed is the following percent of the correct valuation —	The applicable penalty is:
50% or more, but not more than 66-2/3%	10%
40% or more, but less than 50%	20%
Less than 40%	30%

Like the valuation overstatement penalties described above, the estate and gift tax undervaluation penalty applies to returns filed after 1984.

Section 155(c)(1)(B) of the Act created a new Code §6659(f) prescribing special rules for overstatement of charitable deductions claimed for contributions of property. In the case of an understatement of tax attributable to an overvalued charitable contribution deduction, the penalty applies at a flat 30 percent rate. Thus, the TRA's charitable contribution penalty continues the former 150 percent threshold for application of §6659, but applies the pre-TRA maximum penalty percentage of 30 percent whenever the penalty applies in a charitable contribution context.

The Act also limits the ability of the Secretary to waive the penalty on a showing of good faith and a reasonable basis for the claimed value. In the case of a overstated charitable deduction, the penalty may be waived only if the Secretary determines that: (a) the claimed value of the property was based upon a "qualified appraisal" made by a "qualified appraiser" (both terms having the meaning to be assigned under regulations the IRS is directed to promulgate by December 31, 1984 under §170(a)(1)); and (b) in addition to the appraisal, the taxpayer made a "good faith investigation" of the value of the contributed property.

Comment: The legislative history provides no insight into the intended scope of the good-faith-investigation requirement. Presumably, this is intended to permit application of the penalty to a taxpayer who procures an appraisal showing an inflated value which the taxpayer has reason to know (or should have reason to know) is improper (*e.g.*, where the taxpayer conceals material facts from the appraiser, or fails to notify the appraiser of a misunderstanding of facts concerning the property).

In addition, §158 of the Act amended Code §6601(e)(2) to make the overvaluation penalty of §6659 "time sensitive." Thus, the penalty will bear interest from the due date of the return (including extensions) to the date of eventual payment.

2. Independent Appraisal Requirements

Section 170(a)(1) of the Code has for many years provided that a charitable contribution shall be allowable as a deduction only if it is verified under regulations prescribed by the Secretary. Section 155 of the Act directs the Secretary to prescribe, not later than December 31, 1984, regulations requiring qualified appraisals for verification of most property contributions. In this respect, the Act does not amend the Code, but merely mandates the promulgation of regulations under existing law (§170(a)(1)).

The TRA rules apply to any contribution of property other than publicly-traded securities, where the claimed value of the property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000. In the case of nonpublicly-traded stock, a $10,000 threshhold applies in place of the $5,000 rule that is generally applicable.

The taxpayers who must abide by the TRA's verification requirements are individuals, closely-held corporations (defined in Act §155(a)(6)(A) as any corporation other than an S corporation meeting the stock ownership requirement of §542(a)(2)) and personal service corporations (defined in Act §155(a)(6)(B) as any corporation other than an S corporation which is a service organization within the meaning of Code §414(m)(3)).

Whether a security is publicly-traded or nonpublicly-traded turns upon whether, as of date of the contribution, market quotations are readily available on an established securities market.[18]

Where the substantiation requirements apply, the donor must obtain a qualified appraisal for the contribution, attach an appraisal summary to the return on which the deduction is first claimed for the contribution, and include on the return such additional information (including cost basis and acquisition date of the contributed property) as the regulations may require. The regulations will require the taxpayer to retain any qualified appraisal, presumably to have it available for audit. The term "qualified appraisal" means an appraisal prepared by a qualified appraiser which includes the following items:

(a) A description of the property appraised;

(b) The fair market value of the property on the date of contribution and the specific basis for the valuation;

(c) A statement that such appraisal was prepared for income tax purposes (this requirement is apparently intended to subject the appraiser to liability under §6701 for aiding and abetting the understatement of the donor's tax liability if the valuation is ultimately challenged);

(d) The qualifications of the qualified appraiser;

(e) The signature and tax identification number of the appraiser; and

(f) Such additional information as the Secretary chooses to include in the regulations.

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A critical element of the TRA's appraisal rules is the requirement that a "qualified appraiser" be utilized. The definition given in Act §155(a)(5), however, focuses almost exclusively upon the independence of the appraiser rather than his or her professional qualifications. Under that provision, a qualified appraiser is one qualified to make appraisals of the type of property donated, who is not any of the following:

(a) The taxpayer (*i.e.*, the donor);

(b) A party to the transaction in which the taxpayer acquired the property;

(c) The donee;

(d) Any person employed by any of the foregoing persons or a sibling, spouse, ancestor or lineal descendant of such a person; or

(e) Any person whose relationship to the taxpayer would cause a reasonable person to question the independence of such appraiser.

Implementation of these rules will require careful reexamination of many existing practices. For example, it is not uncommon for a donor to request the assistance of the donee in valuing contributed property. In some instances, such as specialized museum items, the donee may be uniquely suited to estimate the value. Under the qualified appraisal rules, however, it seems likely that any participation by the donee in the valuation process could cause the resultant appraisal to be rejected, and thus create the possible disallowance of the donor's deduction. The apparent justification for this is the inherent conflict of interest created for the donee, for a higher value will make it more likely for the donor to make the contribution. Similarly, a person who originally sells the property to the taxpayer has a stake in finding a high valuation, as this will tend to indicate the reasonableness of the original sale price. Moreover, disqualification of such persons will help discourage tax shelter transactions of the sort involved in *Anselmo v. Comr.*,[19] in which a "investor" purchased a package deal including property to be contributed and an appraisal of its value as of the subsequent contribution date.

A special rule is provided for appraisal fees. An appraisal will not be treated as a qualified appraisal if all or part of the fee paid for it is based upon a percentage of the appraised value of the property. A special exception is provided, however, for fees based on a sliding scale that are paid to a generally recognized association regulating appraisers.

Comment: This exception is apparently tailored to accomodate the practices of the Art Dealers Association of America, a fact that has brought some criticism of the exception as constituting special interest legislation.

A summary of the appraisal, signed by the qualified appraiser and acknowledged by the donee, must be attached to the return on which a deduction is claimed for the contribution.

The Conference Report makes it clear that the 1984 Act may not be the final legislative word in this area. The continuing concern of the Treasury Department over the adequacy of substantiation and penalty provisions to prevent overvaluation of charitable deductions is specifically noted. The Senate version of the bill contained a special disallowance provision for overvalued charitable contributions; in addition to the §6659 penalty described above, a donor would also find part or all of his or her charitable contribution deduction disallowed. Although this rule was not enacted, the Conference Committee acknowledged that some additional legislation might be required to curb abuses in this area. The Conference Report indicates that Treasury and the IRS are expected to monitor the effectiveness of the TRA provisions and to notify the tax-writing committees of Congress if valuation problems continue to be experienced. Existing compliance tools, such as negligence and fraud penalties, are suggested as additional measures to enforce charitable valuations, and the tax authorities are asked to call the attention of Congress to other compliance problems for which legislative solutions may be appropriate. One example cited was the possibility that deductions may be claimed by taxpayers, or their tax return preparers, on the basis of checks made out to qualified charities, where the checks in fact represent payment for merchandise purchased at an auction, bazaar, or otherwise. Thus, additional enforcement appears likely.[20]

3. Donee Reporting Requirement

Section 155(b) of the Act created a new Code §6050L, entitled "Returns Relating to Certain Dispositions of Donated Property." Under this rule, a charitable donee which sells, exchanges, or otherwise transfers donated property within two years of its receipt must furnish an information report to the IRS, with a copy to the donor, describing the circumstances. The report must set forth the donor's name, address, and tax identification number, as well as a description of the property, the date of contribution, the amount received on the disposition, and the date of disposition.

These reporting requirements apply if the amount for which a deduction was claimed by the taxpayer on his or her return for the contribution (other than publicly-traded securities) exceeds $5,000 for any single item of property or, in the aggregate, for similar items of such property. Unlike the appraisal requirements, there is no higher limitation for closely-held securities in this instance. In addition, §6678, which imposes penalties for failure to furnish various statements, is amended to apply to a charity's failure to comply with these information reporting requirements.

A donee's compliance with the information reporting requirement is intended to be facilitated by the donor appraisal requirements. Thus, the $5,000 threshhold for reporting is based upon the amount claimed by the donor on his or her return, and the regulations to be promulgated under §170(a)(1) will require the donor to (1) submit the appraisal summary for the donee's acknowledgment signature, and (2) inform the donee of any donations of similar items made during the same year.

Note: The legislative history makes it clear that the donee's acknowledgment signature on the summary appraisal is intended merely to acknowledge receipt of the items described in the summary appraisal, and not to indicate agreement with, or acceptance of, the amount claimed.[21] The regulations are to provide "appropriate rules" for situations where the donor is unable to obtain the donee's acknowledgment.

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III. Increase in Standard Mileage Rate for Charitable Usage of Automobile

A. Introduction

A taxpayer who performs volunteer services for a charitable organization is entitled to a deduction, as a charitable contribution, for unreimbursed, out-of-pocket expenses incurred in the process.[22] This rule includes the cost of fuel used in operating a passenger automobile in the course of providing charitable volunteer services. The amount of the contribution deduction attributable to the operation of the vehicle may be determined on the basis of actual expenses, or the taxpayer may use a standard rate, which presently stands at 9 cents a mile.[23] If the actual expense approach is used, the taxpayer may deduct the expenses of operating the car, including parking fees and tolls, but not general repair or maintenance expenses, depreciation, insurance and the like; the latter amounts are deductible only for an automobile devoted to business usage. For this reason, the standard mileage charge for volunteer charitable services is lower than the comparable rate utilized to determine deductions for automobile use.

Effective for taxable years beginning after 1984, the Act increases the allowance to 12 cents per mile.

B. Overview

Section 1031 created a new §170(j). That section provides that, for purposes of computing the charitable deduction allowable for use of a passenger automobile, the standard mileage rate shall be 12 cents per mile.

Effective Date. This amendment is applicable to taxable years beginning after December 31, 1984.

IV. Allowance of Charitable Deduction for Certain Reformed Split-Interest Transfers

A. Introduction

The Act provides, by adding a new §2055(e)(3), a permanent rule for correction or reformation of charitable remainder trusts and charitable lead trusts which do not meet the detailed requirements of the Tax Reform Act of 1969. In general, reformation will be allowed where either of two situations exist: (1) the instrument evidences an intent to comply with the 1969 Act rules (*i.e.*, the trust utilizes an annuity trust or unitrust format), or (2) reformation proceedings are begun before the IRS has an opportunity to audit the matter (*i.e.*, within 90 days after the filing of the return on which a deduction for the transfer to the trust is claimed or, if no such return is required, within 90 days after the filing of the first income tax return for the trust itself).

The actuarial values and durations of the charitable and non-charitable interests in an affected trust must remain approximately the same both before and after the reformation. Variations of up to 5 percent will be permitted.

Both *inter vivos* and testamentary trusts may be reformed under the legislation. The rule provides a permanent successor to the various temporary transition rules enacted by Congress on several occasions since the expiration of the original 1972 transition rule in the 1969 Act. Qualified reformation may be achieved by any method permissible under local law, provided all relevant parties are bound by the change. The Treasury is directed to issue regulations permitting reformation of charitable interests involving remainder interests in pooled income funds, personal residences and farms.

A special rule is provided for situations in which all of the non-charitable "income" beneficiaries of a charitable remainder trust die before the filing of the estate tax return on which the charitable deduction for funding the trust is claimed. Under these circumstances, the trust will now be deemed to have been reformed. Thus, a deduction will be allowed for the value of the charitable interest in the trust, computed as if it had been a qualified trust as of the date of the decedent's death.

The reformation provisions of the 1984 Act apply retroactively to reformations made after 1978, as well as those accomplished currently. A special rule reopens the statute of limitations for one year after the date of enactment to permit time for donors and estates to seek refunds or credits with respect to completed transactions.

Persons who have had deductions disallowed for contributions to faulty trusts should thus investigate whether the TRA may create a new opportunity for correction of their trust instruments. For some trusts, the deduction may be saved only if reformation proceedings are commenced by October 16, 1984 (*i.e.*, within 90 days of the date of enactment of the 1984 Act).

B. Detailed Analysis

For a detailed analysis of these provisions *see* Chapter 54, Part I, *infra.*

V. Transitional Rule for Certain Contributions of Qualified Conservation Easements

A. Introduction and Overview

A charitable deduction is available for income, estate, and gift tax purposes for contributions of property to charitable organizations or governmental entities. As a general matter, a contribution of less than the donor's entire interest in the contributed property will not give rise to a charitable deduction unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions are provided for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and gifts of qualified conservation interests.

Qualified conservation interests are real property interests donated in perpetuity for any of the following conservation purposes:

(a) The preservation of land areas for outdoor recreation by, or for the education of, the general public;

(b) The protection of a natural habitat of fish, wildlife, plants, or a similar ecosystem;

(c) The preservation of open space (including farmland and forest land) but only if such preservation (1) is either for the scenic enjoyment of the general public, or pursuant to a clearly delineated federal, state, or

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local governmental conservation policy, and (2) will yield a significant public benefit; or

(d) The preservation of an historically important land area or a certified historic structure.

The foregoing rules are delineated in §170(h).

Deductible conservation interests take any of three forms. First, a deduction is allowable for the value of a remainder interest. Second, the value of an easement or other similar restriction on the use of the property is deductible provided it is granted in perpetuity. Finally, a contribution of the donor's entire interest is deductible, except that the donor may retain his or her interest in subsurface oil, gas or other minerals, and the right of access to such minerals.

In the 1984 Act, Congress was concerned about a requirement which applies where the donor retains a mineral interest under the rule described in the preceding sentence. Where the donor retains such an interest, no deduction is allowable if at any time there may be extraction or removal of minerals by any surface mining method. Congress acknowledged that this restriction created problems in certain instances.[24] Historical patterns of land ownership in some areas of the United States preclude the utilization of the conservation easement because of a donor's inability to provide firm assurances that surface mining will not occur in any event.

The Act creates an exception to the general rule precluding a deduction for conservation contribution where any possibility exists of surface mining on the land with respect to which the contribution relates. Under the exception, deductions for contributions of conservation easements satisfying all the other requirements of a conservation contribution will nevertheless be deductible if two additional conditions are satisfied. First, the surface estates and mineral estates in the property must have been separated prior to June 13, 1976. Second, the probability of surface mining on the property must be so remote as to be negligible.

B. Detailed Analysis

In some areas of the United States, particularly in the western states, land ownership patterns are such that some rights to subsurface minerals have been separated from the ownership of the other rights in the property. In some instances, this separation occurred pursuant to government land grants, and in some instances it is difficult even to determine who owns all of the subsurface rights. Under these circumstances, it sometimes proved impossible for a prospective donor of a conservation contribution to demonstrate definitively that surface mining on the property could never be permitted.

To remedy this situation, §1035 of the Act amends Code §170(h)(5)(B) to provide a special rule applicable where ownership of the surface estate and mineral interest were separated before June 13, 1976, and remain so separated. Under these circumstances, if the probability of surface mining occurring on the property is so remote as to be negligible, the prohibition on surface mining will be treated as being met.

The legislative history indicates that, where ownership of the surface and mineral estates in a property first become separated *after* June 12, 1976, and surface mining is not completely precluded, a contribution of the restriction in the property will not qualify as a conservation contribution.[25] In addition, under the exception, no deduction will be permitted if the owner of the surface interest at any time transferred, directly or indirectly, the mineral interest to the present owner and that present owner is related to the owner of the surface estate.[26] For this purpose, the determination of whether a party is related is to be made in a manner similar to that provided under §267.

The circumstances under which the probability of surface mining occurring is so remote as to be negligible will be the subject of regulations to be promulgated by the Treasury.

Effective Date: The TRA rules governing qualified conservation contributions are applicable to contributions made after the date of enactment of the 1984 Act (*i.e.*, after July 18, 1984).

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[1] *See* §§170(b)(1)(A) and 170(b)(1)(E).
[2] §170(b)(1)(E)(ii) (§170(b)(1)(D)(ii) prior to the Tax Reform Act of 1984). The period expires on the 15th day of the third month after the close of the foundation's taxable year in which contributions are received.
[3] *See* §§170(b)(1)(E)(ii) and (iii). For purposes of this chapter, the term "public charity" refers to any organization quaifying for the 50 percent limitation (*i.e.*, an organization described in §509(a)(1), (2), or (3) or a private foundation described in §170(b)(1)(E)(i), (ii), or (iii).
[4] §170(b)(1)(C).
[5] §170(b)(1)(B) (prior to the Tax Reform Act of 1984).
[6] §170(d).
[7] §§170(b)(2) and 170(d)(2).
[8] §170(e)(1)(B). In the case of a corporate donor, the reduction is 28/46 of the gain inherent in the property.
[9] §170(e)(1)(B)(i).
[10] §170(e)(1)(A).
[11] Senate Bill §302.
[12] *See* Senate Bill §812.
[13] Contribution base is defined in §170(b)(1)(F) as adjusted gross income computed without regard to any net operating loss carrybacks determined under §172.
[14] *See* §170(e)(1)(B)(i) and (ii), respectively.
[15] Under the last section of §170(b)(1)(D)(i), the property contribution is taken into account after all other charitable contributions.
[16] This requires a holding period of six months in the case of property acquired after June 22, 1984 and before January 1, 1988, and 12 months in the case of other property.
[17] 80 T.C. 46 (1983).
[18] *See* Act §§155(a)(6)(C) and (D).
[19] *Supra*, footnote 17.
[20] *See* Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. 998-9 (1984).
[21] Conference Report, *supra*, at 998.
[22] Regs. §1.170A-1(g).
[23] Rev. Proc. 82-61, 1982-2 C.B. 849.
[24] S. Rep. No. 169, 98th Cong., 2d Sess. 727 (1984).
[25] *Id.*
[26] *Id.*

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Chapter 8

MODIFICATIONS IN THE INTEREST DEDUCTION RULES

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I. Interest Deductions Affected by New and Revised Provisions Related to the Time Value of Money [Act §§41-44, 92 and 172]

A. Overview

Sections 41-44, 92 and 172 of the 1984 TRA were enacted to bring about a more accurate reflection in the Code of the time value of money as measured in the marketplace. In general, the Chapter 2 summary covers the Act's provisions relating both to inclusion in income and deductions of interest. As the Code is structured, the detailed provisions relating to the treatment of original issue discount (OID) are included in Subchapter P relating to inclusion of amounts in gross income. OID is treated for most purposes of the Code as interest. The related deductions allowable to the payor of the interest are provided for in §163(e).

Sections 41-44, 92, and 172 of the Act are discussed in greater detail in Chapter 2.

Provisions relating to the time value of money may be grouped as follows:

Act §§41-44 — New Code §§1271-1278 §§1281-1283 §§1286-1288	Provides amended rules relating to original issue discount; amends §483; disallows interest deductions for leveraged purchases of market discount bonds and short-term obligations; provides rules for determining basis for discounted tax-exempt obligations.
Act §92 — New Code §467	Provides rules relating to deferred payment for the use of property and services.
Act §172 — New Code §7872	Provides rules for the treatment of below-market interest loans.

1. Original Issue Discount (§§1271-1275)

Sections 1271-1275 extend the principles underlying the TEFRA amendments relating to original issue discount (OID) reflected in repealed §§1232, 1232A and 1232B. The most significant of these changes is to provide for OID in debt instruments issued for untraded property, rather than solely for traded property as under prior law. Excepted are transactions involving total payments of $250,000 or less (including principal and interest). Central to these new provisions is the "applicable federal rate" (AFR), meaning the average market yield on U.S. government securities. Instruments not providing for interest of at least 110 percent of the AFR are OID instruments. Such OID is to be included in income by the holder and deducted by the issuer over the life of the instrument on a constant interest basis at an imputed rate of 120 percent of the AFR. Application of these provisions generally affect sales or exchanges occurring after December 31, 1984.

2. Amended §483

Where an obligation to make future payments for untraded property does not fall within the new OID provisions, it is subject to §483, as amended by the Act, unless it is specifically excepted. Like the OID provisions, §483 now tests sales contracts by the "applicable federal rate" compounded semiannually. As under former law, allocation of payments to principal or interest for tax purposes depends on whether an adequate rate of interest was charged. Where the rate charged is less than 110 percent of the applicable federal rate, interest at 120 percent of such rate will be imputed and the characterization of payments adjusted accordingly. Unlike the OID rules, §483 does not require that interest on a debt instrument be currently included in the income of the holder and deducted by the issuer symmetrically notwithstanding their respective methods of accounting. The issuer of a debt instrument not falling within the OID rules may deduct interest only when paid or accrued in accordance with the issuer's method of accounting. It is provided, however, in §44 of the Act containing the effective dates for the OID and §483 changes (generally effective as to sales or exchanges of property after December 31, 1984) that §483 notwithstanding, no interest on pre-1985 instruments issued after March 1, 1984 is deductible before the period to which it is allocable. This rule also applies to instruments unaffected by §483 issued after June 8, 1984.

A detailed analysis of the new OID provisions and the amendments made to §483 is set forth in Chapter 21, *infra*.

3. Market Discount Bonds (§§1276-1278)

New §1277 disallows deductions for interest on indebtedness incurred to purchase or carry market discount bonds. The disallowance extends to the "net direct interest expense," meaning such interest in excess of amounts includible in income during the taxable year as interest with respect to the bond (including OID). Such net direct interest expense is disallowed to the extent it does not exceed the accrued market discount on the bond during the year. Disallowed interest is not lost, however, but carried

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over and allowed as a deduction in the year the bond is disposed of. Electing holders may also deduct previously disallowed interest in any year in which there is net interest income on the bond. Sections 1276 and 1277 apply to obligations acquired after July 18, 1984, enactment date. These provisions are discussed in detail in Chapter 21, *infra.*

4. Short-Term Obligations (§§1281-1283)

New §1282, similar to §1277, disallows interest deduction on indebtedness incurred to purchase or carry short-term obligations with respect to which discount (either acquisition or original issue discount) is not currently included in the income of the holder. Interest so disallowed is allowed in the year the bond is disposed of. Taxpayer may elect obligation of §1281 for the first taxable year ending after July 18, 1984, enactment date.

The provisions of §1282 are analyzed in Chapter 21, *infra.*

5. Deferred Payments for the Use of Property or for Services (§467)

Where a rental agreement or agreement to pay for services involves future payments is a "§467 rental agreement," the amounts treated as rental income and rental deductions may be adjusted under new §467 enacted by §92 of the 1984 TRA. A §467 rental agreement is one involving more than $250,000, which calls for uneven payments or at least one payment allocable to the use of property during a calendar year which is not due until after the close of the calendar year of use. Affected are long–term leases (extending over 75 percent or more of the property's recovery period) and sale-leasebacks, the terms of which are determined to be motivated, at least in part, by tax avoidance. The §467 provisions apply to agreements entered into after June 8, 1984.

New §467 is discussed in detail in Chapter 22, *infra.*

6. Below-Market Loans

Under new §7872, added by §172 of the Act, the terms of certain loans of money which are determined to provide a below-market rate of interest (the applicable federal rate), are recharacterized with the result that both the lender and borrower are considered, for tax purposes, to have agreed to a market rate of interest, and their tax liabilities are adjusted accordingly. In the case of a gift or demand loan, the foregone interest is treated as having been transferred from the lender to the borrower and retransferred by the borrower to the lender as interest. In the case of a term loan, the borrower is treated as having received in cash on the date of the loan agreement an amount equal to the excess of the amount loaned over the present value (using the applicable federal rate to discount the payments) of all payments to be made under the loan. The borrower's obligation thus becomes an OID debt instrument, subject to the OID rules referred to above. The above provisions apply to loans made after June 6, 1984.

The provisions of new §7872 are discussed in detail in Chapter 22, *infra.*

Note: Section 91 of the Act amending §461 by adding new subsection (h) (denying deductions for payments made for goods or services in any taxable year before the year in which "economic performance" occurs) applies to transactions not within the ambit of the OID rules or the provisions of §483. Deferred payment transactions (loans, installment purchases of property) effected after June 8, 1984 are subject to new §461(h), and, as provided by §44(b)(3)(A)(i)(II) of the Act, which reflects the amendments to §461, accelerated interest payments will, generally, be disallowed. However, Act §44(b)(3)(C) exempts from this rule self-amortizing installment loans providing for substantially equal annual payments.

This is further explained in Chapter 21, *infra.*

II. Expenses Related to Short Sales [Act §56]

A. Summary of New Statutory Provisions

Section 56 of the Act, amending Code §§263, 163 and 265, discussed in detail in Chapter 10, *infra,* eliminates certain tax advantages related to expenses incurred in connection with short-sales.

1. Payments in Lieu of Dividends

The short seller of stock or securities is allowed a deduction for amounts paid to the lender of the stock or securities during the period the short sale is open in lieu of dividends or interest. In a short sale, the seller borrows stock which is immediately sold and undertakes to replace the borrowed stock whenever either he or the lender choses to close the sale. Before that time, any dividends paid on the stock, which are received by the purchaser, must be compensated for by payment of an equivalent amount by the borrower to the lender of the stock. Section 263 is amended by adding new subsection (h) requiring the capitalization of such payments where the short sale remains open more than 45 days (1 year where the dividend in question is an "extraordinary dividend"). These periods are suspended where the borrower of the stock has acquired an offsetting position reducing risk of loss with respect to the short sale. Where collateral is posted by the borrower securing his obligation to replace the borrowed stock, and interest is earned on such collateral, the payment required to be capitalized under the above described rule is allowed as a deduction to the extent of such interest, except where the dividend involved is an "extraordinary dividend." An "extraordinary dividend" has the same meaning as in §1059(c) (added to the Code by Act §53, meaning dividends exceeding 5 percent of the taxpayer's basis in preferred stock or 10 percent of basis in other stock.

2. Investment Interest

Section 163(d) (limiting the interest deduction under the general rule of §163(a) to net investment income plus $10,000) is amended. Paragraph (D) of §163(d)(3) (defining investment interest) is amended to include as investment interest any amount allowable as a deduction in connection with personal property used in a short sale.

3. Denial of Deduction for Short-Sale Connected Expenses

Section 265(2) denying deductions for expenses and interest relating to tax-exempt income is supplemented by new §265(5) which provides that any amount paid or incurred by a person making a short sale in connection with property used in the short sale, or by another person for the

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use of any collateral with respect to a short sale will be treated as interest and denied deduction.

The above additions to the Code apply to short sales made after July 18, 1984.

These provisions will be discussed and analyzed in detail in Chapter 10, *infra.*

III. Elections to Treat Subchapter S Income Under Prior Law for Purposes of Investment Interest Limit [1]

A. Introduction

Pursuant to §163(d) of the Code, the deduction allowed to a taxpayer for investment interest expenses is generally limited to net investment income plus $10,000. "Investment income" includes the gross income from dividends, but only to the extent such income is not derived from the conduct of a trade or business of the taxpayer. Prior to enactment of the Subchapter S Revision Act of 1982 which repealed §163(d)(4)(C), that subsection stated that the investment interest paid or accrued and the other items of income and expense which would be taken into account if §163(d) applied to S corporations shall be attributed to the shareholders *pro rata* pursuant to regulations to be promulgated.

Although regulations were never issued, the Commissioner took the position that S corporation shareholders were entitled to take into account their ratable share of the corporation's investment income and interest and that the dividends paid by an S corporation to its shareholders (including undistributed taxable income treated as dividend income under §1373(b)) are not a "dividend" for purposes of §163(d)(3)(B). In *Crook v. Comr.*,[2] the Tax Court held that Subchapter S distributions (and undistributed taxable income) are clearly dividends under §§316(a) and 1373(b). The court noted that: (i) Congress had not provided that these amounts should not be treated as dividends for purposes of §163(d)(3)(B), although it had stated that such amounts were not to be treated as dividends for certain other purposes,[3] and (ii) the Commissioner has in his regulations and rulings consistently treated such amounts as dividends for numerous other purposes.

B. Detailed Analysis

The Subchapter S Revision Act of 1982 (P.L. 97-354) (The "1982 Act"), effective for taxable years of S corporations beginning after 1982, provides that the character of items of income, deduction, loss, and credits of the corporation will pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to the partners. In addition, of course, each shareholder takes into account his *pro rata* share of the corporation's "nonseparately computed" income which is determined by excluding the pass-thru items. Although the statute is silent on the matter, it was apparently assumed that after the 1982 Act, S Corporations would so resemble partnerships that the investment income issue would be mooted. In fact, the House Committee Report states that "... S corporation business income will *no longer* be treated as investment income." [4] The Report then goes on to say that "[i]n order to lessen the impact of the transition to the new subchapter S rules for certain corporations, the committee wishes to allow shareholders of S corporations an additional two years to treat the S corporation income as investment income." No similar provision was included in the Senate bill.

The statute as enacted is not nearly so unequivocal. Section 1066 of TRA 1984 [5] states that for taxable years of S corporations beginning in 1983 or 1984, a shareholder may elect that any "qualified income" (income other than personal service income) which a shareholder takes into account by reason of being a shareholder "... shall be treated for purposes of §163(d) ... as such income would have been treated but for the enactment of the [1982 Act]." The Conference Report warns that "[n]o inference is intended as to the proper interpretation of prior law." [6] It is not inconceivable that the Commissioner may interpret such language as an invitation to further litigate the issue which he lost in *Crook, supra.*

Effective Date: As if included in 1982 Act.

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[1] Act §1066.
[2] 80 T.C. 27 (1983).
[3] §1375(b).
[4] H.R. Rep. 432, 98th Cong., 2d Sess., p. 1755 [emphasis added].
[5] There is no change made in the Code.
[6] H.R. Rep. 861, 98th Cong., 2d Sess., p.1270.

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CHAPTER 9

RELATED PARTY DEDUCTION RULES OF §267 REVISED

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I. Introduction

Section 267 disallows deductions for losses on sales and exchanges of property between related persons, and (prior to the 1984 Act) disallowed deductions for unpaid expenses and interest owed by an accrual basis taxpayer to a related cash basis taxpayer. The disallowance provisions apply to defined transactions between persons in any of several defined relationships, without regard to the motives of the parties or the bona fides of the transaction. The evil against which §267(a)(1) is directed is the contrivance of transactions that create tax losses without removing property from friendly hands. The Supreme Court aptly characterized the legislative purpose underlying the predecessor of present §267(a)(1):

> Section 24(b) states an absolute prohibition — not a presumption — against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intragroup transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.[1]

Congress added what is now §267(a)(2) to the Code in order to thwart attempts to take advantage of the mismatched accounting methods of related entities. In a typical form of such a transaction, an accrual-basis entity would borrow from a cash-basis entity. The accrual-basis entity would deduct interest as it became due, but make no payments, so that the cash-basis creditor would have no income to report. Prior to the 1984 amendments, the legislative response embodied in §267(a)(2) was absolutely to disallow such expenses and interest.

The operation of §267(a)(1) was simple. Any loss on a sale or exchange of property between persons in one of the proscribed relationships, except for a loss on a distribution in the course of a corporate liquidation, was disallowed. If the related purchaser later should sell the property at a gain, he would be required to recognize only the portion of the gain in excess of the amount of the loss previously disallowed by reason of §267(a)(1).[2] If the related purchaser were not so fortunate as to sell the property at a gain, then the loss disallowance would be permanent. As we shall see, the 1984 Act leaves §267(a)(1) substantially unchanged, but creates exceptions to the rather draconian general rule.

Section 267(a)(2) disallowed deductions for expenses or interest where three conditions coincided: the expenses or interest were not paid during the taxable year or within 2½ months thereafter; by reason of the accounting method of the person to whom payment was to be made, such person would not include such amount in gross income unless actually paid; and the relationship between the person claiming the deduction and the person to whom payment was to be made was one of the several relationships described in §267(b). Section 267(f), added by the subchapter S Revision Act of 1982 (P.L. 97-354), provided a different rule for S corporations. An S corporation was prohibited from deducting expenses or interest owed to a related person until such time as the amount of the expenses or interest became includable in the income of the payee.[3] In effect, §267(f) matched the accounting methods of the related persons by deferring the deduction of the accrual-basis payor until payment was made to the cash-basis payee. Solely for purposes of §267(f), any person owning 2 percent or more of the value of the outstanding stock of an S corporation, and any person related to such a shareholder by reason of §267(b) or §707(b)(1)(A), were treated as persons related to the S corporation.

Prior to the 1984 amendments, §267(b) defined the following as related persons, and therefore subject to the disallowance provisions of §267(a) and the deferral provisions of §267(f):

(1) Members of a family, including brothers, sisters, spouse, ancestors, and lineal descendants;

(2) A shareholder and a corporation, if the shareholder owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation;

(3) Two corporations, if the same individual owns, directly or indirectly, more than 50 percent in value of the outstanding stock of each corporation, and if one of the corporations was a personal holding company or a foreign personal holding company for the taxable year preceding the date of the sale or exchange;

(4) A grantor and a fiduciary of a trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary and a beneficiary of a trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

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(8) A fiduciary of a trust and a corporation, if the grantor of the trust owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation;

(9) A person and a controlled tax-exempt organization;

(10) An S corporation and a partnership, if the same persons own more than 50 percent in value of the outstanding stock of the S corporation, and more than 50 percent of the capital or profits interest in the partnership;

(11) Two S corporations, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(12) An S corporation and a C corporation, if the same individual owns more than 50 percent in value of the outstanding stock of each corporation.

For purposes of determining whether persons are related within the meaning of §267(b), constructive ownership as well as actual ownership of stock is taken into account. Section 267(c) contains the following rules for attribution of ownership:[4]

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is attributed proportionately to its shareholders, partners, or beneficiaries;

(2) Stock owned, directly or indirectly, by or for an individual's family, including his brothers, sisters, spouse, ancestors, and lineal descendants, is attributed to the individual;

(3) Stock owned, directly or indirectly, by or for an individual's partner is attributed to the individual, but only if the individual already owns some stock in the corporation (other than by reason of attribution of ownership from his family members); and

(4) Stock constructively owned by reason of Rule (1) shall be treated as actually owned by the constructive owner for purposes of reattribution under Rules (1), (2), and (3), but stock constructively owned by reason of Rule (2) or Rule (3) shall not be treated as owned by him for the purpose of reattribution of the ownership of such stock to another person. The operation of the constructive ownership rules may be illustrated by the following example:

Example 1: On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under §267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by §267(a) (except for distributions in liquidation of X Corporation).[5]

In enacting the amendments to §267 in the Tax Reform Act of 1984, Congress appears to have had two major purposes. First, Congress sought a more refined mechanism for matching expense and interest deductions with income. The 2½ month grace period for payment of expenses or interests after the close of the taxable year was thought to be too lenient, since in many cases the grace period allowed a taxpayer to deduct expenses or interest one year before a related entity recognized the corresponding income. On the other hand, the Committee Reports indicate that Congress believed that permanent disallowance of an expense or interest deduction is unduly harsh in cases where payment is actually made, albeit more than 2½ months after the close of the taxable year. Second, Congress wished to broaden the coverage of §267. Thus, the Tax Reform Act of 1984 adds certain related parties, such as a partnership and its partners, and members of a controlled group of corporations, to those which are subject to the related party rules.[6]

II. Overview

A. Amendments to §267

Expense and interest deductions for amounts owing from an accrual-basis entity to a cash-basis entity, which were formerly disallowed, are now merely deferred until the expense or interest is actually paid and the cash-basis entity recognizes income. The former grace period for expenses or interest paid during the 2½ months following the close of the taxable year, during which time payments were not subject to disallowance under §267(a)(2), has been repealed. Now, any delay in payment by an accrual-basis taxpayer to a related cash-basis taxpayer will result in postponement of the deduction for the expense or interest until actual payment.

The rule deferring the deduction of expenses and interests owed by an accrual-basis taxpayer to a related cash-basis taxpayer, applicable only to obligations of an S corporation to its shareholders under prior law, will now be extended to the obligations of a shareholder to an S corporation, obligations of partnerships to partners, and obligations of partners to partnerships. The former exception from the rule for amounts owing from an S corporation to a shareholder with less than a 2 percent interest in the S corporation has been eliminated. This rule will also apply to a partnership or S corporation that owns a partnership interest in a lower-tier partnership and another partner in the lower-tier partnership. Similarly the rule will apply to an S corporation or partnership and any person related (within the meaning of §267(b) or §707(b)(1) to partners in the partnership, shareholders in the S corporation, or partners in a lower-tier partnership in which the upper-tier partnership or S corporation owns an interest. The rule will not apply to guaranteed payments to which §707(c) is applicable. Instead, the prior law requirement continues, that a partner must include such payments as ordinary income for his taxable year during which the partnership's taxable year in which the partnership deducted such payments ends. The Act also contains an exception for certain resyndications of low-income housing (within the meaning of §189(e)(5)) permitting the deduction of specified expenses and interest incurred in connection with the resyndication.

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The Act amends §267(b) to broaden the relationship rules. The extension of the relationship rules will apply to both the disallowance of loss on a sale or exchange of property between related parties and to the deferral of deductions for unpaid expenses and interests owed by an accrual-basis taxpayer to a cash-basis taxpayer. Section 267 will now apply to transactions between a partnership and a corporation which are commonly controlled, and to transactions between an S corporation and a C corporation which are commonly controlled (whether by one individual, as under prior law, or by more than one person). The Act also extends §267 to transactions between groups of controlled corporations. Corporations will be treated as members of a controlled group if they satisfy the tests of §1563(a), except that a 50 percent control test will be substituted for the 80 percent control test of §1563(a). In the case of a transaction between members of a controlled group of corporations, the disallowance of a loss on the sale or exchange of property under §267(a)(1) will not apply. Instead, losses will be deferred until the property is disposed of to an unrelated third party in a transaction which results in recognition of gain or loss under consolidated return principles. Loss on a transfer to a DISC or on certain sales of inventory to a foreign member of the same controlled group, and certain foreign currency losses, will not be subject either to disallowance or deferral.

B. Effective Dates

Amendments made by §174(a) of the Act (amending Code §267(a)(2) to provide for deferral of deductions for expenses and interests owing from an accrual-basis taxpayer to a cash-basis taxpayer) and §174(b)(1) of the Act (special rules for deferral of expense and interest deductions of "pass-thru entities" and related parties) shall apply to deductions otherwise allowable for taxable years beginning after December 31, 1983. Amendments by §174(b)(2) of the Act (deferral of loss on a sale or exchange and deferral of expense deductions as to transactions within a controlled group of corporations) shall apply to transactions after December 31, 1983 in taxable years ending after such date, except that such amendments shall not apply to property transferred to a foreign corporation on or before March 1, 1984. The amendments made by Act §174(b)(3) (making a commonly controlled corporation and partnership related parties) and Act §174(b)(4) (making a commonly controlled S corporation and C corporation related parties) and §174(b)(5) (making conforming amendments to sections other than §267) shall also apply to transactions after December 31, 1983 in taxable years ending after such date. None of the amendments to §267 shall apply to amounts paid or incurred on indebtedness that was incurred, or pursuant to a contract that was binding, as of September 29, 1983. This exception for indebtedness and contracts existing as of September 29, 1983 will not apply to any amounts paid or incurred after a subsequent renegotiation, extension, renewal, or revision of the indebtedness or contract.

III. Detailed Analysis

A. Matching of Deduction and Corresponding Income Item

Section 267(a)(2), as amended by the Tax Reform Act of 1984, will defer a deduction of expenses or interest if the following conditions are met:

(1) The expenses or interest are not paid during the taxable year;

(2) By reason of the accounting method of the person to whom payment is to be made, the amount of expenses or interest is not includable in the gross income of the payee until paid; and

(3) At the close of the taxable year of the taxpayer for which the expenses or interest would otherwise be deductible, both the taxpayer and the person to whom the payments should be made are related persons specified in §267(b). Thus, an accrual-basis taxpayer may not deduct expenses or interest owed to a related cash-basis taxpayer until the amount is paid. The 2½ month grace period following a taxable year during which payment was treated as paid during the taxable year and the permanent disallowance of deductions for unpaid expenses and interest owed by an accrual-basis taxpayer to a cash-basis taxpayer have been eliminated.

B. Special Rules for Partnerships and S Corporations

For purposes of applying the expense and interest deduction deferral rules of §267(a)(2) only, the Act amends §267(e)(1) to treat the following entities and individuals as related persons:

(1) A partnership or an S corporation (the generic term in the statute is "pass-thru entity") and a partner in the partnership or a shareholder in the S corporation;

(2) An upper-tier partnership or S corporation that owns an interest in a lower-tier partnership, and any other person who owns an interest in the lower-tier partnership; and

(3) A partnership or S corporation, and any person related (within the meaning of §267(b) or §707(b)(1)) to a partner in the partnership, a shareholder in the S corporation, or a partner in the lower-tier partnership in which the upper-tier partnership or S corporation owns an interest.

A partner in a lower-tier partnership in which the upper-tier partnership or S corporation owns an interest will be treated as related to the upper-tier partnership or S corporation for purposes of §267(a)(2) only if the expense or interest paid or incurred is related either to the operations of the lower-tier partnership or to an interest in the lower-tier partnership.

The rules of §267(e)(1) may be illustrated by the following examples:

Example 2: Corporation Z owns a one percent profits interest in Partnership X and a 51 percent capital and profits interest in Partnership Y. Partnership X uses the accrual method of accounting and Partnership Y uses the cash method. Unpaid interest owed by X to Y cannot be deducted until actually paid, because Y is related to a partner of X by reason of §707(b)(1)(A), and therefore is related to X by reason of §267(e)(1)(D).[7]

Example 3: Assume the same facts as in Example 2, except that Corporation Z has only a 40 percent interest in Partnership Y. The Corporation is not related to Y under §707(b)(1), and §267 does not apply. (However, both the House and Senate Reports contain the following footnote: "It is expected that the Treasury

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regulations under this provision will provide a rule for cases not specifically covered by the new rules where the same persons are partners in both the payor partnership and payee partnership which will defer deduction accruals (until paid) to the extent of such partners' aggregate interests in the payor partnership." [8] If such regulations are promulgated, one percent of the interest deductions accrued by X must be deferred until the amounts are paid to Y, but 99 percent of the deductions would be allowed currently if otherwise allowable.

Example 4: Partnership A and Individual C each owns a one percent partnership interests in Partnership B. Individual C lends money to partnership A in a transaction unconnected with the operations of, or with an interest in, Partnership B. If Partnership A is an accrual-basis taxpayer, A may deduct interest payable to C as it accrues even though the interest remains unpaid. Although C owns an interest in a partnership in which A owns interest, and therefore is related to A by the terms of §267(e)(1)(C), §267(e)(1) provides that subparagraph (C) shall apply only to transactions related to the operations of, or to an interest in, the lower-tier partnership.

Example 5: Individual C owns a two percent partnership interest in Partnership B. C sells a one percent partnership interest in Partnership B to Partnership A, receiving in payment cash and a promissory note. If C is a cash-basis taxpayer, A may not deduct accrued interest on the promissory note until A actually pays the interest, even if A is an accrual-basis taxpayer. Since the transaction between A and C relates to a partnership interest in a partnership in which both A and C own interests, §267(e)(1)(C) applies to the transaction, and §267(a)(2) requires deferral of the interest deduction. However, if C realized a loss on the sale of the partnership interest, §267(a)(1) would not operate to disallow C's loss deduction. Section 267(e)(1) treats parties as related only for purposes of §267(a)(2).

For purposes of determining ownership of a partnership interest pursuant to §267(e)(1), the constructive ownership rules of §267(c) will apply with two modifications. First, §267(c)(3), which attributes stock ownership from one partner to another partner in the same partnership, shall not apply for purposes of attributing ownership of a partnership interest under §267(e)(1). Second, a partnership interest owned, directly or indirectly, by or for a C corporation shall be attributed to a shareholder only if the shareholder owns, directly or indirectly, five percent or more in value of the stock of the corporation.[9]

Guaranteed payments to which §707(c) applies shall not be subject to deferral by reason of §267(e) and §267(a)(2).[10] As under prior law, a partner must include such payments as ordinary income for his taxable year during which the partnership's taxable year in which the partnership deducted such payments ends.[11]

Certain expenses and interest of low-income housing resyndications are exempted from the application of §267(e)(1) and §267(a)(2). Section 267(e)(5) provides that the deferral rule will not apply to qualified expenses and interest paid or incurred by a partnership owning low-income housing to a "qualified five-percent or less partner" in the partnership. A "qualified five-percent or less partner" is defined as a partner owning a five-percent or less interest, but only if one of the following two conditions is met:

(1) The partner owned the low-income housing at all times during the two-year period ending on the date when the housing was transferred to the partnership, or

(2) The partnership acquired the low-income housing pursuant to a purchase, assignment, or other transfer from the Department of Housing and Urban Development or any State or local housing authority. For purposes of determining whether a partner has a five percent or less interest, the partner shall be treated as constructively owning any partnership interest owned by a related person (within the meaning of §267(b) or §707(b)(1)).[12] The term "qualified expenses and interest" is defined as any expense or interest which satisfies all of the following three conditions:

(a) The interest or expense must be incurred with respect to low-income housing held by the partnership;

(b) The amount of the expense or interest must be unconditionally required to be paid by the partnership not later than 10 years after the date when the amount was incurred; and

(c) In the case of interest, the annual interest rate may not exceed 12 percent.[13] "Low-income housing" is defined as in §189(e)(5), and also includes an interest in a partnership owning low-income housing.[14]

C. Relationship Rules of §267(b) Extended

The Act amends the relationship rules of §267(b), both for purposes of the loss-disallowance provisions of §267(a)(1) and for purposes of the deduction-deferral provisions of §267(a)(2). Section 267 will now apply to a corporation and a partnership, if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership.[15] Formerly, §267 applied to a commonly controlled S corporation and partnership, but not to a commonly controlled C corporation and partnership. Section 267 will now also apply to an S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation.[16] Formerly, §267 applied to an S corporation and a C corporation only if a single individual owned more than 50 percent in value of the outstanding stock of each corporation. The Act also extends the application of §267 to corporations which are members of the same controlled group (as defined in §267(f)).[17] The term "controlled group" has the same meaning as in §1563(a), except that a greater than 50 percent control test is substituted for the 80 percent control test of §1563(a), and subsections (a)(4) and (e)(3)(C) of §1563 do not apply.[18] Section 1563(a), as modified by §267(f)(1), defines three different kinds of controlled groups:

(1) *Parent-Subsidiary*, where more than 50 percent of the total voting power or value of the stock of each corporation, except the common parent corporation, is owned by one of the group of corporations, and the common parent corporation owns more than 50 percent of the total voting power or total value of the stock of at

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least one other corporation in the group, excluding (treating as not outstanding) for this purpose stock owned directly by other corporations in the group;

(2) *Brother-Sister,* where five or fewer individuals, estates, or trusts own more than 50 percent of the total voting power or total value of the stock of each of two or more corporations, and own more than 50 percent of the total voting power or total value of the stock of each corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each corporation (in other words, taking into account the ownership of each person only to the extent of the smallest ownership percentage of that person in any corporation in the group); and

(3) *Combined Group,* where three or more corporations are each a member of a parent-subsidiary controlled group or a brother-sister controlled group, and one corporation is both a common parent in a parent-subsidiary controlled group and a member of a brother-sister controlled group.

In the case of a transaction between members of a controlled group of corporations, the disallowance of a loss on the sale or exchange of property under §267(a)(1) will not apply. Instead, the loss will be deferred until the property is transferred outside the controlled group and there would be recognition of loss under consolidated return principles, or until such other time as may be prescribed in regulations.[19] The loss deferral rules are not intended to overrule the consolidated return regulation rules where the controlled corporations file a consolidated return.[20] The deferral rules will apply, however, to taxpayers who have elected not to apply the deferred intercompany transactions rules.[21]

The language of new §267(f) has created an ambiguity where a commonly controlled S corporation and C corporation, which are treated as related parties under §267(b)(12), are also members of a controlled group as defined in §267(f). This may happen when the S corporation and C corporation constitute a brother-sister controlled group as defined in §1563(a)(2), as modified by §267(f)(1). The overlap between the two definitions raises the issue whether a loss on a sale or exchange between a commonly controlled S corporation and C corporation will be disallowed pursuant to §267(b)(12) and §267(a)(1), or merely deferred pursuant to §267(f)(2). The answer is not obvious. Not all commonly controlled S and C corporations will qualify as a controlled group under §267(f)(1) and §1563(a)(2). Therefore, it is arguable that Congress intended to legislate different treatment for controlled groups of S and C corporations that are owned in different proportions. It is not at all clear, however, what legislative policy might underlie such a distinction. A rational response to the overlap would be that all commonly controlled S and C corporation pairs should be treated alike, and §267(f) should be interpreted as implicitly excluding S corporations from the definition of a controlled group. This interpretation finds some support in Regs. §1.1563-1(b)(2)(ii)(c), which specifically excludes S corporations from the definition of a controlled group. However, the Act would seem to preclude reliance on Regs. §1.1563-1(b)(2)(ii)(c), since §267(f)(1) borrows only subsection (a) from §1563, and the regulation is a gloss on §1563(b) (defining "component" and "excluded" members). The legislative history specifies that: "The component member rules of §1563(b) have no application."[22] The overlap of §267(b)(12) and §267(f) may be illustrated by the following examples:

Example 6: Individual A owns 50 percent of the stock of corporation X and 50 percent of the stock of corporation Y, and individual B owns 50 percent of the stock of corporation X and corporation Y. Corporation X is an S corporation, and corporation Y is a C corporation. X sells property at a loss to Y. Section 267(b)(12) applies to X and Y, so §267(a)(1) would seem to disallow X's loss on the sale. However, §267(f) also applies to X and Y, since they are a brother-sister controlled group as defined by §1563(a)(2), as modified by §267(f)(1). Arguably, §267(f)(2) should operate to defer rather than disallow the loss.

Example 7: Individual A owns 75 percent of the stock of corporation X and 25 percent of the stock of corporation Y. Individual B owns 25 percent of the stock of corporation X and 75 percent of the stock of corporation Y. X is an S corporation and Y is a C corporation. X sells property to Y at a loss. Section 267(b)(12) applies to the sale, and §267(a)(1) operates to disallow X's loss. Section 267(f) does not apply, because X and Y are not a controlled group as defined by §1563(a) and §267(f)(1). Although X and Y meet the test of §1563(a)(2)(A) as modified by §267(f)(1), since five or fewer persons own stock possessing more than 50 percent of the voting power or value of the stock of each corporation, they do not meet the test of §1563(a)(2)(B), since A and B own only 50 percent of the stock of each corporation if only identical ownership is taken into account. (A owns 75 percent of the stock of X, but only 25 percent is taken into account for purposes of §1563(a)(2)(B), since B owns only 25 percent of the stock of X; B owns 75 percent of the stock of Y, but only 25 percent is taken into account, since A owns only 25 percent of the stock of Y.) Hence, the argument that the loss should be deferred rather than disallowed is not available in this situation.

Another curiosity relating to §267(f) is the following statement which appears in the Conference Report:

> The Secretary may prescribe exceptions from these principles [deferral of loss on a sale or exchange until the property is transferred outside the group], for example, where necessary to properly reflect the net amount of income on a transaction. For example, it is intended that where any income is properly taken into account by the controlled group with respect to the face amount of a note receivable (for example, the income is accruable in accordance with the principles set forth in Rev. Rul. 71-365) at any time prior to the transfer of the property outside the group, any loss due to the discount in the note or receivable (to the extent of such income previously recognized) shall be allowed no later than the time that both the income has been taken into account and that loss has been sustained.[23]

This statement is apparently intended to preserve prior law treatment of an accrual-basis credit card company or bank that sells notes or receivables to an affiliated corporation at a discount. As an example of where income is taken into account with respect to the face amount of a note or receivable, the conference report cites Rev. Rul. 71-365,[24] which holds that fees charged by a bank to merchants in

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the form of a discounted purchase price for the indebtedness owed to the merchant for goods or services must be accrued by an accrual-basis bank in the year in which the bank purchases the customer obligation from the merchant. The justification offered for excepting the sale of receivables by an accrual-basis bank to an affiliate appears to be that the bank has already paid tax on such income, and therefore should not be denied a loss deduction to the extent of the income recognized. However, any taxpayer who would be entitled to recognize a loss but for the provisions of §267(a)(1) has, in effect, purchased his basis in the property with after-tax dollars. It is unclear why a taxpayer whose basis in property derives from the payment of taxes (as in the case of a bank that has taken part of a note or receivable into income) should be preferred to a taxpayer whose basis derives from a cash payment (on which taxes were presumably paid at one time or another). The disparity of treatment seemingly required by the language in the Conference Report may be illustrated by the following examples:

Example 8: Corporation A and corporation B are both members of a controlled group, as defined in §267(f). Corporation A purchases receivables (for goods or services charged on a credit card issued by A) at a discount from participating merchants. As A is an accrual-basis taxpayer, it recognizes income to the extent of the discount at the time of its remittance to the merchant (see Rev. Rul. 71-365). A sells the receivable to B at a discount from the face amount, though not at a discount from the amount remitted to the merchant. (The face amount of the receivable equals 100, the payment to the merchant equals 95, and the payment from B to A equals 95.) According to the Conference Report language, A may recognize loss on the sale of the receivable to B to the extent that A recognized income at the time of the purchase from the merchant. On the other hand, if B is a cash-basis taxpayer, it will not recognize income until the receivable is actually collected (see Rev. Rul. 78-40, 1978-1 C.B. 136).

Example 9: Corporation A and corporation B are members of a controlled group. Corporation A purchases receivables from a merchant at a discount. A is a cash-basis taxpayer, and so accrues no income at the time it purchases the receivable. A sells the receivable to B at a deeper discount. (The face amount of the note equals 100, the payment from A to the merchant equals 95, and the payment from B to A equals 90.) Although A had a basis of 95 in the receivable and would otherwise have recognized a loss of 5, §267(f)(2) defers the loss deduction until the receivable is collected (or not collected) or sold to an unrelated third party.

In three situations, the Act provides that neither the deferral provision of §267(f)(2) nor the disallowance provision of §267(a)(1) shall apply to a loss on the sale or exchange of property between members of a controlled group. First, loss deferral or disallowance will not be required in the case of a transfer to a DISC.[25] Also excepted is a sale or exchange of inventory (as defined in §1221(1)) in the ordinary course of business, where the property is inventory both in the hands of the transferor and in the hands of the transferee, and where either the transferor or the transferee is a foreign corporation.[26] Finally, §267 will not defer or disallow a loss sustained by a member of a controlled group at the time of repayment of a loan made to another member of the controlled group, if the loan is payable in a foreign currency or is denominated in a foreign currency, and the loss is attributable to a reduction in value of the foreign currency.[27] This exception may be illustrated by the following example:

Example 10: Corporation X and its foreign subsidiary corporation Y are members of a controlled group as defined in §267(f)(1). Corporation X lent funds to corporation Y, and received a promissory note payable in the currency of the foreign country in which Y is based. Between the time that X lent funds to Y and the time that Y repaid X, the currency of the foreign country suffered a reduction in value relative to the United States dollar, and X realized a loss upon repayment of the loan. Section 267(f)(3)(C) prescribes the issuance of regulations that will permit the present deduction of such foreign currency losses, which would otherwise be subject to deferral by reason of §267(a)(1) as modified by §267(f)(2).

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[1] *McWilliams v. Comr.*, 331 U.S. 694, 699 (1947).
[2] §267(d). Unless otherwise indicated, all statutory references are to the Internal Revenue Code.
[3] For purposes of §267(f), the 2½ month grace period for payment of expenses or interest after the close of a taxable year did not apply.
[4] Section 267(c) was unchanged by the Tax Reform Act of 1984. However, the constructive ownership rules are modified in their application to partnership interests. See new §267(e)(3).
[5] Regs. §1.267(c)-1(b) (Example 3).
[6] H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., 1578-1579 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 494-495 (1984).
[7] H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1579-1580 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 495-496 (1984).
[8] H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., 1580, n. 40 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 496, n. 17 (1984).
[9] §267(e)(3).
[10] §267(e)(4).
[11] See Regs. §1.706-1(a) and §1.707-1(c).
[12] §267(e)(5)(B).
[13] §267(e)(5)(C).
[14] §267(e)(5)(D).
[15] §267(b)(10).
[16] §267(b)(12).
[17] §267(b)(3). The requirements of prior law that the same individual own more than 50 percent of the value of the outstanding stock of each corporation, and that one of the corporations be a personal holding company or a foreign personal holding company, have been eliminated.
[18] §267(f)(1).
[19] §267(f)(2).
[20] H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1580 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 496 (1984).
[21] Conf. Rep. No. 861, 98th Cong., 2d Sess. 1033 (1984). See Regs. §1.1502-13(c)(3), permitting an affiliated group to elect not to defer gain or loss on any deferred intercompany transactions with respect to all property or any class or classes of property.
[22] H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., 1580, n. 41 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 496, n. 18 (1984).
[23] Conf. Rep. No. 861, 98th Cong., 2d Sess., 1033 (1984).
[24] 1971-2 C.B. 218.
[25] §267(f)(3)(A).
[26] §267(f)(3)(B).
[27] §267(f)(3)(C).

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CHAPTER 10

TREATMENT OF EXPENSES RELATED TO SHORT SALES

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I. Background

A. Mechanics of a Short Sale

While the term "short sale" is not defined in the Code or in any regulations,[1] for purposes of the legislation to be discussed, it refers to the short sale of stock executed through a securities exchange regulated by the SEC and in accordance with the rules of such exchange. A short sale involves, normally, three parties, the person who is the short seller, (the seller) the short seller's broker, and the person whose stock is used in the short sale, referred to as the lender.[2] The seller may also be a broker. In a short sale, the seller borrows stock from the lender. This stock is sold on the exchange. The sale proceeds are retained by the broker executing the sale as security for the seller's obligation to return the stock to the lender. The broker will usually invest these proceeds or use them in his business operations. Unless the seller is a customer who transacts a substantial volume of business through the broker, the latter will, normally, not pay the seller interest on the proceeds while the short sale is open (*i.e.*, prior to the time the sale is closed by delivery of the replacement stock to the lender). Where the broker does pay interest on the proceeds, the payment is referred to as a "rebate fee." As stated, a short sale is "closed" when, upon demand by the lender or at the election of the seller, stock identical to the stock borrowed is returned to the lender. The principal purpose of a short sale is to profit from a downturn in the price of the borrowed stock, since if identical stock can be purchased at a price lower than the price for which the borrowed stock was sold, and this stock is used to close the sale, the seller retains the excess sale proceeds. Sometimes, short sales are made "against the box," that is, where the seller holds stock identical to the stock sold short. The short sale serves to lock in or guarantee the current market price. If the market price subsequently declines, the stock held by the seller can be used to close the sale, at which time the seller becomes entitled to the sale proceeds. The seller is free, of course, to close the sale with stock purchased at any time before closing whether or not the sale is made against the box.

B. Treatment of "In Lieu of Dividend" Payments

While the short sale is open, the seller must pay to the lender an amount equal to any dividends to which the lender would become entitled had he retained the stock. Such payments are payments "in lieu of dividends." Dividends are usually declared periodically and are payable to the shareholders of record as of a specified date. At that time,the stock is referred to as "ex dividend," meaning that a person who acquires the stock after such date is not entitled to the current dividend distribution. The market price of ex dividend stock will normally decline temporarily (all other things being equal) reflecting the dividend payment. It may occur that a corporation will declare an extraordinary dividend for any number of reasons. Such dividend will substantially exceed the usual periodic distribution of current earnings. It may result, for example, from the decision to distribute to the shareholders the proceeds of the sale of corporate assets or some other unusual gain unrelated to the corporation's normal operating profits. The decision to make such a dividend will usually be announced, and the price of the stock will usually reflect anticipation of the distribution. Here, the ex dividend drop in the stock price will be much more dramatic than in the case of the normal periodic dividend.

A short sale executed shortly before a stock goes ex dividend will usually insure the short seller of a profit from the short sale. This will be offset by the in lieu of dividend payment the seller is obligated to make. The IRS has ruled that a payment in lieu of a dividend is fully deductible.[3] Gain or loss from a short sale is, except in unusual circumstances, capital gain.[4] Unless the seller held stock substantially identical to the stock sold short at the time of the short sale,[5] any gain from the short sale will be short-term capital gain.[6] When the seller has capital losses for the taxable year in which the short sale is closed, the gain from the short sale can be offset against such losses. Where the seller has long term gains and short term losses, he is ideally situated for this type of transaction. The seller is also entitled to set off the deductions for in lieu of dividend payments against unrelated ordinary income. These results are, of course, greatly magnified in the case of a short sale made prior to an extraordinary dividend.

As stated above, the seller's broker will normally retain the proceeds of the sale of the borrowed stock without payment to the seller of any rebate fees. However, where such fees are paid to the seller, his position is analagous to the position of a taxpayer who borrows money and invests the proceeds of the loan at present interest rates. Payments in lieu of dividends, in such a case, are analagous to payments of charges for the use or forbearance of the money borrowed and are, therefore, analagous to interest.[7] In the case of the broker who executes a short sale for his own account, the same analogy applies. He will invest the sale proceeds or use them in his business operations. Where the sale is executed for the account of a customer, while the broker will not have to make in lieu of dividend payments, any rebate fees paid are economically indistinguishable from interest paid for the use of borrowed funds. Where the sale is executed on the broker's own behalf, his position is the same as that of a customer; in lieu of dividend payments

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are analagous to interest charged for the use of the borrowed funds.[8] Under law prior to the 1984 Act, in lieu of dividend payments were not considered "interest" for purposes of §163(d) which limits the deduction of "investment interest" in excess of "net investment income" to $10,000 for any taxable year.

C. *Indebtedness Incurred to Carry Tax-Exempt Securities*

Section 265 of the Code contains a number of provisions disallowing deductions for expenses incurred to purchase or carry tax-exempt securities. Section 265(2) disallows interest on indebtedness incurred or continued to purchase or carry securities the interest from which is tax-exempt. Where a taxpayer holds tax-exempt securities and borrows funds which are used to purchase investment property, the indebtedness generally is considered incurred to carry tax-exempt securities. In the case of a broker,the IRS has adopted the position that where interest expense cannot be traced directly to the purchase of tax-exempt securities, such nontraceable expense is multiplied by a fraction the numerator of which is the average basis in tax-exempt securities owned during the taxable year and the denominator of which is the broker's average basis in all securities owned during the year.[9] There is segregated from this computation amounts paid as interest on funds borrowed solely for customer transactions (*e.g.*, the purchase of stock on margin).[10] Where a broker pays rebate fees for the use of collateral in connection with a short sale, it is unclear whether such fees are subject to the above computation.

II. Overview

A. *Code Sections Amended*

Section 56 of the Act, entitled "Denial of Deductions for Certain Expenses Incurred in Connection with Short Sales," amends Code §263 (relating to the mandatory capitalization of certain expenses), §163(d) (relating to deductions of investment interest), and §265 (relating to the denial of certain expenses incurred in connection with tax-exempt income).

B. *Amendments to Section 263*

Act §56(a) adds new subsection (h) to §263. The subsection is headed "Payments in Lieu of Dividends in Connection with Short Sales." The new subsection provides that where the taxpayer makes an in lieu of dividend payment, and the closing of the short sale occurs on or before the 45th day after the date of the short sale, no deduction is allowed with respect to such payment. The amount of such disallowed payment is to be added to the basis of the stock used to close the short sale.[11] In the case of an "extraordinary dividend," the above provisions will apply substituting "the day one year after the date of such short sale." [12]

The term "extraordinary dividend" has the meaning given to such term by §1059(c) (explained below), except that such section is to be applied by treating the amount realized by the taxpayer in the short sale as his adjusted basis in the stock. Section 1059, added by §53(a) of the Act, requires the reduction of the basis of stock owned by a corporation where the latter receives an extraordinary dividend on such stock and where the dividend is subject to the dividend received deduction provided by §§243-256 inclusive. "Extraordinary dividend" is defined, for purposes of §1059, as any dividend paid with respect to stock which equals or exceeds the threshold percentage of the shareholder's adjusted basis in the stock. The "threshold percentage" means: (1) 5 percent in the case of stock preferred as to dividends,and (2) 10 percent in the case of any other stock.[13] Rules are provided relating to the aggregation of dividends paid within an 85-day period and a one-year period and for substituted basis transactions.

The 45-day and one year periods which must elapse between the short sale and closing the sale specified in the above provisions are suspended during any period in which the taxpayer holds, has an option to buy, or is contractually obligated to buy, substantially identical stock or securities, or, under regulations, the taxpayer has diminished his risk of loss (with respect to the short sale) by holding one or more positions in substantially similar or related property.[14]

The denial of deductions for in lieu of dividend payments is not to apply to the extent such payments do not exceed amounts received by the short seller as compensation for the use of collateral with respect to any stock used in a short sale, provided such compensatory amounts are treated as ordinary income.[15] This exception does not apply, however, with respect to any payment made in lieu of extraordinary dividends (as defined above).[16]

Section 263(g) denies deductions for interest, carrying charges and other expenses relating to any position of a straddle, as that term defined by §1092(c).[17] Act §101(e)(8) amended §263(g), adding paragraph (4) which provides that in the case of any short sale, the provisions of subsection (g) are to be applied after subsection (h).[18] Section 263(h)(6) makes the identical provisions, *i.e.*, the provisions of subsection (h) are to be applied before applying subsection (g).

C. *Amendments to Section 163(d)*

Act §56(b) amends subparagraph (D) of §163(d)(3) (defining "investment interest") to provide that the term "investment interest," meaning interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment, includes any amount allowable as a deduction in connection with personal property used in a short sale.[19] This presumably includes amounts paid in lieu of dividends but not rebate fees paid by brokers.

D. *Amendments to Section 265*

Act §56(c) amends §265 by adding new paragraph (5) which provides special rules for the application of paragraph (2) (denying deductions for interest on indebtedness incurred or continued to purchase or carry tax-exempt securities). Paragraph 95(A) provides the general rule that the term "interest" includes any amount paid or incurred:

> (i) by any person making a short sale in connection with personal property used in such short sale, or
>
> (ii) by any other person for the use of any collateral with respect to such short sale.

An exception is provided in clause (i) above. This clause does not apply if the taxpayer provides cash as

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collateral for a short sale and receives no material earnings on such cash during the period of the sale.

E. Effective Date

The amendments made by Act §56 apply to short sales after July 18, 1984 in taxable years ending after such date.

III. Detailed Analysis

A. General Observations

The amendments outlined above are designed to deal with two unrelated abusive situations. The conversion of ordinary income to capital gain by the short sale of stock shortly before the ex dividend date followed by the closing of the short sale after such date will no longer be possible in view of the amendments made to §263 requiring the capitalization of in lieu of dividend payments where the closing of the short sale takes place less than 45 days (one year in the case of extraordinary dividends) after the date of the short sale. In addition, the treatment of in lieu of dividend payments as interest for certain purposes reflects the perception that in a short sale, the seller is, as a practical matter, borrowing property which is converted into cash, and that payments to the lender of amounts equal to the investment yield on such property should be treated in the same manner as interest. Lastly, where the broker pays rebate fees for the use of the short sale proceeds while the sale remains open, such payments are indistinguishable from the payment of interest for borrowed funds and, where such broker carries tax-exempt securities, these rebate fees should be considered as interest on indebtedness incurred to carry such tax-exempt securities in appropriate cases.

B. The Amendments to Section 263

Under new subsection (h) of §263, as outlined above, an in lieu of dividend payment may be deducted only where there elapses a period of at least 45 days between the short sale giving rise to the payment and the closing of the short sale.[20] Where the payment is in lieu of an extraordinary dividend equal to 10 percent or more of the proceeds of the stock sold in a case involving any stock other than preferred (as to dividends *i.e.*, 5 percent in the case of such preferred stock) the period which must elapse between the short sale and the closing is one year and one day.[21]

The statute provides that the time period described above will be suspended during any period the taxpayer holds what can be loosely termed as a long position with respect to the stock sold short. There are two categories of long position. The first consists of holding, or holding an option to buy, or being contractually obligated to buy, stock or securities "substantially identical" to the stock sold short. The second category is, under regulations, the holding of any position in "substantially similar or related property" which diminishes the risk of loss from the short sale.

The term "substantially similar stock or securities" is a familiar one, appearing in both the wash sale rules of §1091 and the short sale rules of §1233. While there may be some exceptional circumstances in which this may not hold true [22] stock is almost invariably substantially identical only to stock of the same class issued by the same corporation, or, possibly, a debenture convertible into such stock where the prices of the stock and of the debenture move in unison.[23]

The phrase "substantially similar or related," however, is a new addition to the Code. It appears in more than one of the 1984 TRA amendments. Act §53(b) amended §246(c), disallowing a dividend received deduction under §§243-245 where the stock is sold or disposed of after being held for 45 days (15 days under pre-TRA law) or less.[24] Former law also denied the deduction where the taxpayer was under an obligation (whether under a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities.[25] Act §53(b) changed "corresponding" to "related," and, further, changed "substantially identical stock or securities," to "substantially similar or related property." Also, paragraph (4) of §246(c) was amended. This paragraph provides for the suspension of the holding period where the taxpayer's risk of loss is diminished. The same two categories of positions (short, however, rather than long positions) are provided for, *i.e.*, short positions with respect to "substantially identical stock or securities," and risk of loss reducing positions in "substantially similar or related property," the latter to be defined in regulations to be issued.[26] The "substantially similar or related" standard is discussed in the Conference Committee Report [27] relating to the §246 amendments. The Committee Report relating to the §263(h) provisions [28] states that "substantially similar or related property" has the same meaning as when used in §246(c).[29]

To be entitled to a deduction for an in lieu of dividend payment, therefore, the taxpayer must at the time of the short sale divest himself of all long positions in the stock and of any other positions which may be considered as "substantially similar or related property." The regulations interpreting this term will, presumably, be effective as of July 18, 1984, the date of the enactment of the 1984 TRA.[30]

> *Example*: Taxpayer A sells short 100 shares of ABC common stock at a time when the stock price is 100. Six days later, a dividend is declared on the stock and the stock price, ex dividend, falls to 97. The dividend is paid 14 days later, and A makes payment in an equal amount to the lender of the stock. If the dividend is less than $10 per share, A may deduct the in lieu of dividend payment if he waits for 26 days before closing the short sale. If the dividend is $10 or more per share, A cannot deduct the in lieu of dividend payment unless he waits for 1 year and a day after the date of the short sale before closing it. If the sale is closed before these respective waiting periods, the in lieu of dividend payment is added to the basis of the stock used by A to close the sale. This will probably result in a short-term capital loss. If at any time after the short sale, A holds a long position in the stock, the 45 day (1 year) period is suspended until A divests himself of such position. The period is also suspended if A holds any position in "substantially similar or related property," as that term will be defined in regulations.

Query: Would the granting by A of a put option on the stock be considered as placing A "under a contractual obligation to buy" the ABC stock? Probably not. In

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§246(c), the holding period is suspended where the shareholder is "under a contractual obligation to sell" [31] the stock. But the statute also provides for suspension where the taxpayer" is the grantor of an option to buy substantially identical stock or securities.[32] The first described position apparently does not include the second.

As was noted in the Overview, where the seller receives rebate fees, the in lieu of dividend payments are deductible to this extent irrespective of the holding period of the stock used to close the short sale, so long as such rebate fees are treated as ordinary income.[33] There is no requirement that the rebate fees be included in gross income in the same year that the in lieu of dividend payments are made, but the fees and payments must relate to the same short sale. This exception does not apply to payments in lieu of extraordinary dividends.[34] To be able to deduct such payments, regardless of the amounts of any rebate fees payable, the stock used to close the short sale must be held for more than one year (during which time there must be no other holdings suspending the holding period).

C. Investment Interest Includes in Lieu of Dividend Payments

For purposes of §163(d), restricting the amount of investment interest deductible during the taxable year, in lieu of dividend payments allowable as deductions are treated as payments of interest, analogizing the borrowing of stock in connection with a short sale to the borrowing of money, and the payment of in lieu of dividend payments as a charge for the use of money.[35] In the case of the lending broker who retains the sale proceed as collateral, there would appear to be no question that the rebate fees paid the short seller are interest; no statutory provision was needed for this purpose. Where the in lieu of dividend payments are not deductible by reason of §263(h), they are not considered to be "investment interest" for §163(d) purposes.

D. New Section 265(5)

In accordance with the view that payments in lieu of dividends are in economic effect closely similar to interest where the short sale proceeds (even though imprisoned as collateral) are used to generate investment income, new §265(5) provides that such payments are to be taken into account as "interest" in applying the provisions of §265(2) denying deductions for interest on indebtedness incurred or continued to purchase to carry tax-exempt securities. These provisions apply whether or not the in lieu of dividend payments are otherwise deductible, *i.e.*, do not have to be capitalized under the general rule of §263(h) and added to the basis of the stock used to close the short sale. Thus, a taxpayer holding tax exempt bonds who enters into a short sale and who makes any in lieu of dividend payments in connection with such sale may not be allowed to deduct such payments irrespective of the time the short sale was closed. Treatment of in lieu of dividend payments as interest for purposes of §265(2) is unrelated to the tax abuse which §263(h) was enacted to counter. By the same token, payments by a broker of rebate fees in connection with collateral on deposit with him is to be treated the same as interest on loans taken out for purposes of investment, as distinguished from loans made in connection with services rendered to customers. Such fees are to be taken into account in applying the formula noted above for determining the portion of the broker's total interest expenditures during the taxable year attributable to the purchase or carrying of tax-exempt securities.

These amendments to §265(5) will not apply to a taxpayer who has deposited cash collateral with the lending broker and receives no material earnings on such cash while the short sale remains open.[36] The in lieu of dividend payments lose their interest-like character where the taxpayer derives no income from the sale proceeds.[37]

In some instances, the seller may, in lieu of cash, post with the broker securities as collateral. Interest on these securities belongs, of course, to the seller. Such an arrangement releases the short sale proceeds to the seller who may then use them as is seen fit. If these are used to purchase tax-exempt securities, or if tax-exempt securities are used as collateral, the analogy of in lieu of dividend payments to interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds is more clearly perceived. But such direct connection between the short sale and the generation of tax-exempt interest is not necessary for the provisions of §265(2), as supplemented by §265(5) to apply.

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[1] The term is *used* in the Code, *e.g.*, the provisions of §1233 where it refers to the short sale of stock, securities and commodity futures. §1233(e)(2).

[2] The broker may be, and often is, also the lender's broker.

[3] Rev. Rul. 72-521, 1972-2 C.B. 178, and Rev. Rul. 62-42, 1962-1 C.B. 133.

[4] Where a short sale is made by a dealer against the box and the stock held by such dealer is inventory, the gain or loss will be ordinary.

[5] In view of the amendments made by Act §1001(a) to §1222 shortening the long-term holding period to more than six months, short sale against the box may be expected to generate long term gain in more cases than formerly.

[6] §1233(b).

[7] Section 263(g)(2), as amended by Act §102(e), disallowing interest and carrying charges allocable to the positions of a straddle, provides that "interest" shall include amounts paid in connection with personal property used in a short sale.

[8] Payments in lieu of dividends are not considered "dividends" in the hands of the recipient for purposes of §§243-245. They are taxed as ordinary income.

[9] *See* Rev. Rul. 72-18, 1972-1 C.B. 740.

[10] Rev. Rul. 74-294, 1974-1 C.B. 71.

[11] §263(h)(1)(A) and (B)

[12] §263(h)(2).

[13] §1059(c)(1) and (2).

[14] §263(h)(4)(A) and (B).

[15] §263(h)(5)(A).

[16] §263(h)(5)(B).

[17] *See* chapter 27 for a discussion of amendments made by Act §§101-108 to tax straddle provisions of the Code, including §§1092 and 263(g).

[18] §263(g)(4)(A).

[19] §163(d)(3)(D)(ii).

[20] The 45 day (one year) period begins on the day *after* the short sale. To avoid §263(h), the taxpayer must wait until the period has expired before closing.

[21] *Id.*

[22] *E.g.*, stock of one corporation whose price is closely related to stock in another corporation due to a pending stock-for-stock exchange pursuant to a reorganization.

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[23] *See Hanlin v. Comr.*, 108 F. 2d 429 (3rd Cir. 1939); Rev. Rul. 77-201, 1977-1 C.B. 250, cited in S. Rep. No. 169, 98th Cong., 2d Sess., at p. 171.
[24] §246(c)(1).
[25] §246(c)(1)(B).
[26] *See also* §1092(d)(3)(B)(i)(I) and (III) (stock is "personal property" (for straddle purposes) where offset by a position (short) in "substantially identical stock or securities" or, under regulations, "substantially similar or related property (other than stock)."
[27] H.R. Rep. No. 861, 98th Cong., 2d Sess., at p. 818-819.
[28] *Id.*, at p. 827.
[29] However, as pointed out above, the positions referred to in §246(c) are short positions, whereas those referred to in §263(h) are long positions.
[30] In accordance with the Conference Committee's statements relating to the §246(c) amendments, *see* H.R. Rep. No. 861, cited above at p. 818.
[31] §246(c)(4)(A).
[32] §246(c)(4)(B).
[33] §263(h)(5)(A).
[34] §263(h)(5)(B).
[35] §163(d)(3)(D)(i), (ii).
[36] §265(5)(B).
[37] But where the seller satisfies the collateral requirement by depositing stock or securities (remaining entitled to any dividends or interest paid thereon) this exception will not apply irrespective of the use made by the seller of the short sale proceeds turned over to him.

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Chapter 11

AMORTIZATION OF START-UP EXPENDITURES AND CONSTRUCTION PERIOD INTEREST AND TAXES

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I. Amortization of Start-up Expenditures

A. Introduction and Summary

Under §162(a), a taxpayer is entitled to deduct ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business. Expenses incident to the investigation, creation, or acquisition of a business are not currently deductible, however, since at the time such expenses are incurred, the taxpayer is not yet engaged in the trade or business to which the expenses relate. Section 195 provides that business start-up expenditures may be amortized, at the election of the taxpayer, over a period of not less than 60 months beginning with the month in which the business begins. For this purpose, "start-up expenditures" include amounts (1) paid or incurred in connection with investigating the creation or acquisition of an active trade or business or creating an active trade or business, and (2) which would be allowable as a current deduction if paid or incurred in connection with the expansion of an existing trade or business in the same field as the business being investigated or created. Thus, capital expenditures and other costs that may not be deducted or amortized do not qualify as start-up expenditures.

Start-up expenditures are amortizable beginning with the month in which the newly acquired or created business begins. Thus, the taxpayer must in fact create or acquire a business in order to be able to amortize start-up expenditures. An acquired business is deemed to begin on the date it is acquired by the taxpayer. In general, the determination of when a newly created business begins is to be made with reference to the provisions for amortization of organizational costs in §§248 and 709.[1] Under these provisions, the determination is made based on the facts and circumstances of each case. The regulations and the Service take the position that a business will be considered to have commenced when operating assets have been acquired or completed and placed in service.[2] But the point at which a business begins for purposes of §195 amortization is not clearly delineated under current law.

Although the definition of start-up expenditures precluded amortization under §195 of capital expenditures, it is not clear whether a specific pre-opening cost should be expensed, or amortized as provided in §195. A taxpayer not electing §195 amortization could contend that start-up expenditures were currently deductible under §162 or §212.

B. Detailed Analysis

Section 195, as amended by §94 of the Act, provides that no deduction whatever shall be allowed for business start-up expenditures except as provided in §195.[3] Thus, unless the taxpayer elects to amortize such expenses in accordance with §195, the expenses must be capitalized regardless of whether or not they are properly chargeable to capital account. Presumably, the taxpayer will be permitted to amortize these expenditures over the life of the asset, if any, to which they relate.

The Act expands the definition of "start-up expenditures" to include not only costs incurred in creating or investigating the creation or acquisition of an active trade or business, but also those incurred in connection with any activity engaged in for profit and the production of income prior to the day the business begins, incurred in anticipation of such activity becoming an active trade or business.[4] According to the Finance Committee Report, this provision is intended to encompass rental payments under a ground lease covering land on which the taxpayer will construct and operate an office building.[5] The Act provides further that start-up expenditures allowable as deductions under §§163, 164 and 174 (*i.e.*, deductions for interest, taxes and research expenditures, allowable without regard to whether they were incurred in a business context) will not be treated as start-up expenditures for purposes of §195 amortization.[6]

If a taxpayer completely disposes of a trade or business prior to the end of the amortization period, any start-up expenditures that have not been amortized are deductible as losses to the extent permitted under §165.[7] It is not clear whether the option to deduct unamortized expenditures under §165 extends to expenditures as to which the taxpayer did not make an election under §195, *i.e.*, expenditures required to be capitalized. The Senate Report suggests that upon disposition of the business, only amounts remaining to be amortized on the schedule selected by the taxpayer can be deducted as losses under §165.[8]

The Act states that the determination of when a newly-created trade or business begins shall be made in accordance with such regulations as the Treasury may prescribe.[9] The Treasury therefore has been accorded great latitude in determining when the amortization period will be deemed to have commenced. The standard ultimately adopted, however, will probably resemble the test developed for purposes of §§248 and 709.

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C. *Effective Date*

The §195 amendments will apply to taxable years beginning after June 30, 1984.

II. Modification of Rules Governing Construction Period Interest and Taxes

A. *Background*

Section 189 requires the capitalization of interest and taxes paid with respect to real property during the period in which the property is under construction. Under preexisting §189(d), this general capitalization requirement did not apply to residential real property acquired, constructed or carried by a corporation (other than an S corporation, a personal holding company or a foreign personal holding company). The term "residential real property" was defined as property that is residential rental property (§167(j)(2)(B)) or dwelling units (§167(k)(3)(C)) held as inventory assets.

B. *Expansion of §189 Coverage*

The Senate Report on the Act states that an allowance for expensing of construction capital interest and taxes is at odds with the principle that expenses incurred in improving or constructing property with an extended useful life should be capitalized as part of the cost of the property.[10] Accordingly, §93 of the Act eliminates the exemption from amortization requirements for corporations.

By technical correction to the Tax Equity and Fiscal Responsibility Act of 1982, §712(c) of the Act expands the definition of residental real property under §189(e) to include real property held by a cooperative housing corporation and used for dwelling purposes.

C. *Effective Date*

The extension of §189 to corporations applies to taxable years beginning after December 31, 1984 with respect to construction beginning after March 15, 1984. The inclusion of cooperative housing corporation property is effective as of July 18, 1984, the date of enactment.

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[1] S. Rep. 1036, 96th Cong., 2d Sess. 14 (1980).

[2] *See* Regs. §§1.248-1(a)(3); 1.709-2(c); Rev. Rul. 81-150, 1981-1 C.B. 119.

[3] §195(a).

[4] §195(c)(1)(A)(iii).

[5] S. Rep. 169, 98th Cong., 2d Sess. 282-83 (1984). The Report cites *Hopengarner v. Comr.*, 80 T.C. 538 (1983) (rents paid prior to completion of office building not deductible under §162).

[6] §195(c).

[7] §195(b)(2).

[8] S. Rep. No. 98-169, 98th Cong., 2d Sess. 283 (1984).

[9] §195(c)(2)(A).

[10] S. Rep. No. 169, 98th Cong., 2d Sess. 280 (1984).

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CHAPTER 12

MISCELLANEOUS AMENDMENTS AFFECTING DEDUCTIONS

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I. Percentage Depletion for Secondary and Tertiary Production [Act §25(b)]

A. *Introduction*

1. *General*

In the Tax Reduction Act of 1975, Congress severely restricted the availability of the percentage depletion deduction. For crude oil and natural gas, the principal exception to this change is the exemption for independent producers and royalty owners provided by §613A(c), which retains the percentage depletion allowance for limited quantities of oil and gas production. Section 613A(c)(1) allows percentage depletion at a rate, effective January 1, 1984, of 15 percent. Prior to the Tax Reform Act of 1984, §613A(c)(6) continued the percentage depletion allowance for secondary and tertiary oil production at a 22 percent rate, but only through December 31, 1983.

The continued availability of percentage depletion is generally limited to, after 1980, a maximum of 1,000 barrels per day. Prior to the Tax Reform Act of 1984, if a taxpayer had both primary production and secondary and tertiary production, then the 1,000 average daily barrel maximum was first allocated to secondary or tertiary production of crude oil.

Example: Assume that in 1983, taxpayer had daily secondary or tertiary production of 100 barrels per day, and an average primary production of 1,100 barrels per day. The 22 percent rate would apply to the 100 barrels per day of secondary and tertiary production, and the 15 percent rate would apply to 900 barrels per day of the primary production (1,000 barrel per day maximum less 100 barrel secondary or tertiary production).[1]

2. *Transfer of Certain Oil and Gas Properties*

Section 613A(c)(9) denies the exemption for independent producers and royalty owners to a transferee in a transfer of a proven oil or gas property after December 31, 1983. If certain transfer restrictions are met, however, in limited cases cost depletion remains available to the transferee.[2] Proposed Treasury regulations, issued May 13, 1977, stated that the transfer restrictions would not apply to transfers of secondary and tertiary production property, and percentage depletion would be available with respect to such production regardless.[3]

B. *Overview*

1. *Summary of Amendments*

The Tax Reform Act of 1984 eliminates the distinction between primary and secondary or tertiary production after 1983. Thus, independent producers may claim percentage depletion in 1984 at a rate of 15 percent on up to 1,000 barrels of all their production.

In addition, starting in 1984, percentage depletion on secondary and tertiary production will not be available after 1983 for production from crude and properties transferred since 1974 unless one of the exceptions provided for in §613A(c)(9) applies to the transfer.

2. *Effective Date*

The amendments are effective January 1, 1984.

C. *Detailed Analysis*

1. *Availability of 15 Percent Percentage Depletion Deduction for Post-1983 Secondary and Tertiary Production*

Section 613A(c) allows percentage depletion on so much of the taxpayer's average daily production of crude oil and natural gas as does not exceed the taxpayer's "depletable quantity."[4] Generally, the taxpayer's average daily production of domestic natural gas or crude oil for any taxable year is determined by dividing the aggregate production of crude oil or natural gas, as the case may be, during the taxable year, by the number of days in the taxable year.[5] Certain partial interests of the taxpayer are also included according to the taxpayer's percentage participation in revenues.[6] Prior to the Tax Reform Act of 1984, production of crude oil or natural gas from secondary or tertiary processes[7] was excluded from the calculation of average daily production.[8]

The "depletable oil quantity" equals the so-called "tentative quantity", which after 1980, is 1,000 barrels per day, minus the taxpayer's average daily secondary or tertiary production for the taxable year.[9]

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This depletable oil quantity is somewhat of a misnomer, as the exemption effectively applies to 1,000 barrels of average daily production of domestic crude oil, or, at the election of the taxpayer, to 6,000 cubic feet of average daily production of natural gas multiplied by the number of barrels of the maximum 1,000 barrel amount that the taxpayer chooses to apply to natural gas production. The depletable oil quantity for the taxable year is reduced by the number of barrels elected to apply to natural gas production.[10]

Through 1983, §613A(c)(6) provided a 22 percent depletion allowance for secondary and tertiary oil. The production which qualified under this more liberal provision reduced, barrel for barrel, the 1,000 barrel per day quantity for which the normal 15 percent rate was available. Thus, a taxpayer with 1,000 barrels of tertiary or secondary production in 1983 would be entitled to no depletion deduction under §613A(c)(3).

However, §613A(c)(6)(C) terminated the availability of the 22 percent rate for secondary and tertiary production after December 31, 1983. It was argued that, despite the unavailability of the deduction for secondary and tertiary production, such production would nonetheless continue to reduce the average daily primary production through the operation of §613A(c)(3)(A)(ii).

> *Example*: Assume that in 1984, taxpayer again had daily secondary or tertiary production of 100 barrels per day, but an average primary production of only 1,000 barrels per day, rather than 1,100 as in 1983. The 22 percent rate of percentage depletion would no longer apply to the 100 barrels per day of secondary and tertiary production, while the 15 percent rate would apply to only 900 barrels per day of the primary production.

To remedy this apparent oversight, §25(d) of the Tax Reform Act of 1984 amends §613A(c)(2) to provide that, in determining a taxpayer's average daily production, production of crude oil or natural gas resulting from secondary or tertiary processes shall no longer be excluded. In effect, this removes the distinction between primary, and secondary and tertiary production, so that, beginning in 1984, a 15 percent percentage depletion deduction is also available on secondary and tertiary production. Of course, the 1,000 average daily barrel maximum remains in effect.

A conforming amendment to §613A(c)(3)(A) provides that the reduction required in subparagraph (ii) is inoperable after December 31, 1983.[11] A similar amendment is made to subparagraph (E) of §613A(c)(7), which generally provides special rules for the allocation of percentage depletion among properties if the taxpayer's average daily production of crude oil exceeds 1,000 barrels.[12]

2. Applicability of §613A(c)(9) Transfer Restrictions to Transfers of Secondary and Tertiary Production Property

Section 613A(c)(9) generally provides that in the case of a transfer after December 31, 1974 of an interest in a proven oil or gas property, percentage depletion available pursuant to §613A(c)(1) (relating to percentage depletion for primary production) shall not be available with respect to production of crude oil attributable to such interest, and such production shall not be taken into account for any computation by the transferee.

Several transfers are excepted from this rule, including:

(1) transfers of property at death;

(2) certain transfers in an exchange to which §351 applies;

(3) certain changes of beneficiaries of a trust by reason of the death, birth or adoption of any vested beneficiary;

(4) transfers of property between corporations which are members of the same controlled group of corporations;

(5) transfers of property between business entities which are under common control or between related persons in the same family; and

(6) certain transfers of property between a trust and related persons in the same family.[13]

That the general rule denying a transferee percentage depletion was not intended to apply to percentage depletion for secondary or tertiary production, pursuant to §613A(c)(6) is apparent from Prop. Regs. §1.613A-3(h), example 4, which states:

> *"Example (4)*: On January 1, 1975, property which produces oil resulting from secondary processes was transferred to D. The exemption under §613A(c) applies to D because §613A(c)(9) (relating to transfers of oil and gas property) does not apply with respect to secondary production. In addition, even if at the time of transfer the production from the property was primary and D applied secondary processes to the property transferred and obtained secondary production, D would be entitled to percentage depletion with respect to the secondary production."

Because the distinction, for purpose of the availability of percentage depletion deductions, between primary production and secondary or tertiary production has been eliminated, transfers of secondary or tertiary production property are subjected to the restrictions of §613A(c)(9). This is accomplished by amending §613A(c)(9)(A) to render it applicable to §613A(c) in its entirety.[14]

II. Cutback in Corporate Tax Preferences and Technical Changes

The 1984 Act generally increases the 15-percent preference cutback to 20 percent. The benefits of the new FSC legislation in the Act will be reduced by 6¼ percent in the case of a corporate FSC shareholder. The cutback in the depletion allowance for coal and iron ore remains unchanged. The 71.6 percent preference inclusion rule for the add-on minimum tax will be decreased to 59 5/6 percent. In addition, certain technical changes are made in order to clarify TEFRA.

III. Deduction for Golden Parachute Payments Limited

Included among the corporate tax reform provisions of the Tax Reform Act of 1984 (TRA) are rules designed to

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discourage so-called "golden parachute" arrangements under which excessive severance payments are made to corporate executives to ease their fall from corporate power. These new rules deny the corporation any deduction for excessive golden parachute payments, and subject the payments to a nondeductible 20 percent excise tax, in addition to income and Social Security taxes. Because these rules define an "excess parachute" by totalling payments under all contracts that either: (1) make payments contingent on a takeover; or (2) are entered into within a year prior to takeover, and then subtracting "reasonable" compensation, they will apply to a surprising number of corporate takeover situations, irrespective of whether the acquired company is publicly or privately held. The golden parachute rules thus require careful study not simply because of their effect upon recognizable golden parachute termination pay, but also because of their interaction with traditional compensation and retirement arrangements.

The TRA rules were criticized by the tax bar and opposed by the Treasury Department as an unnecessary incursion by the federal tax laws into an area more effectively addressed by either federal securities laws or state law limitations on corporate waste. Even as these criticisms were being voiced, the golden parachute provisions were being expanded rather than limited. As finally enacted, these provisions will create considerable work for compensation advisors, by requiring proof that many payments swept into a "parachute" are nonetheless reasonable compensation, thereby allowing the deduction to the paying corporation and exempting the payments from the 20 percent excise tax.

For a detailed analysis of the golden parachute provisions, *see* Chapter 32, V, *infra.*

IV. Ten Year NOL Carryback Period for Deferred Statutory or Tort Liability Deductions [Act §91d]

A. Introduction

Section 172 provides a deduction for net operating losses sustained by corporate and individual taxpayers.[15] "Net operating loss" is defined [16] as the excess of deductions allowed by "this chapter" [17] over gross income.

When a net operating loss has been established, it generally may first be carried back as a deduction to the third preceding taxable year, with the excess then carried to the second preceding taxable year and finally to the immediately preceding taxable year. If an unused portion of the deduction still remains after this computation, it can be carried forward to the first succeeding taxable year, and so on, until the 15th succeeding year is reached. Any excess still unused at that point expires unused. Any taxpayer wishing to do so may, pursuant to §172(b)(3)(C), elect to forego the three year carryback and proceed directly with the 15 year carryforward. Such an election is irrevocable for that taxable year.

The carryforward/carryback rules apply in general to net operating losses incurred in taxable years ending after December 31, 1975.[18] Special exceptions to the rules have been enacted by Congress with respect to net operating losses in the case of foreign expropriation losses [19] (10 year carryforward); Cuban expropriation losses [20] (20 year carryforward); a REIT net operating loss [21] (15 year carryforward, but no carryback); certain financial institutions, including commercial banks and savings and loans associations [22] (5 year carryforward and 10 year carryback); banks for cooperatives organized and chartered under the Farm Credit Act of 1933 [23] (5 year carryforward and 10 year carryback); the Federal National Mortgage Association to the extent the net operating loss exceeds the FNMA mortgage disposition loss [24] (5 year carryforward and 10 year carryback); certain product liability losses [25] (10 year carryback, no carryforward); and general stock ownership corporations [26] established under §1391 (10 year carryforward, no carryback).

B. Overview

1. In General

Section 91(d) of the 1984 Act creates yet another special exception to the general three year carryback and 15 year carryforward rules. In the case of deferred statutory or tort liability losses, §172(b)(1)(k) [27] provides for a 10 year net operating loss carryback for losses in taxable years beginning after December 31, 1983.

The term "deferred statutory or tort liability loss" is defined as the *lesser of* (a) the net operating loss for the taxable year reduced by a foreign expropriation loss or a product liability loss; or (b) the sum of the amounts allowable as a deduction [28] which is taken into account in computing the net operating loss for the taxable year and is an amount incurred with respect to a liability arising under federal or state law or out of a taxpayer's tort (and in either case the liability arose because of an act or failure to act which occurred at least three years before the taxable year).[29] As a corollary to this three year requirement, the new section also requires that the taxpayer must have used the accrual method of accounting during the period in which his actions or failures to act caused the liability to arise.[30]

The new law coordinates treatment of the deferred statutory or tort liability loss with the computation of the amount of carrybacks and carryovers under §172(b)(2), by treating such a loss "in a manner similar to the manner in which a foreign expropriation loss is treated." [31]

Finally, the new section prevents carrybacks to any taxable year beginning before January 1, 1984, unless the loss may be carried back to that year regardless of the enactment of §172(b)(1)(k).[32]

2. Special Rule for Nuclear Power Plants

New §172(k)(2) provides a special rule applicable to the decommissioning of nuclear power plants. Where a portion of a deferred statutory or tort liability loss is attributable to amounts incurred in decommissioning a nuclear power plant (or a unit of a nuclear power plant), that decommissioning loss may be carried back to each taxable year in a period beginning with the year the plant or unit was placed in service and ending with the taxable year immediately preceding the loss year. The carryback rule is subject to modification by regulations issued by the Secretary of the Treasury.[33]

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C. *Detailed Analysis*

1. *In General*

Section 91(d), which creates the new deferred statutory and tort liability carryback, was enacted as part of the premature accruals section in the Accounting Changes portion of the Act. The accrual basis of accounting utilizes the matching principle. The matching principle requires recognition and matching of expense with the revenue to which it relates or arose regardless of when the cash is actually expended.[34] The accrual method as adapted for tax purposes under the "all events" test may not provide precise matching of expense with income in all cases, particularly when the liability for the expense is not fixed until several years after the commission of the act that eventually results in the liability. A statute or court judgment establishing liability may not arise, for example, until a number of years has elapsed after the act or omission that creates the liability. The Act's provisions enable accrual basis taxpayers to better match the approximate earlier periods when a deferred statutory and tort liability arose with the later period when settlement was made and paid, although exact matching may not be achieved. The new provision allows a carryback of the loss (subject to the limitation that the act or omission creating the liability occurred at least three years prior) for a liberal span of 10 years, so that matching is more likely to occur as a result. The Act enables qualified taxpayers to benefit from the net operating losses for taxable years beginning after December 31, 1983, and, in some cases,[35] to take an immediate carryback.

By definition the deferred statutory or tort liability loss consists of the lower of the net operating loss (reduced by product liability and foreign expropriation losses) or the sum of amounts taken into account in calculating the net operating loss for the year, but only to the extent that such amount is incurred with respect to a federal or state law liability or tort liability, either of which must have been the result of actions or ommissions occurring at least three years before the beginning of the taxable year.

Example: For 1984 Corporation Z has a net operating loss of $100x; a foreign expropriation loss of $20x and a tort liability of $70x for chemical waste injuries suffered by individuals. The "deferred statutory or tort liability loss" would be $70x since that is the lesser amount (the net operating loss $100x reduced by foreign expropriation loss $20x = $80x).

Comment: Had the acts or ommissions causing the chemical waste injuries occurred within the last three years, the $70x figure could not be used in calculating the "deferred statutory or tort liability loss."

Only a taxpayer who utilized the accrual method of accounting during the periods when tort or statutory liability was occurring through that taxpayer's acts or ommissions can take such a liability into account in determining the "deferred statutory or tort liability loss" figure under §172(k)(1)(B).

Comment: It is interesting to note that the special rules of §172(j) which apply to the 10 year carryback for product liability losses allowed by §172(b)(1)(I) do not require that the taxpayer have utilized the accrual method at the time the liability arose in order to qualify for the carryback. It is not clear what definitional distinction there is between a product liability loss and a tort liability or statutory liability and why the latter requires the accrual method during the earlier period while the former does not.

Section 172(k)(3) directs that in applying the carryback and carryforward rules of §172(b)(2), a "deferred statutory or tort liability loss" shall "be treated in a manner similar to the manner in which a foreign expropriation loss is treated." Under §172(b)(2) the taxable income of prior taxable years is calculated by determining the net operating loss deduction without regard to the portion of the loss, if any, attributable to the foreign expropriation loss, if it can not be carried back under §172(b)(1)(D).[36] Moreover, foreign expropriation losses are considered to be separate net operating losses for purposes of §172(b)(2), if §172(b)(1)(D) applies to such loss. Section 172(b)(3) provides special rules[37] for the application of the §172(b)(1)(D) 10 year carryforward provision. Presumably the language "treated in a manner similar to the manner in which a foreign expropriation loss is treated" means that the term "deferred statutory or tort liability loss" should be substituted wherever the term "foreign expropriation loss" appears in §172(b)(3).

Observation: If the above analysis is correct, better phraseology than "in a manner similar" could have been used. The vagueness of this phrase will surely lead to difficulties in construing the provision. Either language substituting one term for the other or precise instructions for applying the deferred losses under §172(b)(2) should have been put in place here.

Section 172(k)(4) prohibits the carryback of a deferred statutory or tort liability loss to a tax year beginning before January 1, 1984, unless it could otherwise be carried back under §172 rules without regard to the newly enacted §172(b)(1)(k) 10 year carryback. This apparently was enacted to give a mostly prospective application to the statute, since a loss which otherwise can be carried back obviously needs no additional provision to do so.

Comment: A limited three year carryback may be implicit in this provision, since, absent the enactment of the special 10 year carryback for deferred statutory and tort liability losses, the general rules of three years back and 15 forward apply to an otherwise qualifying loss.

2. *Nuclear Power Plant Decommissioning Losses*

Under federal and state law, utilities that operate nuclear power plants are obligated to decommission them at the end of their useful lives.[38] The Act sought to clear up uncertainties in the law as to when an accrual basis taxpayer should properly accrue decommissioning expenses.[39] As an ancillary matter, Congress provided for a carryback period beginning in the year a nuclear power plant (or unit thereof) was placed in service and ending in the taxable year preceding the loss year[40] with respect to that portion of deferred statutory or tort liability losses which are attributable to decommissioning expenses. This special rule is also subject to the prohibition contained in §172(k)(4) against carrying a deferred statutory or tort liability loss back to a year beginning before January 1, 1984 unless such loss can otherwise be carried back.[41]

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V. At-Risk Limitations for Certain Corporations Liberalized

Section 432 of the 1984 Act exempts certain activities of closely-held C corporations from the "at-risk" limitations of §465. To qualify for immunity from the at-risk rules, the corporation must satisfy a number of minimum activity requirements relating to the number of active employees and the amount of business expenditures attributable to each activity. The Act makes certain modifications in pre-existing at-risk rules relating to aggregation of activities (for purposes of computing income, loss and at-risk amounts) and liberalizes the treatment of funds borrowed by the taxpayer from related persons for use in an activity. The new provisions are discussed in detail in Chapter 24.

VI. Medical Expense Deduction Allowed for Certain Lodging Expenses [Act §482]

A. Introduction

The medical expense deduction [42] was enacted in 1942 to alleviate the extra burden of medical hardships on those taxed under wartime conditions.[43] Medical and dental expenses, as defined in §213(d), which are incurred and actually paid by the taxpayer on his own behalf, for his spouse and his dependents is deductible by him to the extent the amount exceeds a floor amount of 5 percent [44] of adjusted gross income.

The term "medical care" as defined under §213(d)(1) encompasses payments made in three areas: (a) generally for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (b) for transportation "primarily for and essential to" that medical care described above; and (c) for medical care insurance.[45] Attempts by taxpayers to deduct lodging expenses incurred in connection with transportation expenses have met with varying degrees of success.

Regs. §1.213-1(e)(1)(iv) provides that transportation expenses primarily for and essential to medical care does not include the costs of meals and lodging while away from home receiving medical treatment. The cases have tended to adopt a distinction between "in transit" expenses (allowed) and what might be called "on site" out-patient expenses (disallowed).

The Supreme Court in *Comr. v. Bilder* [46] disallowed an attempt by a taxpayer to deduct rental payments as medical expenses. There the taxpayer had suffered four heart attacks over an eight year period and was advised by his physician to spend the winter months in a warm climate. While the Service did allow his transportation costs for trips between Newark, New Jersey and Ft. Lauderdale, Florida,[47] it disallowed all of the rental payments on a Ft. Lauderdale apartment which he, his wife and daughter occupied for three months. The Court distinguished between food and lodging costs incurred while traveling to and from the site where medical treatment would be received and those same costs incurred while at the site,[48] the latter not being deductible according to the 1954 Code legislative history.[49]

"In transit" expenses, however, have been recognized as deductible where incurred while bringing a patient to the place of treatment. For example, in *Montgomery v. Comr.*,[50] the court allowed the taxpayers deductions for food and lodging while traveling from their home in Kentucky to the Mayo Clinic in Minnesota noting that the very liberal provisions of the 1939 Code predecessor [51] to §213 created significant abuses whereby patients would travel to resort areas on doctor's orders and then deduct all the costs of food and lodging while there on "medical vacations." [52] The court agreed with the *Bilder* Court that Congress in 1954 sought to reduce these abuses, but indicated a belief that Congress intended food and lodging expenses incurred while traveling, (which it conceded to be substantially higher than the cost of living at home), to be deductible.[53] The court also felt that Congress' use of the narrow term "transportation" in §213 instead of "travel" was indicative of its intent to exclude food and lodging expenses incurred after arrival at the place of treatment.[54]

The results have also been mixed where more than one person is involved in the transportation, as, for example a patient and parent or patient and spouse. The Service early recognized that if it were necessary for a parent to accompany a sick child on a trip to obtain medical care, the travel costs of both the parent and the child were deductible as medical expenses.[55] In Rev. Rul. 58-110,[56] the costs of transportation of both the taxpayer and his nurse were deductible where he was unable to travel by himself. However, courts have determined that failure to show necessity by the person accompanying the patient [57] or not being directed to take the trip by a physician will preclude deduction of such costs.[58]

The issue of whether food and lodging expenses may be deducted when incurred in on-site out-patient treatment (*i.e.*, if incurred other than as part of the hospital bill) [59] has been uniformerly decided against the taxpayer. In *Foyer v. Comr.*,[60] the trips by the taxpayer and his wife to Arizona and Hawaii were made without the direction or suggestion of the wife's physician and the cost of their food and lodging at each location was held to be a personal expense rather than a medical expenses.[61] However, even where the trip was made at a doctor's direction, the deduction was disallowed where the lodging was at a motel rather than a hospital or similar facility, as the court *in Rose v. Comr.*,[62] determined.

In the *Rose* case, the New Orleans taxpayers' daughter was severely affected by bronchial asthma caused by household dust. When efforts to make her room at home dust-free failed, the daughter, accompanied by her mother and later her physician father, went to a motel in Florida where the family had stayed previously. After a two week's stay the daughter returned to school in New Orleans and lived, with her mother, in a high rise apartment adjacent to a hospital, in order to both cut exposure to dust and to be close to a hospital. At the end of the year the daughter and mother flew to Arizona so that the daughter could attend an outpatient clinic for asthmatics while they lived at a motel.

The taxpayer unsuccessfully argued that the motel rooms in each location as well as the rented apartment in New Orleans were substantially equivalent to hospital or institutions and that the wife's activities in injecting the

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daughter with allergy medicines made her a quasi-nurse whose expenses were also deductible.[63] The Tax Court ruled that the motel rooms were not any more hospital-like than other motel rooms and that the equipment, such as nebulizers, were portable and insufficient to create a hospital-like environment.[64] With regard to the rented apartment, the court noted:

> "It is the nature of the services rendered as medical care, its therapeutic nature to the individual, that determines whether or not it qualifies for deduction under §213, not the location of the facility." [65]

The court also disallowed the transportation and living expenses of the husband for his trip to Florida, since his presence was not shown to be required or directed by the daughter's physician.[66]

Similarly, where the parent of a patient goes to visit that patient in a distant location, as opposed to accompanying him there, the expenses for food and lodging while there are not deductible. In *Hunt v. Comr.*,[67] the taxpayer went from Florida to visit her son who was being treated at the Meninger Clinic in Topeka, Kansas. The Tax Court disallowed her lodging and food costs while on that visit.

B. Overview

1. Certain Lodging Expense Deductible as Medical Care

Section 482 of the Act amends subsection (d) of §213 by adding a new paragraph (2) which provides that amounts paid for lodging while away from home on a trip which is primarily for and essential to medical care (as defined in §213(d)(1)) are deductible as medical care if (a) the medical care is provided by a physician in a licensed hospital (or equivalent facility) and (b) there is no significant element of personal pleasure, recreation or vacation in the travel away from home.

The new law allows this treatment only for lodging expenses which are "not lavish or extravagant under the circumstances" and limits the per diem allowance to "$50 for each night for each individual." It requires that the medical care be provided by a physician in a licensed hospital or in a medical care facility related to a licensed hospital, or in a medical care facility which is the equivalent of a licensed hospital.

Observation: The equivalency requirement set up by the bill may be a reaction to Dr. Rose's attempt to equate a motel room with a hospital room.[68]

2. Effective Date

This amendment applies to taxable years beginning after December 31, 1983.

C. Detailed Analysis

1. Lodging Expenses

This provision narrowly expands the old rule concerning deductibility of expenses incurred on-site as an outpatient by allowing the lodging expenses to be treated as medical care [69] while continuing to disallow food expenses.[70] The Senate, in particular, recognized that either specialized care or the availability of better care in other locations cause patients to travel away from home to receive medical care.[71] Convenience of specialized treatment, (*e.g.*, chemotherapy), which may be given at a hospital-related facility on a less expensive out-patient basis, was one factor leading to the change.[72] The older cases and rulings which recognized the need for a non-patient to accompany the patient were also adopted in the law, which allows lodging expenses for the non-patient.

Comment: It is not clear whether, for example, more than one parent may accompany a sick child, since the section only places a cap on the amount spent per person per night. Dr. Rose, *Rose v. Comr., supra,* attempted to take his own, his wife's and his sick child's food and lodging as deductions, although the court found no reason for Dr. Rose to accompany the other two.[73] As alluded to above, the nature of the facility must be "related to, or the equivalent of" a licensed hospital, so that the result in *Rose* with respect to the motel room would still obtain. The daughter's attendance at the out-patient clinic in Arizona, however, would result in a deduction for her lodging and her mother's.

The section places three limits on the amount which can be deducted. The first is that the lodging itself be "not lavish or extravagant under the circumstances." The second is a specific $50 per night, per person *per-diem* cap. The *per-diem* cap was intended to aid the Service in administering the section in cases where the distinction between travel for medical care and that for vacation was not clear.[74] Finally, the law prohibits the deduction if there is a significant element of personal pleasure, recreation or vacation in the travel. Taken together, the law appears to allow travel to resort areas, with some incidental personal enjoyment by the patient and/or non-patient, if the bill is kept to under $50.00 per day per person. Since resort areas, most typically Florida, Arizona and Hawaii, are also the areas to which patients have traditionally been sent for climatological changes, the law neatly allows those types of states to maintain their specialized medical facilities while not stemming vacation traffic.

2. Application of the Law

In most of the cases described above in A, the lodging deduction would be allowed for "on site" expenditures, as well as for "in transit" expenditures (already allowed along with food expenses). In fact, the Senate Report specifically stated that lodging expenses "on site" should only be deductible if the patient or non-patient could deduct transportation expenses while "in transit." [75]

Medical care facilities, including particularly out-patient facilities, are included under the law. Clearly a visiting parent such as in *U.S. v. Hunt, supra,* still may not deduct lodging expenses, if his or her presence is not necessary for the care of the patient. The multiple month lodging in a warmer climate is less clearly deductible, although if done at a qualifying facility and with the prescribed limits, it arguably is deductible.

Some possibilities for abuse still exist. Apparently, a patient choosing discretionary minor surgery, such as cosmetic surgery, could deduct lodging costs at a resort location as long as the medical facility requirement was met and the vacation or entertainment portion of the trip was minimized.[76]

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VII. Changes Affecting the Casualty Loss Deduction [Act §§711(c) and 1051]

A. Introduction

1. The Coordination of §165(h) with §1231

Section 165(a) of the Code provides for a casualty loss deduction for any loss sustained during a taxable year which is not compensated for by insurance or otherwise. Non-trade or business losses are deductible under §165(c)(3) only if arising from fire, storm, shipwreck, or other casualty, or from theft, except as provided in §165(h). Individual casualty losses can only be deducted to the extent that they exceed a $100 base amount under subsection (h).[77]

Due to Congress' concern that the casualty loss deduction offset a higher percentage of losses for higher bracket than for lower bracket taxpayers, plus a realization that the lower bracket taxpayers were less able to purchase insurance coverage for their assets,[78] the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) included a provision which allowed non-business casualty losses to be deducted only to the extent that total casualty losses exceeded 10 percent of adjusted gross income.[79] The effect of this new provision was to require the taxpayer to first subtract $100 from each separate casualty loss, add up those netted losses and then deduct the total to the extent that it exceeded the 10 percent floor.[80]

The gain or loss from non-trade or business (personal) theft and casualties was subject to the netting rules of §1231. Under the post-TEFRA law, all involuntary conversions, whether trade or business, for capital assets held for more than 12 months or a personal casualty, are subject to §1231 treatment. If casualty losses exceed casualty gains they are treated as ordinary gains and ordinary losses. If casualty gains exceed losses, they are treated as §1231 gains and losses and aggregated with other non-casualty and theft §1231 gains and losses. If the aggregated amount constitutes a net gain, the treatment is long-term capital gain.

If the netted amount is a loss, the treatment is ordinary gain and loss. The non-corporate taxpayer then uses these ordinary gains and losses in one of two ways. If he is self-employed, and incurs the loss in his trade or business, is an outside salesman, or if he has rental or royalty income,[81] the loss is deducted above the line in arriving at adjusted gross income. In all other cases, including the personal (non-trade or business) casualty loss, it is taken as an itemized deduction.

In determining adjusted gross income, the capital gains deduction was allowed under §1202. Where the recognized gains from casualty losses exceed recognized losses, the capital gains deduction may depend on the amount of casualty loss allowed as a deduction, thus affecting the adjusted gross income. Due to this circular computation problem, the casualty loss deduction was sometimes not mathematically determinable.[82]

2. Disaster Loss Treatment

Under §165(i), a taxpayer who sustains a disaster loss in an area later determined by the President of the United States to be entitled to assistance under the Disaster Relief Act of 1974 may elect to claim the loss in the immediately prior taxable year. The 10 percent floor rule discussed above also applies to non-business type losses taken under this section. A special transitional rule [83] applies so that the 10 percent floor applies to the taxpayer's last tax year ending before 1983.

Because of the nature of some casualty losses, no loss was allowed for damage inflicted on residences by such disasters, which resulted in state or local government relocation or demolition orders.

B. Overview

1. Coordination of §165(h) to §1231

Section 711(c) of the 1984 Act amended both §§165(h) and 1231 of the Code to provide that for purposes of the 10 percent floor on nontrade or business casualty loss deductions, adjusted gross income will be determined for taxable years beginning after 1983 without application of §1231 to the involuntary conversion gains or losses resulting from casualty or theft.

For taxable years beginning after December 31, 1983, §165(h) has been amended to provide that if recognized gains exceed recognized losses in non-trade or business transactions, the losses will not be subject to the floor amount of 10 percent of adjusted gross income.[84] To the extent that recognized losses exceed recognized gains, however, the general rule of §165(h)(2)(A) is that such losses are only allowed to the extent of the sum of gains for that taxable year, plus the amount by which the excess exceeds the 10 percent floor amount. In those cases, the deduction for personal casualty losses for any taxable year must be treated as a deduction allowable in computing adjusted gross income to the extent such losses do not exceed personal casualty gains for the taxable year.[85]

> *Example*: Taxpayer A has $100,000 of adjusted gross income (without regard to §165(c)(3) casualty gains and losses), $50,000 of such casualty gains and $40,000 of such casualty losses (after applying the $100 floor amount) for that taxable year. All the taxpayer's personal casualty gains and losses will be treated as capital gains and capital losses. The 10 percent adjusted gross income floor does not apply.[86]

> *Example*: Taxpayer B has $100,000 of adjusted gross income as above, $50,000 in casualty gains and $70,000 in casualty losses. The gains and losses are all treated as ordinary; $60,000 of the casualty losses are allowed as a deduction. This is calculated by first taking the losses to the extent of gains ($50,000). Then the floor amount of adjusted gross income is taken (10% of $100,000 = $10,000). This figure is subtracted from the remaining loss not yet taken ($70,000 - 50,000 = $20,000 - $10,000 = $10,000). The result ($10,000) is added to the initial allowed loss ($50,000) to equal $60,000.[87]

The Act also provides a special rule for determining adjusted gross income in the cases of estates and trusts. The rule states that a trust or estate's adjusted gross income is computed in the same manner as an individual's adjusted gross income, except that deductions for costs paid or incurred in connection with the administration of the trust or estate are allowable deductions.

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Section 1231(a) is also rewritten for taxable years beginning after December 31, 1983, to coordinate it with the changes made in §165(h).

The definition of "§1231 gain" was changed in new §1231(a)(3)(A)(ii)(II) to include, for involuntary conversion purposes, capital assets held for more than six months if they are used in a trade or business or in a for-profit transaction. Similarly, the rule (in the last sentence of former §1231(a)) that §1231(a) would not be applied to the involuntary conversion of trade or business property or capital assets held more than one year (now six months) if recognized losses exceed recognized gains, has been amended, with respect to capital assets, to apply only to those held in connection with a trade or business or a transaction entered into for profit.[88] Moreover, the same treatment is applied for purposes of former §1231(a)(2) which now treats losses of capital assets from partial or total destruction, theft, seizure or condemnation as losses from compulsory or involuntary conversion only if they are held in connection with trade or business or a for-profit transaction.[89] The net effect of these provisions is that capital assets not held for the requisite holding period and either used in a trade or business or in a transaction entered into for profit, will not be §1231 property. Therefore, property subject to the personal casualty loss, which is by definition not used in a trade or business, will no longer be subject to §1231 treatment, and must be netted separately from §1231 gains and losses.

2. Disaster Loss Deduction for Condemned Residences

Section 1051 of the 1984 Act creates a new subsection (k) in §165.[90] This provision grants relief to taxpayer owners of residences which have been rendered unsafe by a disaster in an area determined by the President to warrant assistance under the Disaster Relief Act of 1974 by treating the demolition or relocation of such residence as a disaster loss under §165(i). In order to qualify for this treatment, (a) the residence must be rendered unsafe for such use by reason of the disaster, (b) the area has to have been declared a disaster area by the President and (c) the taxpayer must have been ordered by his state or local government to relocate or demolish the residence no later than the 120th day after the President's determination.

The law applies to taxable years beginning after December 31, 1981, with respect to residences in areas determined to warrant Federal disaster relief after that date. Because of the treatment of the demolition or relocation as a casualty loss under §165(i), the taxpayer may elect, under that subsection, to deduct the loss in the immediately preceding taxable year from the year in which the demolition or relocation order was made.[91]

The purpose of an earlier version of the law was to grant relief to those taxpayers forced to demolish or relocate residences due to mudslides, earthslides or flooding. In the interests of fairness, it was felt that a deduction should not be allowed for a taxpayer whose home was physically destroyed but not to an adjoining taxpayer whose home was rendered uninhabitable by the same disaster.[92] Although this aspect of the earlier bill was retained, no change was made to remedy the problem posed by collusive condemnations or buildings subject to pre-existing unsafe conditions but unaffected by the disaster, which are condemned or relocated by government order.[93] Presumably, the Service could deal with this problem by regulation.

VIII. Allocation of Expenses to Parsonage Allowance [Act §1052]

A. Introduction

In January 1983 the IRS issued Rev. Rul. 83-3,[94] which held that itemized deductions for mortgage interest and real estate taxes taken by ministers of the gospel for their residences must be reduced to the extent the expenses are allocable to the tax-free rental allowance received from the church. The Ruling was given application from July 1, 1983, except that it was not to apply until the earlier of January 1, 1985, or the date on which the minister no longer occupies a home, in the case of a minister who owned or occupied a home before January 3, 1983, or had a contract to purchase a home before that date and subsequently owned and occupied that home. Other provisions of the Ruling dealt with various educational expense deductions.

B. Overview

Section 1052 of the Act precludes application of the deduction disallowance created by Rev. Rul. 83-3 until January 1, 1986. No other portion of the Ruling is affected by this delay.

C. Detailed Analysis

The Senate Report indicates that Congress felt that the ministers and their church employers should be given an extra year in which to adjust the minister's compensation or the housing allowance to allow for the loss of the previously double tax benefit permitted by the IRS.[95] Earlier versions of the provision added the same delay period as applied to the tax-free housing allowances received by members of the Armed Forces, in response to the IRS's announced intention to study the members' entitlements to deduct interest and real estate taxes.[96] The final version, however, deleted this language.

IX. Disallowance of Deductions for Demolishing Historic Structures

A. Background

Prior to TRA, §280B disallowed otherwise permissible deductions to the owner or lessee of a certified historic structure for amounts expended for, or losses sustained on account of, the demolition of the structure. These amounts were to be treated as properly chargeable to capital account with respect to the underlying land. Under prior law, the provision was to lapse with respect to demolitions commencing after December 31, 1983.

B. TRA Amendment

The Act extends the disallowance of demolition expenses and losses to all structures on a permanent basis, effective with respect to taxable years beginning after December 31, 1983.

It should be noted that the Senate Bill (which the Conference Agreement purports to follow) called for the moratorium to apply to *demolitions* commencing after

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December 31, 1983. Under the TRA amendment (which is effective for *taxable years* beginning after December 31, 1983), a taxpayer with a taxable year ending after that date should be able to claim deductions for demolition expenses and losses (including those attributable to certified historic structures) incurred prior to the end of its taxable year. This "window" for demolitions occurring after December 31, 1983, but before the end of the taxable year, appears to have been left open inadvertently by the conferees.

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[1] §613A(c)(3)(A).
[2] §§613A(c)(9) or (10)
[3] Regs. §1.613A-3(h), example 4.
[4] §613A(c)(1)(A) and (B).
[5] §613A(c)(2)(A).
[6] §613A(c)(2)(A).
[7] *See* Prop. Regs. §1.613A-7(k) for definition of "secondary or tertiary production."
[8] §613A(c)(2)(flush language).
[9] §613A(c)(3).
[10] §613A(c)(4).
[11] TRA §25(b)(2).
[12] TRA §25(b)(3).
[13] §613A(c)(9)(B).
[14] TRA §25(b)(4).
[15] §172(a).
[16] §172(c).
[17] Chapter 1, Normal Taxes and Surtaxes, Internal Revenue Code.
[18] §172(b)(1)(B).
[19] §172(b)(1)(D).
[20] *Id.*
[21] §172(b)(1)(E).
[22] §172(b)(1)(F).
[23] §172(b)(1)(G).
[24] §172(b)(1)(H). The mortgage disposition loss itself, however, remains subject to the 3 year carryback and 15 year carryforward rules, §172(b)(1)(H)(ii). The Act also adds the net operating loss of the Federal Home Loan Mortgage corporation for taxable years beginning after December 31, 1984.
[25] §172(b)(1)(I).
[26] §172(b)(1)(J).
[27] Act §91(d)(1).
[28] Other than amounts allowable as deductions under §§162 and 165 and attributable to product liability or the expenses incurred in investigating, defending or settling a product liability claim, *see* §172(j)(1)(B).
[29] §172(k)(1).
[30] *Id.*
[31] §172(k)(3).
[32] §172(k)(4).
[33] §172(k)(2).
[34] *See* 407 T.M., *Cash and Accrual Methods of Accounting*, citing Welsh, Zlatkovich and White, *Intermediate Accounting*, Fourth Edition (Richard D. Irwin, Inc., Homewood, Illinois; 1976) at 33.
[35] *See* §172(k)(4).
[36] §172(b)(2)(B)(ii).
[37] Section 172(b)(1)(D) applies only if the foreign expropriation loss for the year equals or exceeds 50 percent of the net operating loss for the year and the taxpayer elects for the 10 year carryforward to apply; *see* §172(b)(3)(A)(i) and (ii).
[38] Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. at 877 (1984).
[39] *Id.*
[40] §172(k)(2).
[41] *See* Conf. Rep. at 877.
[42] §213 of the Code.
[43] *See* 436 T.M., *Deductions — Conceptual Aspects.*
[44] The "floor amount" was originally 5 percent. It was lowered to 3 percent, with a 1 percent floor for medicine and drugs, upon enactment of the 1954 Internal Revenue Code. Section 202(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) raised the floor back to 5 percent for taxable years beginning after December 31, 1982. TEFRA also eliminated the 1 percent floor for drugs and medicine for taxable years beginning after December 31, 1983, substituting a requirement that the drug be prescription (or subject to prescription) or insulin.
[45] §213(d)(1)(A), (B) and (C).
[46] 369 U.S. 499 (1962) rev'g 289 F.2d 291 (3rd Cir.).
[47] *Id.* at 500 n. 2.
[48] *Id.* at 502-503.
[49] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A60 (1954) and S. Rep. No. 1622, 83rd Cong., 2d Sess. 219-220 (1954).
[50] 428 F.2d 243 (6th Cir. 1970) *See also Pfersching v. Comr.*, 46 T.C.M. 424 (1983).
[51] I.R.C. 1939, §23(x), 26 U.S.C.A. 23(x).
[52] 428 F.2d at 245.
[53] *Id.* at 246.
[54] *Id.*
[55] I.T. 3786, 1946-1 C.B. 75, declared obsolete by Rev. Rul. 69-43, 1969-1 C.B. 310.
[56] 1958-1 C.B. 155.
[57] *Rose v. Comr.*, 435 F.2d 149 (5th Cir. 1970)
[58] *Foyer v. Comr.*, 19 T.C.M. 1370 (1960).
[59] *See* Regs. §1.213-1(e)(1)(v).
[60] *See* footnote 58 *supra.*
[61] There were other factors involved, including the fact that 14 years had elapsed between the wife's medical condition and the trip and the fact that one of the couple's daughters lived in Hawaii, 49 T.C.M. at 1372-1373.
[62] 52 T.C. 521 (1961), aff'd *per curiam*, 435 F.2d 149 (5th Cir. 1970), cert. denied, 402 U.S. 907 (1971) reaff'd, 485 F.2d 581 (5th Cir. 1973).
[63] 52 T.C. at 529-531.
[64] *Id.*
[65] 52 T.C. at 530.
[66] 52 T.C. at 531.
[67] 31 T.C.M. 1119 (1972).
[68] *See* text accompanying footnote 63 *supra.*
[69] *See* S. Rep. No. 169, Pt. 2, 98th Cong., 2d Sess., at 1583 (1984) Hereinafter S. Rep.
[70] *Id.* at 1584; Conference Report H.R. No. 861, 98th Cong., 2d Sess. at 1130 (1984) Hereinafter Conf. Rep.
[71] S. Rep. at 1583.
[72] *Id.*
[73] *See* text accompanying footnote 65 *supra.*
[74] S. Rep. at 1583. *See also* Statement of R. Woodward, Treasury News (Sept. 21, 1983) at 30-31.
[75] S. Rep. at 1584. Thus, the Senate Report states, a parent accompanying a child on a trip which satisfies the law's requirements, can deduct a total of $100 per day for lodging.
[76] *See* Woodard, *supra* footnote 73, at 30.
[77] §165(h)(1)(A). A husband and wife making a joint return are treated as one individual for this purpose, *see* §165(h)(2)(A).
[78] S. Rep. No. 494, Vol. 1, 97th Cong., 2d Sess. (1982) at 115-116.
[79] Present §165(h)(1)(B).
[80] *See also* Rev. Rul. 66-50, 1966-1 C.B. 40.
[81] *See* 274 T.M., *Losses — Casualty.*
[82] *See* H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess., at 1612 (1984).
[83] §165(h)(2)(B).
[84] §165(h)(4)(A).
[85] §165(h)(4)(A).
[86] Conf. Rep. at 1220, Example.
[87] *Id.*
[88] §1231(a)(4)(C)(ii).
[89] §1231(a)(4)(B)(ii).
[90] Former §165(k) is redesignated as §165(l). Act §1052(a).
[91] *See* Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. at 1264 (1984).
[92] *See* statement of R. Woodward to the House Ways and Means Subcommittee on Select Revenue Measures, Treasury News, at 12-13 (Sept. 21, 1983).
[93] *Id.* at 13.
[94] 1983-1 C.B. 72, clarified in IRS Ann. 83-100, I.R.B. 1983-22, 26.
[95] S. Rep. No. 169, Part 1, 98th Cong., 2d Sess. at 869 (1984).
[96] *See* Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. at 1268 (1984).

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Chapter 13

RULES GOVERNING DOMESTIC RELATIONS TRANSACTIONS REFORMED

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I. Property Transfers Between Spouses Incident to Divorce — Nonrecognition of Gain or Loss

A. Introduction

1. Prior Law

a. Transfer of Appreciated Property

In *U.S. v. Davis*,[1] the Supreme Court held that a transfer of appreciated property in consideration of the relinquishment of marital rights is a taxable event. The taxpayer in *Davis* transferred to his former spouse, pursuant to a divorce settlement agreement and in discharge of her marital rights, stock which he owned separately. At the time of transfer, the value of the stock exceeded the taxpayer's cost basis in it.

Upholding the Commissioner's determination that this difference represented taxable gain to the taxpayer, the Court stated that, in the absence of contrary evidence, the "amount realized" by the taxpayer on the transfer — *i.e.*, the value of the relinquished marital rights — "must be assumed" to be equal to the value of the property exchanged for the rights. Finding no evidence antithetical to this assumption of equivalence, the Court concluded that the taxpayer's amount realized was equal to the value of the transferred stock and, thus, that he was taxable on the excess of this amount over his cost basis. In dictum, the Court added that the taxpayer's former wife would take a "cost" basis in the stock, *i.e.*, her basis would be equal to its fair market value.[2]

b. Transfer of Loss Property Between Former Spouses

Under prior law (and assuming the conditions of §165(c)(2) were satisfied), a transfer of loss property between *former* spouses gave rise to a deductible loss even if the transfer was incident to divorce.[3]

2. Reasons for Change

Act §421 overrules the *Davis* decision by providing that all transfers between spouses and transfers between former spouses that are "incident to divorce" are to be accorded nonrecognition treatment. This abrogation of *Davis* stems from a Congressional desire to treat husband and wife as a single economic unit. H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), states at page 1491 that when they are viewed as a unit, "it is inappropriate to tax transfers between spouses."

In addition to its desire to treat husband and wife as a unit, Congress was motivated by other factors in its decision to overrule *Davis*. The *Davis* rule of gain recognition was, in the view of the Committee on Ways and Means at page 1491 of the Supplemental Report, a potential trap for the unwary "as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of property upon divorce triggers recognition of gain."

Not only was *Davis* detrimental to the taxpayer, the Committee observed, it often "whipsawed" the government. This occurred where the transferor did not report any gain on the transfer and the recipient spouse subsequently sold the property. Under *Davis*, the latter was entitled to report her gain or loss by reference to a basis equal to the fair market value of the property at the time she received it.

B. Overview

Act §421 adds Code §1041, which provides that property transfers between spouses or, between former spouses if incident to divorce, will not result in the recognition of gain or loss. The transferee will hold the property at the transferor's basis. Also, investment tax credits will not be recaptured.

Section 1041 is generally effective for transfers after July 18, 1984. Taxpayers are permitted to elect §1041 treatment for transfers occurring after 1983 and on or before the general effective date.

C. Detailed Analysis

1. Transfers During Marriage

Section 1041 provides that no gain or loss shall be recognized on transfers of property between spouses. Such transfers are to be treated as gifts for all income tax purposes. Thus, the transferor will not be taxed on the transfer and the transferee will take a carryover basis in the property; *i.e.*, her basis will be the same as the transferor's.

The nonrecognition accorded under §1041 is absolute. The transfer of §1245 property, for example, will not result in recapture income, nor will the transfer of §1245 recovery property or §1250 property.

The legislative history emphasizes that §1041 extends to *all* transfers between spouses. The Supplemental Report

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notes at page 1492 that no gain or loss is to be recognized on any interspousal transfer regardless of whether it is "for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration." The legislative history also specifies that the discharge of indebtedness constitutes a transfer within the meaning of §1041. Thus, an individual's forgiveness of debt owed to him/her by his/her spouse will not be a taxable event for the debtor spouse.

Qualifying transfers under §1041 include not only direct transfers but transfers in trust for the benefit of the transferor's spouse. For purposes of §1041, an individual who has married another individual is considered that person's spouse until the marriage is dissolved by a divorce decree.

2. Transfers After Marriage That are Incident to Divorce

Section 1041 also applies to certain transfers between former spouses that are "incident to divorce." A transfer is incident to divorce if it occurs within one year after the date on which the marriage ceases or, if later, is "related to the cessation of the marriage."

Thus, all transfers between former spouses that occur within one year of their divorce are governed by §1041 regardless of the motive for the transfer. Even if the transfer is unrelated to the divorce, it will be considered "incident" thereto provided it falls within this period.

If a transfer occurs more than one year after the divorce, it will not be covered by §1041 unless it is "related to the cessation of the marriage." This standard is one of facts and circumstances and receives no elaboration in the legislative history. Because it necessarily involves an *ad hoc* determination, one may anticipate that the standard will be the subject of litigation.

Note: The standard requires that the transfer be related to the *cessation* of the marriage, not merely to the marriage.

All transfers between former spouses that are "incident to divorce" are treated in the same manner as transfers between married spouses. Thus, a transfer incident to divorce is treated as a gift with no gain or loss being recognized by the transferor and with the transferee taking a carryover (*i.e.*, the transferor's) basis in the property.[4]

3. Collateral Effects

Act §421 has certain collateral effects. These are summarized in the legislative history as follows:

> "Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under §72), or the usual treatment as the beneficiary of a trust (by reason of §682), notwithstanding that the annuity payments or payments by the trust qualify as alimony or otherwise discharge a support obligation. The transfer of a life insurance contract to a spouse incident to a divorce or separation generally will no longer result in the proceeds of the policy later being includible in income, since the policy will have a carryover basis and therefore the transfer for value rules (§101(a)(2)) will not apply. Also, the transfer of an installment obligation will not trigger gain and the transfer of investment credit property will not result in recapture if the property continues to be used in the trade or business." [5]

4. Effective Date

Section 1041 is generally effective for transfers after July 18, 1984. If, however, a transfer after this date is required or contemplated under an "instrument" (*e.g.*, a contract of sale or divorce decree) in effect on or before July 18, 1984, §1041 will not apply to the transfer unless both spouses (or former spouses) make an election. Two alternative elections are permitted in these circumstances: The parties can elect to have §1041 apply to all transfers after 1983 or to transfers under the instrument made after the general effective date, *i.e.*, after July 18, 1984. Regardless of which election is chosen (and whether or not it is chosen), §1041 will apply to all transfers *outside* the instrument that occur after the general effective date.

The election to have §1041 apply to all transfers after 1983 is not limited to spouses making transfers pursuant to an instrument. Whether they have entered into an instrument or not, spouses can make this election provided they both agree to it. The Internal Revenue Service is delegated the authority to issue regulations prescribing the manner in which to make such election.

5. Planning Implications

Section 1041 eliminates a common planning technique, which is illustrated in the following example. Suppose H owns all the stock of X Co., which has elected subchapter S status. For several years, X Co. has incurred substantial operating losses. The pass-thru of these losses to H has reduced his stock basis to zero.

X Co. is expected to generate a substantial operating loss for its current year. H would like to offset this loss against income from other sources. To do this, however, he must obtain basis in his stock. Because X Co. is a failing corporation, he does not want to infuse new capital into it or lend it money. He instead devises an arrangement whereby he sells half of his stock to his wife (W) on an installment basis. The purchase price fixed for the stock is one-half the book value of X Co. The price thus fixed is substantial notwithstanding X Co.'s financial woes.

As a result of the sale, W would take, prior to §1041, a cost basis in the purchased stock; *i.e.*, her basis would be equal to its purchase price. This basis would be used to absorb the current losses generated by X Co., which would be passed through to W. Since H and W file a joint return, these losses would be deducted against H's income on the return.

Section 1041 precludes this tax result. Under §1041, W would take a carryover basis in the stock. Since H's basis is zero, her basis would be zero. With a zero basis, she would be unable to absorb the losses passed through and, consequently, no deduction would be allowed for them. H's income would go unsheltered.

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II. The Term "Alimony" Redefined [Act §422]

A. *Introduction*

1. *Law Prior to the Tax Reform Act of 1984*

Under §§71 and 215 of the Code, alimony payments are deductible by the payor and includible in the income of the recipient. The deduction for alimony is allowed in computing adjusted gross income. Thus, the deduction is available whether or not the payor itemizes his deductions.

In order to be treated as alimony, a payment must meet several requirements. First, the payment must be in discharge of a legal obligation imposed on or incurred by a spouse because of a family or marital relationship. Second, the payment must be imposed under either (a) a decree of divorce or separate maintenance or under a written instrument incident to such divorce or separation, (b) a written separation agreement; or (c) a decree of support or maintenance. Third, the payment must be "periodic." Installment payments discharging a lump sum obligation are not periodic unless the obligation is payable over a period ending more than ten years after the date of the instrument imposing the obligation. In the event payment of the obligation is permitted over such a period, the annual amount of installment payments that may be treated as alimony is limited to 10 percent of the lump sum obligation.

Payments which are "fixed" as child support by the divorce or separation instrument are not treated as alimony. Such payments are not deductible by the payor or includible in income by the recipient. To qualify as a payment "fixed" for child support, the payment must be expressly identified in the instrument as being allocable to child support. If the payment is not expressly specified as child support, it will not be treated as such. For example, a payment which is designated to be for the support of "wife and children" is treated in its entirety as alimony since the portion of the payment allocable to the children is not specified.

In *Comr. v. Lester*, 366 U.S. 299 (1961), the Supreme Court held that such an undifferentiated payment (*i.e.*, a payment for the support of wife and children) was entirely alimony even though the agreement imposing the payment provided that it would be reduced by a specified percentage each time any of the payor's children died, attained the age of majority or married. These conditions requiring payment reduction were not sufficient, the Court stated, to fix any portion of the payment as being allocable to child support.

2. *Reasons for Change*

Act §422 amends the definition of alimony. The amendment is intended to make the definition more "objective." Congress was concerned that under the prior law's definition, differences in state laws created differences in federal tax consequences. The variation in tax consequences, in turn, gave rise to administrative difficulties for the IRS.

B. *Overview*

Act §422 revises the rules relating to the definition of alimony. Under the revised rules, only cash payments that will terminate on the death of the payee spouse will qualify as alimony. Further, alimony payments, if in excess of $10,000 per year, generally must be payable for at least six years and must not decline by more than $10,000. If the payments decline by more than this amount, the payor is required to recapture as ordinary income the "excess amount" of alimony paid in earlier years. In the event of recapture, the payee is permitted to deduct an amount equal to the recapture.

The prior law requirement that alimony payments be based on a legal support obligation is repealed. Under the revised rules, payors will be required to furnish the IRS with the social security number of the payee spouse. A $50 penalty for failure to do so will be imposed.

The revised rules are generally effective for divorce or separation instruments executed after 1984.

C. *Detailed Analysis*

The Tax Reform Act of 1984 does not change the basic rule that alimony payments are deductible by the payor and includible in income by the payee. The legislation does, however, substantially reshape the class of payments qualifying as alimony. It accomplishes this redefinition of the class by amending in sweeping fashion §71 of the Code.

1. *Revised Definition of Alimony*

Under §71 as amended by Act §422, gross income includes amounts received as "alimony or separate maintenance payments." An "alimony or separate maintenance payment" is defined to be a payment in cash that meets certain criteria. First, the payment must be received by (or on behalf of) a spouse under a "divorce or separation instrument." [6] Second, the instrument must not state that the payment is not to be treated as alimony. Thus, even if a payment qualifies as alimony in all other respects, it will not be treated as such if the instrument specifies that it is not to be accorded that status. Third, after divorce or legal separation has occurred, the payment must not be made to a member of the same household as the payor. Fourth, the obligation to make payments allocable to the future must cease upon the death of the payee spouse, and this must be stated in the divorce or separation instrument.[7]

Section 71(b)(2) defines a "divorce or separation instrument" to mean a decree of divorce or separate maintenance or a written instrument incident to such decree, a written separation agreement, and a decree of support or maintenance.

2. *Child Support Payments*

a. *Introduction*

Under prior law, payments fixed as child support were excluded from alimony treatment. Amended §71 not only retains this exclusion, it expands it significantly. The expansion is accomplished by enlarging the class of child support payments to include payments not specifically earmarked as child support but which are reduced upon the happening of a contingency related to the payor's child.

The amount of reduction to which such payments are subject is henceforth to be treated as child support. This new treatment abrogates the *Lester* holding that such payments are to be considered alimony in their entirety.

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b. Amended §71

As modified by Act §422, §71(c)(1) excludes from alimony treatment "that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse." This language echoes prior law. Like prior law, the key word is "fix." To qualify as child support, an amount must generally be fixed (*i.e.*, specifically identified) as child support. Thus, a payment for the support of "wife and child," without more, will still qualify as alimony in its entirety since the portion allocable to the child is not specified.

If, however, the amount of an undifferentiated payment is conditional on the status of the child, a new provision, §71(c)(2), comes into play. This provision diverges from prior law. It treats as child support the amount by which any payment is subject to reduction for the happening of a contingency related to the payor's child. As examples of covered contingencies, the provision cites "attaining a specified age, marrying, dying, leaving school, or a similar contingency." Thus, in the case of undifferentiated payments which are required to be reduced in the event a child reaches 18 years of age, marries, dies, or experiences some other specified contingency, the payments will be treated in part as alimony and in part as child support. The portion treated as child support will equal the amount by which the payments are subject to reduction. The remaining portion of the payments will be treated as alimony.[8]

Section 71(c)(2) also applies to any payment which is required to be reduced "at a time which can clearly be associated with a contingency" related to the payor's child. This application of the section is aimed at preventing circumvention of the payment reduction rule by substituting calendar dates for child-related contingencies. A support agreement might, for example, in lieu of providing for payment reduction when a child reaches 18, specify that the reduction is to occur on a certain calendar date, the date being that of the child's eighteenth birthday although this fact is not noted in the agreement. In these circumstances, it is likely that the specified calendar date will be considered "clearly associated" with the contingency of the child reaching 18 years of age. Thus, §71(c)(2) will apply and the reduction amount will be treated as child support.

The "clearly associated" test is a facts and circumstances one. It receives no elaboration in the legislative history. Thus, its contours will have to be determined in administrative rulings and case law.[9]

It should be noted, finally, that the payment reduction rules of §71(c)(2) apply to both undifferentiated payments and payments which on their face are solely for the support of one's spouse (or former spouse). Thus, if a payment allocated exclusively to a spouse is required to be reduced either (a) upon the happening of a child-related contingency or (b) at a time "closely associated" with such a contingency, the reduction amount of the payment will be treated as child support.

c. Planning Implications

Even though amended §71 overrules *Lester*, payment reductions without a concomitant loss of alimony status are still possible. The reductions can no longer, however, be expressly conditioned on a child's status. Instead, they should be tied to calendar dates that permit the parties to accomplish the same general goals they would have achieved had the reductions hinged on child-related contingencies.

Provided the calendar dates chosen for payment reduction are not "clearly associated" with such contingencies, the payments will escape characterization under §71(c)(2) and, thus, will be treated as alimony in their entirety. That is, even the reduction amount will be treated as alimony.

Given the modifier "clearly" in the "clearly associated" test, it appears that §71(c)(2) will not be activated unless there is a close connection between the calendar date and the child's status. The level of closeness required, however, is a matter that cannot be predicted with an acceptable degree of certainty.

3. Special Rules to Prevent Excess Front-Loading of Alimony Payments

a. Six-Year Requirement

If alimony payments exceed $10,000 in any calendar year, §71(f)(1) requires that the payor be obligated to pay alimony in each of the six "post-separation years." A post-separation year is defined in §71(f)(4)(A) to be any calendar year in the six-calendar year period beginning with the first calendar year in which alimony is paid. If alimony is not paid in one or more of these years, but more than $10,000 of alimony is paid in any single calendar year, all payments by the payor (regardless of when made) will lose their qualification as alimony.[10]

For purposes of this six-year rule, payment terminations contingent on the death of either spouse or the remarriage of the payee spouse are not taken into account. Thus, the six-year rule will not be violated if a support agreement provides that alimony payments will cease upon the death or remarriage of the payee. Also, the rule will not be infringed if payments are not made in a post-separation year because of the payor's death.

If alimony payments never exceed $10,000 in any calendar year, the six-year rule will not apply.

b. Alimony Recapture

If during the six "post-separation years" annual alimony payments decline by more than $10,000, the payor is required by new §71(f)(2) to recapture the "excess amount" of alimony paid in earlier years. Such excess amount will consist of the excess of the prior year's alimony over the sum of the current year's alimony plus $10,000. This computation is to be made first with respect to the immediately preceding year and then with respect to all other preceding years in the six-year period. If alimony paid in one of those other preceding years has already been recaptured in an earlier year, the amount of earlier recapture will be subtracted from that preceding year's alimony for purposes of the computation.

The sum of the computation, the alimony required to be recaptured, must be included in the payor's gross income for the current taxable year. The payor's prior taxable year in which the alimony was actually paid is not to be

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disturbed. Inclusion of the recaptured amount is to be reflected solely on the current year's return.

To avoid double taxation of the alimony recaptured by the payor, the payee is permitted to deduct the recaptured amount in determining her adjusted gross income. The deduction is allowable for her current taxable year, not for the year when she received the alimony.

Alimony recapture is required only during the six post-separation years. Thereafter, reductions in alimony paid, regardless of the degree of reduction, will not trigger recapture. Moreover, if during the post-separation years annual alimony payments decline by less than $10,000, no recapture will ever be required.

The mechanics of alimony recapture may be illustrated by an example. Suppose alimony payments of $25,000 are made in year 1, payments of $12,000 are made in year 2, and a single $1,000 payment is made in year 3. In year 2, $3,000 of alimony will be recaptured from year 1. This will reduce the alimony paid in year 1, for purposes of recapture computations in years after year 2, to $22,000. In year 3, $11,000 will be recaptured from year 1 and $1,000 from year 2. If annual alimony payments after year 3 equal or exceed $1,000 but do not vary by more than $10,000, no further recapture will be required. If, however, prior to the end of year 6, annual payments decline below $1,000, additional recapture will occur.[11]

c. Exceptions to Special Rules

Section 71(f)(2), the provision for alimony recapture, ceases to apply when two events occur: (1) either of the spouses die or the payee spouse remarries, and (2) alimony payments terminate because of the event described in (1).[12] Section 71(f)(2) is not applicable, in this situation, as of the post-separation year in which the spouse dies or remarries. Regardless of the amount of alimony paid that year, no recapture will be required for the year; further, no recapture will be required in subsequent years.

Neither §71(f)(2) nor §71(f)(1) applies to any alimony payment to the extent it is based on "a continuing liability (over a period of not less than 6 years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment." [13] For this exception to apply, the alimony payment, though potentially fluctuating in amount, must be equal to a "fixed portion" of the payor's income; further, the liability to make the payment must extend over a period of at least six years. Payments meeting these conditions are not subject to recapture or to disqualification as alimony even if the payor's income in a particular post-separation year is zero and, thus, no alimony is paid in that year. Because the amount of payments calculated as a fixed portion of the payor's income is beyond the control of the payor, Congress presumably believed it would be unfair to subject such payments to §§71(f)(1) and 71(f)(2), and the potential for using such payments as a disguised property settlement was minimal.

4. Amendment of §215

a. In General

Act §422 amends §215 of the Code to conform it to the amendments made in §71. Section 215 allows the payor of alimony to deduct the amount thereof in computing her adjusted gross income.

b. Requirement of Identification Number

Amended §215 authorizes the Treasury to prescribe regulations under which any individual receiving alimony is required to furnish her taxpayer identification number to the payor and the payor is required to include such number on his income tax return for each taxable year in which alimony is paid.

c. Penalty For Failure to Furnish Identification Number

Act §422 amends §6676 by adding a penalty provision dealing with the failure to supply an identification number under §215. The new penalty is codified as §6676(c). It applies to any person who is required under §215 to furnish his taxpayer identification number to another person or to include on his return the taxpayer identification number of another person. If a person subject to either of these obligations fails to comply therewith in timely fashion, he will be liable for a penalty of $50.

The penalty is applicable for each failure to comply with a covered obligation. Thus, if the payor of alimony fails for three successive years to state on his return the taxpayer identification number of the payee, he will be subject to an aggregate penalty of $150.

The penalty does not apply if the failure to comply is due to reasonable cause and not to willful neglect.

6. Effective Date

Amended §§71 and 215 are generally effective for divorce or separation instruments executed after 1984. Although not normally covered by the amendments, pre-1985 instruments become subject to the amendments to the extent the instruments are modified after 1984 and the modification expressly provides that it is to be governed by the amendments. If such a modification is made, however, it is unclear whether the amendments will apply only to the modification or will extend to the entire instrument. It may be that even if the modification states that the amendments are to apply to the entire instrument, they will apply only to the modification. Or, conversely, even if the modification states that the amendments are to apply only to the modification, they may apply to the entire instrument. The statute and legislative history are unclear on this point.

The new §6676 penalty and the related amendments concerning the payee's taxpayer identification number are effective for payments made after 1984.

III. Dependency Exemption Rules Amended [Act §§423 and 426]

A. Introduction

1. Background

Under §§151 and 152, a taxpayer is entitled to a $1,000 deduction for each of his dependent children. The deduction is allowable in computing adjusted gross income and is termed a dependency exemption. Normally, in order to qualify as a dependent, a child must have over half of his

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support for the year furnished by the taxpayer. In the case of children of divorced or separated parents, a special rule applies in determining which parent provided over half of the support. The special rule is codified in §152(e). Under this provision, the parent who has custody of the child for the greater part of the year (the custodial parent) is entitled to the dependency exemption for the child provided both parents together have custody of the child for more than one half of the year and they furnish more than one half of the child's support.

Prior to TRA 1984, the rule that the custodial parent is entitled to the exemption was subject to two exceptions. The noncustodial parent was entitled to the exemption if either (1) a decree or written agreement allocated the exemption to the noncustodial parent and the noncustodial parent paid at least $600 for the support of the child during the calendar year, or (2) the noncustodial parent provided at least $1,200 for the support of the child during the year and the custodial parent did not clearly establish that she provided more for the support of the child than did the noncustodial parent.

The dependency exemption was not the only tax item impacted by the amount of child support a parent provided. The deduction for medical expenses, the treatment of a parent as qualifying for either single rates or head of household rates, the earned income credit, and the credit for household and dependent care services were determined, prior to TRA 1984, in part by reference to whether the parent furnished over half of the support of a child.

2. Reasons For Change

Congress believed the rules governing the allocation of the dependency exemption between separated or divorced parents were "often subjective" and presented "difficult problems of proof and substantiation." [14] Because of these problems, the IRS became involved in many disputes between parents who both claimed the exemption based on providing support over the applicable threshold. The cost of resolving these disputes, both to the parties and the Government, was high although the Government generally had "little tax revenue at stake in the outcome." To minimize the Government's involvement in such disputes, Act §423 amends §152(e) with the objective of making its application more "certain." Pursuant to the amendment, the custodial parent is allowed the exemption unless that parent waives his or her right to claim the exemption.

B. Overview

Act §423 amends §152(e) to provide that the $1,000 dependency exemption for a child of divorced or separated parents generally will be allocated to the custodial parent unless the custodial parent signs a written declaration that he or she will not claim the exemption for the year. Regardless of which parent is entitled to the dependency exemption, each parent may claim the medical expenses that he or she pays for the child for purposes of computing the medical expense deduction.

Section 152(e) as amended will be effective for taxable years beginning after 1984.

C. Detailed Analysis

Under §152(e) as amended, the parent having custody of a child for the greater portion of the year (the custodial parent) is generally treated as having provided more than one-half of the child's support and, therefore, is entitled to the dependency exemption. In addition to applying to divorced or separated parents, this rule applies to parents who "live apart at all times during the last six months of the calendar year." [15]

The general rule of amended §152(e) is subject to three exceptions. First, the custodial parent can release her claim to the exemption to the noncustodial parent. To accomplish the release, the custodial parent is required to sign a written declaration that she will not claim the child as a dependent for the year; further, the noncustodial parent is required to attach the written declaration to his tax return. The declaration may be made for one or more specified calendar years. The custodial parent may even make a permanent declaration provided a copy of such declaration is attached by the noncustodial parent to his return for each year.

Note: In most cases, execution of a declaration covering more than one year is inadvisable. By limiting the declaration to a single year, the custodial parent is in a position to withhold the declaration in the event the noncustodial parent defaults under the support agreement.

The second exception to the general rule that the custodial parent is entitled to the dependency exemption involves multiple support agreements. As under prior law, the terms of such agreements override the general rule.

Finally, §152(e)(4) specifies that prior law is to continue to apply to divorce or separation instruments which are executed before January 1, 1985 and which allocate the dependency exemption to the noncustodial parent. Because prior law continues to apply with respect to such instruments, the noncustodial parent thereunder is entitled to claim the exemption if he provides at least $600 for the support of the child during the year. The continuing applicability of prior law may, however, be waived by the parties. To effectuate a waiver, the parties must modify the instrument to expressly provide that prior law is not to be applicable to it.[16]

Act §423 amends §213 of the Code to provide that, for purposes of the medical expense deduction, a child is to be treated as a dependent of both his parents. Thus, a parent can deduct medical expenses that he has paid for the child even if he is not entitled to a dependency exemption for the child.

Act §423 amends various provisions of the Code to provide consistent rules among interrelated Code sections concerning family status of individuals living apart. The amendments are summarized in the Supplemental Report of the House Ways and Means Committee:

> "The basic rule adopted is that in the present child and dependent care credit (§44A). An amendment is made to §143(b) to provide that for an otherwise married individual living with a child to be considered not married, his spouse may not be a member of the household for the last six months of the year, rather than the entire year as under present law. The definition of head of household status (§2) is amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as

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under present law. Further, definitions of marital and head of household status, the earned income credit (§43), and the child and dependent care credit (§44A) are amended to provide that any custodial parent who releases a claim to a dependency exemption . . . will be treated as entitled to the dependency exemption for the purposes of these sections. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met." [17]

The amendments made by Act §423 are generally effective for taxable years beginning after December 31, 1984.

Note: Act §423 is not the only provision of TRA 1984 dealing with the dependency exemption. Act §426 adds a new paragraph (5) to Code §151(e). Section 151(e) provides, in general, that to qualify as a dependent an individual must have gross income of less than $1,000 for the year. Under new paragraph (5) of §151(e), gross income is deemed for this purpose not to include any income received by a permanently and totally disabled individual for services performed at a sheltered workshop operated by a government or charity. The exclusion of such income applies, however, only if: (i) the availability of medical care at the workshop is the principal reason for the individual's presence there, and (ii) the income arises solely from activities at the workshop which are incident to the medical care.

New paragraph (5) applies to taxable years beginning after 1984.

IV. Innocent Spouse Relieved of Liability in Certain Cases [Act §424]

A. Introduction

1. Background

a. Tax liability of Spouses Who File Joint Returns

In general, a husband and wife are permitted to file a joint income tax return, even if one spouse has no income or deductions. Spouses who file a joint return have joint and several liability for the tax computed on their aggregate income.

Under limited circumstances, which are specified in §6013(e) of the Code, a spouse may be relieved of liability for tax (including interest and penalties) on a joint return. Prior to TRA 1984, this so-called innocent spouse relief was limited to cases in which the liability for tax resulted from an omission from gross income that exceeded 25 percent of the gross income stated in the return. In the case of such omissions, the spouse seeking relief was required to establish that the unreported income was attributable to the other spouse and that she had no knowledge of (or reason to know of) the omission.

The determination of the spouse to whom the unreported income was attributable was to be made without regard to community property laws. In addition, the innocent spouse was entitled to relief only if it was "inequitable" to hold that spouse liable for the deficiency in tax resulting from the omission. In determining whether it would be inequitable to hold the innocent spouse liable, §6013(e) directed that consideration be given to whether or not the innocent spouse significantly benefited (directly or indirectly) from the items omitted from income. Finally, in determining whether there was an omission exceeding 25 percent of the income disclosed on the return, amounts as to which adequate information was provided on the return were not to be taken into account.

b. Community Income of Spouses Who Live Apart

In a community property jurisdiction, a husband and wife filing separate returns are each generally required to report one-half of their community income. If, however, certain conditions obtain, an innocent spouse is relieved from the tax liability he or she would otherwise incur for failing to include in income his or her share of the community income.

The conditions for relief are specified in §66 of the Code. Prior to TRA 1984, to qualify for relief, an innocent spouse was required to have lived apart from her spouse during the entire calendar year. Additionally, it was required that: (1) the spouses not have filed a joint return for a taxable year beginning or ending in the calendar year; (2) one or both of the spouses received earned income for the calendar year which was community income; and (3) no portion of such earned income was transferred "directly or indirectly" between the spouses before the close of the calendar year. If all of these conditions were satisfied, §66 provided that the applicable community property law with respect to the income was to be disregarded for federal income tax purposes. The income was, instead, to be allocated in accordance with the rules provided in §879(a) of the Code.

Under these rules, earned income for the calendar year (other than income from a trade or business or a partner's distributive share of a partnership's income) was to be treated as the income of the spouse who rendered the personal services. Further, income derived from a trade or business (other than that carried on by a partnership) was to be treated as the income of the spouse who carried on the trade or business, unless the other spouse exercised substantially all of the management or control of the trade or business. Finally, a partner's distributive share of a partnership's income was to be treated as the income of the partner.[18]

2. Reasons for Change

Congress believed that the rules relieving innocent spouses from liability for tax on a joint return were not "sufficiently broad" to encompass certain cases where the innocent spouse deserved relief. As an example of such a case, the Supplemental Report cites the situation where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and that the "guilty" spouse has squandered the untaxed profits.

Congress was also concerned that "there may be situations in community property states when it is inequitable to tax a spouse filing a separate return on earnings of the other spouse where the innocent spouse received no benefit from the earnings." [19]

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B. Overview

Act §424 amends §§66 and 6013(e) of the Code. The amendment of §6013(e) expands the availability of innocent spouse relief to cover situations involving claims of grossly erroneous deductions and credits. Additionally, the amendment of §6013(e) replaces the substantial omission of income test with a substantial understatement of tax test.

The amendment of §66 extends innocent spouse relief to situations where a spouse filing a separate return (but not living apart from her spouse) establishes that she was not aware of, and had no reason to know of, an item of community income earned by her spouse. In order for the innocent spouse to be relieved of liability in this circumstance, it must be demonstrated that it would be inequitable to require her to include the item in income.

Amended §66 also contains a provision authorizing the Treasury to disregard community property laws in certain situations where it is equitable to do so.

C. Detailed Analysis

1. Section 6013(e): Joint Return Innocent Spouse Relief

Under §6013(e)(1), as amended by Act §424, an innocent spouse is generally relieved of a joint tax liability if: (1) a joint return was made for the underlying taxable year; (2) on the return there was a "substantial understatement" of tax attributable to "grossly erroneous items" of the other spouse; (3) the innocent spouse establishes that in signing the return she did not know, and had no reason to know, of the substantial understatement; and (4) taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax attributable to the understatement. Where these conditions are satisfied, the innocent spouse is generally relieved of liability for the joint tax obligation to the extent the obligation is attributable to the substantial understatement.

For purposes of this rule, the term "grossly erroneous items" encompasses two categories of items: (1) any item of income attributable to the other spouse which is omitted from gross income, and (2) any claim of a deduction, credit, or basis by the other spouse in an amount for which there is no basis in fact or law. The term "substantial understatement" means any understatement of tax (*i.e.*, any tax deficiency) which exceeds $500.

To the extent the substantial understatement is attributable to an erroneous deduction or credit (rather than to an omission of income), the general rule is further qualified. With respect to the portion of the substantial understatement allocable to the deduction or credit, the innocent spouse is entitled to relief therefrom only if the substantial understatement exceeds a specified amount. The specified amount is a percentage of the innocent spouse's adjusted gross income for the "pre-adjustment year." If her adjusted gross income for that year is $20,000 or less, the specified amount is 10 percent of this income figure. If her adjusted gross income is more than $20,000, the specified amount is 25 percent of this figure. Thus, by way of illustration, if the innocent spouse's adjusted gross income for the pre-adjustment year is $15,000 and the substantial understatement is only $1,000, which is less than 10 percent of $15,000, then the innocent spouse will not be entitled to relief with respect to the portion of the understatement which is attributable to the erroneous deduction or credit.

For purposes of applying these income limitations, the term "pre-adjustment year" means the most recent taxable year of the innocent spouse ending before the date the deficiency notice is mailed. In computing the innocent spouse's adjusted gross income, if she is married to another spouse at the close of the pre-adjustment year, her adjusted gross income for that year will include the income of the new spouse.[20]

The limitations tied to the innocent spouse's adjusted gross income are not applicable to the extent the substantial understatement is attributable to an omission of an item of income. Regardless of the amount of the substantial understatement and of the innocent spouse's adjusted gross income, she will be entitled to relief from that portion of the understatement which is attributable to an income omission.

The relief afforded under §6013(e) extends not only to the tax liability itself but also to any interest and penalties assessed with respect to the liability. For purposes of the provision, the determination of the spouse to whom items of gross income (other than gross income from property) are attributable is to be made without regard to community property laws.

The Conference Report states at page 1119 that it is to apply to pending court cases where the decision in the case is not final. The Supplemental Report also states at page 1502 that the determination of whether it would be inequitable to hold the innocent spouse liable should include the consideration of whether that spouse benefited from the substantial understatement. Finally, the legislative history notes that relief is available with respect to an understatement attributable to an omission from income, even if the return contained adequate information disclosing the nature and amount of the omitted item.

2. Section 66: Treatment of Community Income

Under §66, as amended by Act §424, the relief afforded innocent spouses with respect to tax liabilities arising from community income is expanded. The expansion is accomplished by amending §66(b) and adding new §66(c).

Under §66(b), the Treasury is authorized to disallow the benefits of community property laws to a taxpayer if two conditions conjoin: (1) the taxpayer acts as if he is solely entitled to one or more items of community income; and (2) the taxpayer fails to notify his spouse of the nature and amount of such items. The taxpayer is required to notify the spouse before the due date (including extensions) for filing the return for the taxable year in which the items were earned.[21]

Under new §66(c), an item of community income is required to be included in the gross income of the other spouse (and not in the income of the innocent spouse) if four conditions are met: (1) a joint return was not filed for the taxable year in which the item was earned; (2) the innocent spouse did not include the item in her income for the year and, under §879(a), the item would be treated as the income of the other spouse if that provision were

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applicable; (3) the innocent spouse establishes that she did not know of, and had no reason to know of, the item; and (4) taking into account all the facts and circumstances, it is inequitable to include the item in the innocent spouse's gross income.

The Supplemental Report indicates at page 1502 that the determination of whether it would be inequitable to include the unreported item in the income of the innocent spouse should take into account whether that spouse benefitted from the untaxed income and whether the defense of no knowledge was promptly raised so as to prevent the period of limitations from running on the other spouse. The legislative history also indicates that the determination of the innocent spouse's knowledge of the unreported item is to be made as of the time she filed her return. Finally, the legislative history states that if §66(c) is applicable, the unreported item of income is to be included in the income of the other spouse under the special rules of allocation set forth in §879(a).

Note: Section 66(a), dealing with the treatment of community income of spouses who live apart, is unchanged by TRA 1984.

3. Effective Date

Section 66(b) applies to taxable years beginning after 1984. New §66(c) and amended §6013(e) apply to all taxable years to which the Internal Revenue Code of 1954 applies; moreover, provisions corresponding to these subsections are deemed to be included in the Internal Revenue Code of 1939 and apply to all taxable years to which that Code applies.

Notwithstanding the breadth of the effective date of §§66(c) and 6013(e), the legislative history indicates that their effective date is not intended to open a year that has been closed by the statute of limitations, *res judicata*, or otherwise.

V. Estate and Gift Tax Treatment of Property Settlements Incident to Divorce [Act §425]

A. Introduction

1. Background

By virtue of §§2056 and 2523 of the Code, transfers of property (other than certain terminable interests) between individuals who are married at the time of the transfer are not subject to estate or gift tax.

With several exceptions, transfers of property to a *former* spouse in satisfaction of marital or property rights are taxable gifts. This is because the relinquishment of such rights is deemed not to constitute consideration in money or money's worth. Thus, the transfer to the former spouse is deemed to be a gratuitous transfer.

One exception to this general rule is codified in §2516 of the Code. Prior to TRA 1984, §2516 provided that a transfer of property between former spouses was not subject to gift tax if (1) the transfer was pursuant to a written agreement between the spouses, (2) the agreement was entered into during the two-year period immediately preceding the divorce, and (3) the transfer was in settlement of marital or property rights of the former spouses or was to provide a reasonable allowance for the support of minor children.[22]

Prior to TRA 1984, for estate tax purposes, a claim of a former spouse based on the release of marital or property rights was not deductible in computing the taxable estate unless the claim was based on a court decree where the court had the power to determine the marital or property rights of the spouse.

2. Reasons for Change

Congress believed that the estate tax treatment of transfers made in settlement of marital or property rights should be conformed to the gift tax treatment. "This will allow the parties," according to the legislative history, "to rely on a written agreement even though the payor spouse dies before the agreement is completely executed."

Congress also believed that the parties should have additional time to enter into the written agreement.

B. Overview

Act §425 amends §§2043 and 2516 of the Code. The amendment of §2516 extends the period to enter into a property settlement agreement (for purposes of avoiding gift tax) to one year after the divorce. By virtue of the amendment of §2043, an estate tax deduction is allowed for transfers pursuant to claims arising under a written property settlement agreement if (1) the transfers are in satisfaction of marital or property rights and (2) the agreement would have qualified the transfers as non-taxable for gift tax purposes under §2516.

These amendments are applicable to estates of decedents dying after, and to lifetime transfers after, July 18, 1984.

C. Detailed Analysis

1. Expansion of Coverage of Section 2516

Act §425 amends §2516 to extend its coverage to property settlement agreements which are entered into within one year after the divorce. If former spouses enter into a written property settlement agreement within this period, transfers made pursuant to the agreement will not be subject to gift tax provided (1) the transfer is made to either spouse in settlement of his or her marital or property rights or (2) the transfer is made to provide a reasonable allowance for the support of minor children of the marriage. A transfer meeting these conditions is deemed to be a transfer made for full and adequate consideration in money or money's worth and, thus, is not a gift. As under prior law, §2516 continues to apply to property settlement agreements entered into within two years prior to the divorce.

2. Estate Tax Deduction Allowed for Transfers Meeting the Requirements of §2516

Act §425 amends §2043(b) by prescribing an exception to the general rule that the relinquishment of marital or property rights is not treated as consideration in money or money's worth. The exception is embodied in new paragraph (2) of §2043(b).[23] Paragraph (2) provides that for

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purposes of §2053, a transfer of property in satisfaction of marital or property rights is to be considered made for an adequate and full consideration in money or money's worth if the transfer satisfies the requirements of §2516. Thus, if the transfer is made pursuant to a written property settlement agreement entered into within the period of time specified in §2516, the value of the property transferred will be deductible from the gross estate of the decedent.

The fact that such transfers are considered made for adequate and full consideration in money or money's worth is significant for the following reason. Section 2053(a) allows a deduction from the gross estate of amounts paid by the estate for claims against the estate. Section 2053(c)(1), however, limits this deduction. Under this provision, amounts paid pursuant to claims against the estate are deductible only "to the extent [the claims] were contracted bona fide and for an adequate and full consideration in money or money's worth." By treating a transfer in satisfaction of a claim based on the relinquishment of marital or property rights as made in exchange for full and adequate consideration in money or money's worth, §2043 permits such transfers to avoid the §2053(c)(1) limitation.

3. Effective Date

The amendments discussed above are applicable to estates of decedents dying after, and to lifetime transfers after, July 18, 1984.

VI. Alimony Treated as Compensation for Purposes of Contributing to IRAs [Act §529]

Effective generally for taxable years beginning after December 31, 1984, the TRA simplifies the rules under which a divorced spouse can make a deductible contribution to an IRA based on alimony. The TRA [24] amends §219(f)(1) to provide that all alimony received by a divorced spouse is treated as compensation for purposes of the IRA deduction limit. Various technical eligibility restrictions in §219(b)(4) have been repealed by the TRA, including the restriction limiting the IRA deduction based on alimony to only $1,125. Thus, for taxable years beginning after 1984, a divorced spouse may generally contribute up to $2,000 of alimony, which is the general IRA maximum for deductible contributions.

For a more complete analysis of the TRA amendments relating to IRAs, see Chapter 50, V.

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[1] 370 U.S. 65 (1962).
[2] *Davis* does not address the wife's taxability on her receipt of the stock.
[3] *McKinney v. Comr.*, 64 T.C. 263 (1975).
[4] Since transfers "incident to divorce" have the same incidents of taxation as transfers during marriage, the discussion of the latter in the preceding section of this analysis applies with equal force here.
[5] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), p. 1492.
[6] For the purposes of §71, "spouse" includes former spouses. §71(d).
[7] As a corollary to this last condition, §71 requires that, upon the death of the payee, there be "no liability to make any payment (in cash or property) as a substitute for [future alimony] payments."
[8] As previously stated, this bifurcated treatment overrules *Lester*.
[9] For purposes of the test, the calendar date may be expressed in terms of a time interval or a specific calendar date. That is, instead of identifying the payment reduction date as a specific date, the support agreement may merely state that payment reduction is to occur a specified period of time from the date of execution of the agreement or from some other reference date. Regardless of whether the payment reduction date is expressed as a specific calendar date or as a time interval, it will be subject to the "clearly associated" test of §71(c)(2).
[10] Such payments will not be deductible by the payor or includible by the payee.
[11] This example is drawn from the Conference Report at page 1117.
[12] §71(f)(5)(A).
[13] §71(f)(5)(C).
[14] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1498.
[15] §152(e)(1)(A)(iii).
[16] *See* §152(e)(4)(B)(iii).
[17] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1499.
[18] All other community income was to be allocated in accordance with the applicable community property laws.
[19] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1502.
[20] This is so whether or not they file a joint return.
[21] Presumably, the Treasury will promulgate regulations implementing this grant of authority.
[22] Section 2516 is not the only exception to the general rule that transfers of property to a former spouse in satisfaction of marital rights are taxable gifts. Other exceptions provide that property transfers ordered by a divorce court having the power to order the disposition of the property are not taxable gifts and that a transfer of property in discharge of a former spouse's right to support is not a taxable gift. *See Harris v. Comr.*, 340 U.S. 106 (1950).
[23] Paragraph (1) of this subsection contains the general rule.
[24] Act §529(a).

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Chapter 14

SIMPLIFICATION OF TAX CREDITS

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I. Background

A. The Credit Maze Prior to the TRA

1. Allowable Credits

Prior to the enactment of the TRA, the Internal Revenue Code listed the following 19 credits as "allowable" credits:

(a) Section 31, providing a refundable credit for the tax withheld on wages, as well as a refundable credit for special refunds of social security tax and for the recently enacted back-up withholding tax of §3406.

(b) Section 32, allowing a refundable credit to nonresident aliens and foreign corporations for taxes withheld at the source and allowing a refundable credit for the withholding tax on tax-free covenant bonds.

(c) Section 33, allowing the foreign tax credit determined under §901 and the possessions of the U.S. tax credit provided by §936.

(d) Section 37, providing a nonrefundable credit for elderly or permanently disabled individuals.

(e) Section 38, authorizing the investment credit as determined under the rules of Subpart B of Part IV. Subpart B §46 through §48.

(f) Section 39, allowing a refundable credit for certain uses of gas and special fuels, such as use on a farm.

(g) Section 40, authorizing a credit for expenses incurred in a Work Incentive Program (WIN) as determined under Subpart C of Part IV. Subpart C, in turn, consisted of §50A and §50B. The WIN credit was terminated for taxable years beginning after 1981 and, therefore, became obsolete for such years except to the extent a WIN credit earned before 1982 survived as a carryover to later years.

(h) Section 41, providing a modest nonrefundable credit to individuals for contributions to political candidates.

(i) Section 43, setting forth the rules for the allowance of the earned income credit to individuals, a refundable credit for which the maximum amount allowable is $500.

(j) Section 44 providing a now obsolete, nonrefundable credit to individuals for the purchase of a new residence.

(k) Section 44A, allowing a nonrefundable credit for expenses incurred by individuals for household and dependent care necessary for gainful employment.

(l) Section 44B, authorizing the targeted jobs credit, a nonrefundable credit determined under the rules of Subpart D of Part IV, consisting of §51 through §53.

(m) Section 44C, providing individuals with a nonrefundable residential energy credit for qualified energy conservation and qualified renewable energy source expenditures.

(n) Section 44D, allowing a nonrefundable credit for producing fuel from nonconventional sources, such as oil produced from shale and tar sands.

(o) Section 44E, providing a nonrefundable credit for the use of alcohol as fuel.

(p) Section 44F, allowing a nonrefundable credit for increasing research activities.

(q) Section §44G, allowing a corporation to elect a nonrefundable credit for the contribution of its stock to a tax credit Employee Stock Ownership Plan (ESOP).

(r) Section 44H, the most recently added credit to the Code,[1] providing a nonrefundable credit for clinical testing expenses for certain drugs for rare diseases or other conditions.

(s) Section 45, providing a cross reference to §6401 relating to the refundable credit for overpayment of tax.

It is obvious upon review of the foregoing credits that little consistency existed in the placement of the credits within the Code under pre-TRA law. For example, the nonrefundable, business-related investment credit followed the nonrefundable personal credit for the elderly and disabled. The investment credit, in turn, was followed by a refundable business related credit for gas and special fuels, and the ensuing credit under §44 for WIN expenditures was largely obsolete. The sequence of credits within the Code was largely attributable to the chronology of enactment.

2. Order of Application

In general, the nonrefundable credits were allowable as an offset against tax liability in the order that they appeared in the Code. Thus, a taxpayer with an investment credit allowable under §38, a targeted jobs credit allowable

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under §44E, and a nonconventional fuel credit allowable under §44E would first offset tax liability by the investment credit, then by the targeted jobs credit, and lastly by the nonconventional fuel credit. As pointed out in the committee reports accompanying the TRA, this ordering sequence could cause an unintended loss of a tax credit since certain credits, such as the nonconventional fuel credit, could not be carried over, whereas other lower-numbered credits, such as the investment and targeted jobs credits, had carryovers.[2]

3. Tax Liability Limitations

There were also variations in the manner in which business credits were applied in reducing tax liability. With the exception of the investment credit, the credits earned in the current year were used first before any carryforwards or carrybacks. Investment credits were applied on a first-in, first-out (FIFO) basis, whereby an investment credit carryforward was used first against current tax liability, followed by the investment credit earned in the current year, and lastly, by credits earned in later years and carried back to the current year. The investment credit FIFO rule was the more beneficial method of applying credits since it would offset taxes by the credits due to expire first.

Another variation in the utilization of business tax credits was in the amount of tax liability such credits could offset. The investment credit was fully deductible against the first $25,000 of tax and deductible to the extent of 85 percent of tax in excess of $25,000, except that the investment credit for energy property could be used against 100 percent of the tax liability in excess of $25,000.[3] The ESOP credit could offset the first $25,000 of tax liability and 90 percent of the tax liability in excess of $25,000.[4] Under §53, the targeted jobs credit could be used to offset a straight 90 percent of tax liability. The remaining business credits, such as the research credit and alcohol fuels credit, were 100 percent deductible. For purposes of determining the amount of tax a particular credit could offset, tax liability was defined as the income tax imposed reduced by lower numbered credits. Thus, for example, a corporate taxpayer that owed $50,000 in tax before credits and had a $25,000 investment credit (§38 credit) and $25,000 ESOP credit (§44G credit) would apply the two credits in sequence to offset its entire $50,000 tax liability.

4. Credit Carryovers

Significant differences also existed in the carryover provisions applicable to business credits. The credit under §44D for the production of nonconventional fuels and the credit under §44H for the clinical testing of drugs for rare diseases had no carryback or carryforward provisions. The alcohol fuel credit had no carryback feature, but it could be carried forward for fifteen years under §44E(e)(2). The investment credit, targeted jobs credit, research credit, and ESOP credit had a three-year carryback period as well as a fifteen-year carryforward period.[5]

5. Alternative Minimum Tax Effect

It should be noted that, in the case of a noncorporate taxpayer, the alternative minimum tax of §55 set a limit on the amount of total tax liability that nonrefundable credits could offset which was considerably lower than the limitations set forth for each of the credits. Under §55(a), both now and prior to the TRA, the alternative minimum tax is imposed only to the extent that it exceeds the regular tax for the taxable year. The regular tax is generally the tax imposed for the taxable year reduced by the sum of all nonrefundable credits allowable for such taxable year. With the exception of the foreign tax credit, however, nonrefundable credits may not offset the alternative minimum tax pursuant to §55(c)(1). Consequently, nonrefundable credits are effectively treated as a tax preference for alternative minimum tax purposes. The impact of the alternative minimum tax on the utilization of credits prior to the TRA may be illustrated by the following example:

> *Example*: Individuals A and B, husband and wife, have $60,000 of taxable income for 1983 resulting in a regular tax before credits of $16,014 using the joint return schedule. A and B have an investment credit for 1983 of $16,000 and a political contribution credit of $10. Because the regular tax of $16,014 is less than the $25,000 tax liability amount an investment credit can fully offset, the credit may be used in its entirety against the regular tax. The $10 political contribution credit may also be fully used. Consequently, A and B's regular tax liability after credits is $4. Assuming that A and B have no other tax preferences, and adding back for alternative minimum tax purposes the $2,000 in personal exemptions that they took in determining taxable income for regular tax purposes, A and B's alternative minimum taxable income is $62,000. The alternative minimum tax on this amount, after reduction by the $40,000 exemption amount for taxpayers filing joint returns, is 20 percent of $22,000 or $4,400. The investment and political contribution credit cannot be used as an offset against the alternative minimum tax. Thus, A and B's total tax liability for 1983 is $4,400, consisting of the $4 regular tax plus the $4,396 in alternative minimum tax exceeding the $4 regular tax.

Although the credits in the foregoing Example were not fully utilized because of the alternative minimum tax, a compensating adjustment is made in the carryover amount of those credits subject to a carryover.[6] The adjustment, in essence, increases the amount of the carryover by the credit amount not utilized because of the alternative minimum tax. This adjustment is available only for "applicable credits": namely, the investment credit, the WIN credit, the targeted jobs credit, the residential energy credit, the alcohol fuel credit, and the research credit. However, because of the mechanics of the adjustment, which effectively treats nonrefundable credits not having carryovers as being used before any applicable credits, thereby increasing the amount of applicable credits not producing a tax benefit due to the alternative minimum tax. Nonrefundable credits not having carryovers may be preserved where "applicable credits" are also present.

For example, in the foregoing Example, the investment credit carryover is increased by the full amount of the alternative minimum tax of $4,396. Under §55(c)(3), the "applicable credit limitation" (here the investment credit limitation) is deemed to be the amount of the "applicable credit" ($16,000) reduced by the alternative minimum tax ($4,396) or $11,604. The carryover is, therefore, $16,000 - 11,604 or $4,396 under §46(b).

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B. Reasons for Change

Congress' primary reason for restructuring the credits in the TRA is readily apparent — to arrange the credits in a more rational fashion, and to provide more uniform, simpler rules for the application of the credits. A second reason, set forth in the Committee reports for the TRA,[7] is to preclude taxpayers from eliminating their tax liability entirely by the use of credits providing business incentives. The change to effectuate this intention, along with miscellaneous other changes made in restructuring the credits, converts the simplification provisions into another revenue-raising measure. For the six-year period embracing fiscal years 1984 through 1989, it is estimated that the simplification provisions will raise more than $850 million.[8]

C. Outline of New Provisions

The TRA [9] groups the credits into four categories as follows:

1. Nonrefundable personal credits, consisting of the dependent care credit, the credit for elderly or disabled individuals, the residential energy credit, the new mortgage certificate credit,[10] and the political contribution credit.

2. Miscellaneous credits, consisting of the foreign tax credit, the credit for the clinical testing of certain drugs, the credit for nonconventional fuels, and the research credit.

3. Refundable credits, comprised of the wage withholding credit, the earned income credit, the nonresident alien and foreign corporation withholding credit, the gas and special fuels credit, and the credit for overpayments of tax.

4. Business credits, consisting of the investment credits, targeted jobs credit, alcohol fuels credit, and ESOP credit, all of which are grouped into a single credit called the general business credit. This general business credit can offset the first $25,000 of tax liability and 85 percent of any tax in excess of the first $25,000. The credit will be applied on a FIFO basis with a three-year carryback and fifteen-year carryforward period.

The research credit continues to be allowed against 100 percent of the taxpayer's tax liability because Congress believed that this credit is of "such importance that it should not be restructured at this time." [11] Congress also did not alter the foreign tax credit, recognizing that it has a different purpose and rationale than personal credits and business credits and it should not, therefore, be included in any uniform credit.[12]

Under the TRA, the nonrefundable credits are applied to offset taxes in the following order: (i) personal credits, (ii) miscellaneous credits, and (iii) business related credits.

D. Effective Dates

The credit simplification provisions apply to taxable years beginning after December 31, 1983, and to carrybacks from such years.[13] Credits earned in pre-1984 years, to the extent they can be carried to post-1983 years, will be combined into a business credit carryforward from that year to be carried to post-1983 years, for a period not to exceed 15 years from the year of the original credit. Similarly, credits earned in post-1983 years may be carried back to pre-1984 years, subject to the new tax liability limitation rules imposed by the TRA.

II. Detailed Analysis

A. Rearrangement of Credits

The grouping of credits under the TRA can perhaps best be observed using charts. The first chart sets out the credit designations under the TRA, the groups into which they have been placed, and the designation of a particular credit, if any, under prior law. The second chart shows the old credit designations in numerical order and their redesignations under the TRA.

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1954 Code
Chapter 1A, Part IVA
Credits Against Tax

Pre-TRA 1984			Post-TRA 1984		
Old Code Section	Description	New Code Section	New Code Section	Description	Old Code Section
	Subpart A: Allowable Credits			**Subpart A: Nonrefundable Personal Credits**	
§31	Wage Withholding	§31			
§32	Nonresident Alien, Foreign Corporation Withholding	§33	§21	Household and Dependent Care	§44A
§33	Foreign and Possession Taxes	§27	§22	Elderly and Disabled	§37
§37	Elderly and Disabled	§22	§23	Residential Energy	§44C
§38	Investment	—	§24	Political Contribution	§41
§39	Gasoline and Special Fuels	§34	§25	Mortgage Certificate	—
§40	Work Incentive	—	§26	Tax Liability Limitation	—
§41	Political Contribution	§24			
§43	Earned Income	§32		**Subpart B: Miscellaneous Credits**	
§44	New Residence	—	§27	Foreign and Possession Taxes	§33
§44A	Household and Dependent Care	§21	§28	Clinical Testing	§44H
§44B	Targeted Jobs	—	§29	Nonconventional Fuel	§44D
§44C	Residential Energy	§23	§30	Research	§44F
§44D	Nonconventional Fuel	§29			
§44E	Alcohol Fuel	§40		**Subpart C: Refundable Credits**	
§44F	Research	§30	§31	Wage Withholding	§31
§44G	ESOP	§41	§32	Earned Income	§43
§44H	Clinical Testing	§28	§33	Nonresident Alien, Foreign Corporation Withholding	§32
§45	Overpayments of Tax	§35	§34	Gasoline and Special Fuels	§39
			§35	Overpayments of Tax	§45
	Subpart B: Investment Credit				
§46	Amount	§46		**Subpart D: Business Credits**	
§47	Recapture	§47	§38	General Business	—
§48	Definitions	§48	§39	Unused Credit Carryovers	—
			§40	Alcohol Fuel	§44E
	Subpart C: Win Credit		§41	ESOP	§44G
§50A	Amount	—			
§50B	Definitions	—		**Subpart E: Investment Credits**	
			§46	Amount	§46
			§47	Recapture	§47
			§48	Definitions	§48
	Subpart D: Targeted Jobs Credit				
§51	Amount	§51		**Subpart F: Targeted Jobs Credit**	
§52	Special Rules	§52	§51	Amount	§51
§53	Percentage Limitation	—	§52	Special Rules	§52

As can be seen by the foregoing charts, the nonrefundable personal credits have been grouped into Subpart A. This Subpart contains one new credit added by the TRA,[14]/ the §25 credit for interest on mortgages certified in mortgage credit certificates. Subpart B collects the foreign and possessions tax credit and miscellaneous business credits not included in the general business credit. The refundable credits are set forth in Subpart C, and the nonrefundable business credits in Subpart D. Subparts E and F are simply redesignations of old Subparts B and D containing the rules for determining the investment credit and targeted jobs credit, respectively.

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The TRA [15] repeals two obsolete credits: (i) the credit for the purchase of a new residence, and (ii) the WIN credit, as well as the rules for computing the latter credit in §50A and §50B. The TRA [16] also repeals former §38 and former §44B providing for the allowance of the investment credit and targeted jobs credit, respectively. Former §38 referred to the rules set forth in former Subpart B, containing §46 through §48 for the determination of the investment credit. Similarly, former §44B referred to the rules of §51 through §53 in former Subpart F for the determination of the targeted jobs credit. The new general business credit of §38 effectively incorporates these cross-references in §38(b)(1) and (2) by referring to §46(a) for the determination of the investment credit and to §51(a) for the determination of the targeted jobs credit.

Comment: In addition to providing the cross references to the appropriate former subparts, former §§38(b) and 44B(b) authorized the Treasury Secretary to "prescribe such regulations as may be necessary to carry out the purposes of this section and subpart . . ." This grant of regulatory authority under §38(b) has been held to make the investment credit regulations "legislative in character and as binding upon a court as a statute . . ." [17] Presumably, a similar view would be taken of former §44B(b) for purposes of the targeted jobs credit. The TRA did not incorporate comparable language providing such regulatory authority in any of the new provisions concerning the general business credit or in any of the conforming changes to the investment credit and targeted jobs credit. No reason is given in the legislative history for this omission. Thus, it may merely be a legislative oversight that will be cured in a future technical corrections bill. On the other hand, Congress may have concluded that the statutory development of the investment credit and targeted jobs credit had progressed to the point that a delegation of authority to issue legislative regulations was no longer necessary. If this is the case, one might speculate as to the effect of the repeal of this broad regulatory authority on previously promulgated regulations. It could be argued that, in view of the repeal, such regulations should no longer be considered legislative in character. However, since such regulations were promulgated at a time that the specific broad grant of authority existed, it is more likely that courts will view such regulations as remaining legislative in nature. Clearly, any investment credit or targeted jobs credit regulations issued subsequent to the July 18, 1984 effective date of the TRA should not be viewed as having legislative effect since they will have been promulgated pursuant to the general authority to issue necessary regulations contained in §7805(a). Of course, while not having legislative effect, regulations issued under §7805(a) are given considerable deference by the courts.

B. Personal Credits

1. In General

Apart from renumbering the personal credits, the TRA made no significant changes in these credits. One amendment that deserves mention, however, was made in the rules governing the order of application of these credits. Under §23(b)(5)(A), the residential energy credit will be applied after the other nonrefundable personal credits except the mortgage certificate credit which will be the last nonrefundable personal credit used to offset tax liability under §25(e)(1). This treatment is beneficial because residential energy and mortgage certificate credits are the only nonrefundable personal credits for which there are carryforwards. It should be noted, however, that the residential energy credit cannot be carried forward to any taxable year beginning after 1987, as was the case under prior law, and the carryforward of the mortgage certificate credit from an unused credit year is limited to three years.

Code §26 sets forth a uniform limitation on the application of nonrefundable personal credits against tax by providing that the sum of the nonrefundable personal credits for a taxable year cannot exceed the taxpayer's tax liability for such year.

2. Definition of Tax Liability

The definition of the term "tax liability" is contained in §26(b). Tax liability is defined as the tax imposed under the income tax provisions for the taxable year, with the exception of eight penalty-type taxes. The excluded penalty taxes, which cannot be offset by nonrefundable credits, are:

(a) The corporate minimum tax of §56,

(b) The penalty taxes under §72(m)(5)(B), (o)(2), or (q) on certain distributions, such as premature distributions out of qualified plans to 5 percent owners,

(c) The penalty tax of §408(f) for certain distributions from individual retirement accounts,

(d) The accumulated earnings tax of §531,

(e) The personal holding company tax of §541,

(f) The tax imposed by §1351(d)(1) on recoveries of foreign expropriation losses,

(g) The §1374 tax on certain capital gains of S corporations, and

(h) The §1375 tax on certain passive investment income of S corporations.

Section 26(c) provides a cross reference to §55(c) for the treatment of nonrefundable credits under the alternative minimum tax.

Although it may appear unusual that a definition of tax liability for purposes of the nonrefundable personal credits makes references to taxes imposed exclusively on corporations, such as the personal holding company and accumulated earnings taxes, the reason for these references is that the same definition is used for purposes of the business related credits.

C. Foreign Tax Credit and Miscellaneous Business Credits

The credit simplification provisions of the TRA make no substantive changes to the foreign tax credit rules except to provide in §904(g) [18] that the nonrefundable personal credits are applied to offset tax liability before the foreign tax credit.

Under the TRA revisions, the foreign tax credit is applied to tax liability before the clinical testing credit of §28,[19] and this credit, in turn, is applied before the nonconventional fuel credit of §29.[20] The research credit of §30 is

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the last of the foregoing miscellaneous credits to be applied against tax liability. This is because the research credit, unlike the §§28 and 29 credits, may be carried back and carried forward.[21]

To summarize the foregoing credit application rules, the nonrefundable personal credits are applied first to offset tax liability, followed by the foreign tax credit, the clinical testing credit, the nonconventional fuel credit, and, lastly, the research credit.

For purposes of the research credit, the TRA[22] makes it clear that §30 shall be treated as a continuation of former §44F, and shall apply only to the extent former §44F would have applied, in determining whether any excess credit under former §44F for a pre-1984 taxable year is allowable as a carryover under new §30, and in determining the period for which new §30 is in effect.

D. Business Related Credits

1. General Business Credit of §38

a. Definition and Order of Application

The principal change wrought by the TRA credit simplification provisions, besides the redesignation and regrouping of the various credits, has been to collect various business credits into a general business credit, designated as §38, and to subject this credit to a uniform tax limitation and unified carryback and carryforward provision.[23]

Code §38(a) provides that the general business credit allowed for a taxable year is equal to the sum of (i) the business credit carryforwards carried to such taxable year, (ii) the amount of the current year business credit, plus (iii) the business credit carrybacks carried to such taxable year. Thus, the general business credit adopts the FIFO ordering principle of applying business credit carryforwards first against tax, followed by the current year business credit, and, lastly, by the business credit carried back.

Under §38(b), the current year business credit is defined as the sum of the (i) investment credit determined under §46(a), (ii) the targeted jobs credit determined under §51(a), (iii) the alcohol fuels credit under §40(a), and (iv) the ESOP credit determined under §41(a).

b. Tax Liability Limitations

Under §38(c), the total business credit determined under §38(a) cannot exceed the sum of (i) the first $25,000 of the taxpayer's "net tax liability" for the taxable year, plus (ii) 85 percent of the taxpayer's "net tax liability" exceeding the first $25,000. The term "net tax liability" is defined by §38(c)(2) as tax liability within the meaning of §26(b) reduced by the sum of the nonrefundable personal credits, foreign tax credit, the clinical testing credit, the nonconventional fuels credit, and the research credit.

Observation: The unified tax liability limitation, providing only a single $25,000 amount which the business credit can fully offset and setting the percentage limitation at 85 percent for tax liability in excess of $25,000, is perhaps the chief means by which the TRA credit simplification provisions raise revenue. As previously described in I, A, 3, *supra*, separate $25,000 amounts existed for some of the business related credits prior to the TRA, each of which could be fully applied by a taxpayer having multiple credits. Also, in some cases, the business related credits, such as the energy investment credit, could offset 100 percent of tax liability without limit and other credits could offset 90 percent of tax liability. Another change that enhances revenues is the placement of the clinical testing credit, nonconventional fuels credit, and research credit, all of which can still offset 100 percent of tax liability, before the general business credit for purposes of the order in which such credits are applied against tax liability. Prior to the TRA, the clinical testing credit, the research credit, and nonconventional fuels credit had higher number designations than the various credits constituting the general business credit and so were applied after such lower numbered credits in offsetting tax liability. Thus, for example, under prior law if a taxpayer had a total tax liability of $125,000 and possessed a $125,000 investment credit and $15,000 research credit, the taxpayer could have offset $110,000 of his tax liability with investment credits ($25,000 + (85 percent x $100,000) = $110,000) and offset the remaining $15,000 balance with the $15,000 research credit. Under the TRA credit ordering rules, the $15,000 research credit would be applied first against tax liability leaving a balance of $110,000 to be offset by the general business credit. The general business credit, in turn, can offset $97,250 ($110,000 - ($25,000 + (85 percent x $85,000)) = $97,250) which leaves the taxpayer with a tax liability for the year of $12,750.

The $25,000 amount that the general business credit can offset 100 percent is subject to special allocation rules in the case of related taxpayers. Under §38(c)(3)(A), married individuals filing separate returns are limited to only $12,500 apiece. However, the full $25,000 can be used by a taxpayer filing separately if the taxpayer's spouse has no business credit carryforward or carryback to, and has no current business credit for, the spouse's taxable year ending within or with the taxpayer's taxable year.

Section 38(c)(3)(B) provides that the component members of a controlled group of corporations within the meaning of §1563(a) (generally an 80-percent parent-subsidiary chain of corporations or an 80-percent commonly owned brother-sister group of corporations) must apportion the $25,000 among the members in such manner as prescribed in regulations. Presumably, such regulations will be modeled under the investment credit rules for apportioning the $25,000 amount among the members of a controlled group.[24] Under the investment credit rules, the component members can allocate the $25,000 amount in any manner that they select so long as any member that is less than 100-percent owned by the other component members of the group consents to an apportionment plan. Absent an apportionment plan, the $25,000 amount is divided equally among the component members of the controlled group. The investment regulations also provide rules for apportioning the $25,000 amount where some component members file a consolidated return and other component members do not.[25]

A thrift institution is limited to 50 percent of that portion of the $25,000 amount allocated to such member.[26] A regulated investment company or real estate investment trust subject to taxation under subchapter M of the Code is entitled to that portion of the $25,000 amount that such a taxpayer's taxable income bears to its total taxable income computed without regard to its dividends paid deduction.[27]

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Under §38(c)(3)(D), an estate or trust must reduce its $25,000 amount to an amount bearing the same ratio to $25,000 as the portion of the entity's income not allocated to its beneficiaries bears to the entity's total income.

c. Special Ordering Rules for Public Utilities

Section 38(d) provides a special rule for public utilities subject to the normalization requirements of §46(f). Under this rule, for purposes of §§46(f), 47(a), 197(a), 404(i), and any other provision where it is necessary to ascertain the extent to which the business credits that constitute the general business credit are used, the order in which such credits are used is determined on the basis of the order in which they are listed in §38(b). Thus, the investment credit is deemed to be applied first, followed by the targeted jobs credit, the alcohol fuels credit, and lastly, the ESOP credit.

2. Credit Carryover

a. General

The rules for carrying back and carrying forward an unused general business credit are set forth in §39. Under §39(a)(1), a general business credit, to the extent attributable to the amount of the current year business credit, is carried back to each of the three taxable years preceding the unused credit year and is carried forward to each of the 15 taxable years following the unused credit year. The credit carryover is taken into account for a particular carryover year in the manner provided in §38(a), that is, if it is a carryforward, it is applied to offset tax liability before any current year or carryback from a later year, and if it is a carryback, it is applied after any carryforwards from earlier years or any current year credit.

Section 39(a)(2) provides that a general business credit carryover is carried back from the unused credit year to the first of the eighteen taxable years constituting the credit carryover period and then to the other seventeen years to the extent not used within a particular year. Section 38(b) effectively provides that if there is more than one credit carryback from different unused credit years to a particular taxable year, the credit carrybacks from the unused credit years are applied in sequence, the earliest year's first, against tax liability remaining after the application of any carryforwards and current year credit for that taxable year. Section 39(c) provides a comparable rule for credit carryforwards, requiring that credit carryforwards from two or more separate unused credit years be applied on a FIFO basis.

Example: Corporation A has $500,000 of tax liability for 1986. A also has an unused general business credit for 1984 of $50,000 and an unused general business credit for 1985 of $100,000, both of which, it will be assumed, can only be applied as credit carryforwards to 1986. A also has a $200,000 general business credit in 1988 and a $300,000 general business credit in 1989. A has no current year credit. Thus, A has a total general business credit of $650,000, consisting of $150,000 in carryforwards and $500,000 in carrybacks, available to offset tax liability for 1986. The percentage limitation of §38(c), however, limits the amount of 1986 tax this credit can offset to $428,750 ($25,000 + (85 percent x $475,000) = $428,750). Under §§39(c) and 38(a)(1), the 1984 $50,000 credit carryforward is applied first and is completely used up. The $100,000 carryforward from 1985 is used next pursuant to §38(a)(1). Next, under §38(b), the $200,000 credit carryback from 1988 is applied against the remaining tax liability available for offset and, finally, $78,750 of the $300,000 credit carryback from 1989 is used to offset the balance of the tax liability that may be offset in 1986 under the percentage limitation. A credit carryover of $221,250, entirely attributable to 1989, is available as a carryover to 1987 and the succeeding 17 years in the credit carryover period for 1989.

It should be noted that, although the various credits constituting the general business credit are aggregated for purposes of the carryover provisions, the alcohol fuels credit should be accounted for separately. This is because this credit cannot be carried over to any taxable years beginning after 1994. However, in computing the separate alcohol fuels credit carryover, it is treated as having been applied first to offset tax liability.[28] Thus, if a $200,000 general business credit remains available as a carryforward from 1984, $100,000 of which is attributable to an investment credit and $100,000 to an alcohol fuels credit, and if the taxpayer has $10,000 of tax liability each year for the next 10 years through 1994 and no other credits, the $100,000 of total taxes offset by the carryforward will be allocated entirely to the $100,000 alcohol fuel component of the carryforward. Consequently, the $100,000 carryforward remaining after 1994 can continue to be utilized fully for the remaining five years in the carryover period since none of it will be attributable to an alcohol fuel credit.

b. Transitional Rules

Section 39(d) provides transitional rules for the carryforward of pre-1984 refundable business credits and for the carryback of the general business credit to pre-1984 years. Under §39(d)(1)(A), any carryforward from an unused credit year under the investment credit, the WIN credit, the targeted jobs credit the alcohol fuel credit, or the ESOP credit provisions that has not expired before the beginning of the first taxable year beginning after 1983 is combined with other such credits into a business credit carryforward from that year to be carried to post-1983 years for a period not to exceed 15 years from the year of the original credit. Thus, the TRA subjects these credits to the rules governing the carryforward of post-1983 general business credits, such as the 85 percent percentage limitation, while still requiring a separate accounting of each credit for carryforward purposes.

Comment: It is not entirely clear from the statute in what order the pre-1984 credits comprising the general business credit carryforward to post-1983 years should be applied for purposes of calculating the remaining carryforward. Section 39(d)(1)(B) merely provides that the amount carried forward under the transition rule to another taxable year shall be properly reduced for any amount allowed as a credit with respect to such carryforward for any preceding taxable year. Both the House Ways and Means Report[29] and Senate Finance Report[30] state that pre-1983 credits will continue to be carried to post-1983 years under the substantive rules (apart from the tax liability limitations) under which they were earned. If this is the case, an investment credit carryforward from 1978 will be applied

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before a targeted jobs credit carryforward from 1982 in determining the amount of each credit that survives as a carryforward to subsequent years since the §38 investment credit, as a lower numbered credit, was applied to offset tax liability before application of the §44B targeted jobs credit.[31] The same ordering principle will apply regardless of the years in which the respective credits were earned. Thus, if the targeted jobs credit was earned in 1978 and the investment credit in 1982, the investment credit will still be applied first even though the targeted jobs credit carryover will expire first.

Under §39(d)(2), if a general business credit is to be carried back to a taxable year beginning before 1984, it is treated as being used to offset tax liability only after the application of the credits under §§38, 40, 44B, 44E, and 44G (as in effect before the enactment of the TRA). When carried back to pre-1984 years, the general business credit carryback continues to be subject to the single $25,000 offset amount and 85 percent limitation on the tax liability in excess of $25,000 enacted by the TRA.[32] Further, for purposes of determining the net tax liability employed in computing the percentage limitation for the carryback year, net tax liability is defined as the tax liability determined under §26(b) reduced by the sum of the credits allowable for such carryback year under §§33, 37, 41, 44A, 44C, 44D, 44F and 44H (as in effect prior to the enactment of the TRA).

E. Conforming Changes to Business Credits

1. Investment Credit

Since the TRA provides a uniform carryover provision for the general business credit, which is generally modeled after the carryover provisions in §46(b), the carryover provisions in §46(b) have become unnecessary. Consequently, the TRA[33] deletes the carryover provisions of §46(b) and splits former §46(a) into §46(a) and (b). Moreover, §48(n) and §48(o)(3), (4), (5), (6) and (7), all of which relate to the now obsolete investment credit provided for contributions to ESOPs, have been deleted. It should be noted, however, that in the effective date provisions for the simplification rules,[34] it is stated that none of the conforming provisions to the investment credit are to be construed as reducing the amount of any credit allowable in taxable years beginning before 1984.

The special provisions in former §46(a)(7) allowing energy investment credits to offset 100 percent, rather than 85 percent, of tax liability in excess of $25,000 have been eliminated in view of the new uniform percentage limitation.

2. Alcohol and Targeted Jobs Credit

Like the investment credit carryover provisions, the carryover provisions for the alcohol fuel credit and the targeted jobs credit have been rendered unnecessary by the uniform carryover provision for the general business credit. Consequently, these carryover provisions have been deleted from both credits.[35] However, as previously mentioned, §39(e)(2) specifically provides that the alcohol fuels credit may not be carried to any taxable year beyond 1994.

The TRA[36] incorporates the election to claim the targeted jobs credit formerly provided in §44B (which was repealed by the TRA) into new §51(j). However, in contrast to the requirement under former §44B that the taxpayer elect to have the targeted jobs credit apply, new §51(j) provides that the taxpayer may elect not to have this section apply for any taxable year. As under prior law, an election may be made or revoked at any time before the expiration of the three-year period beginning on the due date for filing the return for a taxable year (determined without regard to extensions). The election is made in such manner as is prescribed in regulations.

The TRA also provides a comparable provision to elect out of the alcohol fuels credit in §39(f).[37] This is a new election; former §44E had no election provisions relating to the applicability of the alcohol fuel credit.

Comment: Although the legislative history does not assign any reason for the addition of the election-out feature in the alcohol fuel credit, it presumably was added to give a taxpayer a choice between claiming the credit, thereby recognizing income in the amount of the credit under §87, or electing out of the credit, when the credit would not prove beneficial, thereby not recognizing income under §87.

F. Refundable Credits

Apart from grouping the refundable credits in Subpart C and renumbering certain of these credits, the simplification provisions of the TRA did not effect any significant change in such credits. Refundable credits continue to be applied against tax liability after all nonrefundable credits have been utilized and, as the name implies, are refundable to the extent such credits exceed tax liability for the year.[38]

G. Alternative Minimum Tax

The TRA[39] continues the rule of prior law that nonrefundable tax credits, with the exception of the foreign tax credit, may not be used to offset alternative minimum tax liability. This is accomplished by amending §55(c)(1) to provide that, for purposes of determining any credit allowable under Subparts A, B, or D of Part IV (other than the §27 foreign tax credit), the alternative minimum tax shall not be treated as a creditable tax. The foreign tax credit continues to be allowable against the alternative minimum tax in accordance with the provisions of §55(c)(2)(B).

As under prior law, the alternative minimum tax, rather than any of the tax liability limitations set forth for the nonrefundable credits, will limit the amount of credits a noncorporate taxpayer can use each year. For example, if an individual has a $15,168 tax liability on $60,000 of taxable income and has a research credit of $5,000 and an investment credit of $10,000, the individual will have a regular tax liability after reduction by credits of $168 since the §30(g) and §38(c) tax liability limitations permit the full use of the research and investment credits. The individual's alternative minimum tax, on $62,000 of alternative minimum taxable income (adding back two personal exemptions), is $4,400. Since nonrefundable credits such as the research and investment credits cannot reduce alternative minimum tax liability, the individual's tax for the year is $4,400, consisting of the $168 of regular tax plus $4,232 of alternative minimum tax.

The TRA endeavors to preserve the rule of prior law that a credit carryover is increased by the amount of credit rendered unusable for a taxable year because of the alter-

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native minimum tax.[40] However, the TRA has not technically accomplished this result. As revised by the TRA, §55(c)(3) provides that for purposes of determining the amount of any carryforward or carryback of any residential energy credit, mortgage certificate credit, research credit, or general business credit, the amount of the tax liability limitation under §26, which relates to the residential energy credit and mortgage certificate credit, §30(g), which relates to the research credit, or §38(c) relating to the general business credit shall be deemed to be the amount of the respective tax liability limitation for such taxable year determined without regard to §55(c)(3), reduced, but not below zero, by the amount of alternative minimum tax. In computing the foregoing alternative minimum tax reduction, the alternative minimum tax is itself reduced by (i) the amount of the foreign tax credit allowable under §27(a), (ii) in the case of the research credit limitation under §30(g), the amount of alternative minimum tax taken into account with respect to the §26 limitation for nonrefundable personal credits, and (iii) in the case of the general business credit limitation of §38(c), the amount of alternative minimum tax taken into account with respect to the limitations under §§26 and 30(g).

Thus, the TRA version of §55(c)(3) uses the respective tax liability limitations to compute the carryover increase. In contrast, under §55(c)(3) prior to amendment by the TRA, the increase in the amount of a credit carryover on account of the alternative minimum tax was computed by substituting for the tax liability limitation for a particular credit the amount of the credit allowable against a regular tax reduced (but not below zero) by the amount of the alternative minimum tax. Thus, for example, if an allowable investment credit for the year was $1,000, reducing a taxpayer's regular tax to zero, and the taxpayer's alternative minimum tax was $100, his applicable credit limitation under §55(c)(3) for credit carryover purposes would be the $1,000 credit reduced by the $100 alternative minimum tax or $900. Under §46(b), the investment credit carryover amount would become the excess of the $1,000 investment credit over the $900 §55(c)(3) credit limitation or $100.

The use of the tax liability limitation instead of the amount of the allowable credit produces what the author believes is an unintended result, (confirmed in a discussion with a staff member of the Joint Committee on Taxation), as the following example illustrates.

Example 1: *Computation of Alternative Minimum Tax*. Assume that A, an individual filing a joint return with his spouse, has a regular tax before credits of $100,000, and has a residential energy credit of $1,000, a research credit of $24,000, and a general business credit of $60,000. For purposes of applying the residential energy credit, his tax liability limitation, computed under §26, is $100,000. His research credit limitation under §33(g) is $99,000, which is the $100,000 regular tax less the $1,000 residential energy credit. Under §38(c), A's tax liability limitation for purposes of the general business credit is $67,500, consisting of the first $25,000 of net tax liability of $75,000 ($100,000 - $25,000 Subpart A and B credits) plus 85 percent of the $50,000 net tax liability in excess of $25,000 or $42,500. Since none of A's credits exceeds his respective tax liability limitation, each credit is fully utilizable in offsetting the regular tax. Consequently, A's regular tax liability is $15,000 ($100,000 - $85,000). Next, assume that A's gross alternative minimum tax equals $40,000.[41] A's alternative minimum tax will, therefore, equal $25,000, which is the excess of the $40,000 gross alternative minimum tax over the $15,000 regular tax. A's total tax for the year is $40,000 consisting of the $15,000 regular tax plus the $25,000 alternative minimum tax.

Example (2): *Carryover Computation*. Under new §55(c)(3), one begins with the §23 residential energy credit for which the tax liability limitation under §26, as stated above, is $100,000. This $100,000 limitation is reduced by the $25,000 alternative minimum tax imposed by §55, leaving a tax liability limitation for residential energy credit purposes of $75,000. This $75,000 tax liability limitation is more than sufficient to absorb the $1,000 residential energy credit with the result that none of residential energy credit is available as a carryover. The tax liability limitation for purposes of computing the amount of the allowable research credit presumably remains at $99,000, since that was the amount of the limitation for regular tax purposes and the alternative minimum tax has been entirely taken into account in figuring the tax liability limitation for purposes of the residential energy credit. The research credit limitation thus remains sufficient to absorb fully the $24,000 research credit. Similarly, the general business credit limitation of §38(c) remains at $67,500 since this is the amount of the limitation for regular tax purposes and the alternative minimum tax was applied entirely against the residential energy credit limitation of §26. Consequently, there is no general business credit in excess of the $67,500 limitation available for carryback or carryforward. The result under new §55(c)(3) that no credit carryover is created does not seem proper given that the $25,000 alternative minimum tax causes the loss of $25,000 in credits for the year in question.

Comment: The most readily apparent solution to the foregoing problem in §55(c)(3) would be to restore the rule of prior law that the tax liability limitation for the respective nonrefundable credits be deemed to be the amount of each credit, rather than the tax liability limitation itself. After an informal inquiry by the author concerning the problem, a staff member of the Joint Committee on Taxation agreed that this would provide the correct result. However, a technical correction to §55(c)(3) will be required.

H. Miscellaneous Amendments

1. Unused Business Credit Deduction

Section 196, which formerly applied to investment credits only, has been amended [42] to embrace the targeted jobs credit and alcohol fuels credit as well as the investment credit. Under §196, if any portion of these three credits will expire unused at the end of a carryover period, the portion of the credit not so allowed is deductible by the taxpayer for the first taxable year following the last taxable year for which such credit could have been allowed as a credit under §39. However, as under prior §196, to the extent the unused credit is attributable to an investment credit (other

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than the 15 and 20 percent rehabilitation credits), only 50 percent of the credit is allowable as a deduction.

Similarly, if a taxpayer dies or ceases to exist during the carryover period, §196(b) allows the deduction of the unused credit amount, under prescribed regulations, for the taxable year in which such death or cessation of existence occurs.

The ESOP credit, which is the only other credit includible in a general business credit under §38, has a separate set of rules permitting a deduction for an unused credit.[43]

2. Survival of Business Credit in Corporate Reorganizations

The TRA[44] amends §381, relating to tax attributes that are inherited by the transferee corporation from the transferor corporation in certain tax-free corporate liquidations and reorganizations, to provide that the unused business credit is one of the attributes that can be inherited subject, however, to the limitations applicable to credits in §383.

3. Tentative Carryback Refunds

In another conforming change, the TRA[45] amends §6411(a)(1) to permit the use of the quick refund procedures of §6411 to obtain a refund attributable to the carryback of a general business credit.

4. Repeal of Tax-Free Covenant Bonds

Section 1451(a) provides that where corporate bonds, mortgages, or other similar corporate obligations issued before 1934 contain a contract or provision under which the obligor agrees to pay or reimburse any portion of the tax imposed by the Internal Revenue Code on the holder of the obligation, the obligor is required to withhold as a tax 2 percent of the interest paid on the obligation if such interest is payable to an individual, partnership, or foreign corporation not engaged in a U.S. trade or business. However, under §1451(b), if the obligor's liability does not exceed 2 percent of the interest and the obligee is a nonresident alien individual, partnership not engaged in a U.S. trade or business, or foreign corporation not engaged in a U.S. trade or business, the customary 30 percent withholding tax applies on the interest paid.

The TRA[46] deletes the tax-free covenant bond provisions from the Code. However, these deletions do not apply to obligations issued before 1984. Since §1451 only applies to obligations issued before 1934, the tax-free covenant provisions effectively continue to apply to any such obligations that are still outstanding.

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[1] P.L. 97-414, §4(a), adding §44H, applicable to amounts paid or incurred after December 31, 1982.
[2] H.R. Rep. No. 432, Part II, 98th Cong., 2d Sess. 1573 (1984); S. Rep. 169, 98th Cong., 2d. Sess. 810 (1984).
[3] *See* §46(a)(3) and (7).
[4] §44G(b)(1).
[5] §46(b), §53(b), §44F(b)(2), §44G(b)(2).
[6] §55(c)(3).
[7] H.R. Rep. No. 98-432, *supra;* S. Rep. No. 98-169, *supra.*
[8] S. Rep. No. 98-169, *supra* at 811.
[9] Act §471.
[10] §25, added by Act §612(a).
[11] H.R. Rep. No. 98-432, *supra,* at 1573; S. Rep. No. 98-169, *supra,* at 810.
[12] *Id.*, at 1574; *Id.*, at 811.
[13] Act §475(a); under Act §475(b), the provisions of Act §474 repealing the treatment accorded tax-free covenant bonds do not apply with respect to obligations issued before January 1, 1984.
[14] Act §612.
[15] Act §474(m).
[16] *Id.*
[17] *Kramertown Co. v. Comr.*, 488 F.2d 728, 730 (5th Cir. 1974).
[18] As amended by Acts §474(r)(21).
[19] *See* §28(d)(2).
[20] §29(b)(5).
[21] *See* §29(g)(2).
[22] Act §474(i)(2).
[23] Act §473.
[24] Regs. §1.46-1(p).
[25] Regs. §1.46-1(p)(4).
[26] *See* §38(c)(3)(C).
[27] *Id.*
[28] *See* §40(e)(2).
[29] H.R. Rep. No. 98-432, *supra,* 1574.
[30] S. Rep. No. 98-169, *supra,* 811.
[31] Former §53(a)(1).
[32] *See* §39(a)(1); S. Rep. No. 98-169, *supra.*
[33] Act §474(o).
[34] Act §475(c).
[35] *See* Act §474(k)(5) and (p)(8).
[36] Act §474(p)(3).
[37] Act §474(k)(6).
[38] *See* §6401(b), as amended by Act §474(r)(36).
[39] Act §474(q).
[40] §55(c)(3), as amended by Act §474(q) and §612(e)(3).
[41] Assuming no other tax preferences besides credits, A's alternative minimum tax will be $39,840. In order to simplify computations, it will be assumed that A's alternative minimum tax equals $40,000.
[42] Act §474(r)(8).
[43] *See* §404(i), as amended by Act §474(r)(14).
[44] Act §474(r)(11) and (12).
[45] Act §474(r)(37).
[46] Act §474(r)(29).

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CHAPTER 15

CHANGES IN INVESTMENT TAX CREDIT RULES

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I. Revision of Investment Tax Credit At-Risk Rules [Act §431] — Code Sections 46(c) and 48(d)

A. Introduction

As part of the Economic Recovery Tax Act of 1981,[1] Congress imposed an at-risk limitation on amounts qualifying for investment tax credit.[2] These rules apply to individuals and closely-held corporations that engage in a trade or business or other income-producing activity other than real estate or certain corporate leasing.[3] The investment tax credit is not allowed for amounts invested in qualifying property to the extent that invested amounts are not at-risk within the meaning of the at-risk loss provision contained in §465(b).

An amount is not considered at-risk if the taxpayer borrowed the amounts for use in an activity and (1) he is not personally liable for repayment of the amount (*i.e.*, the debt is non-recourse and the taxpayer has solely pledged the purchase property as security for the borrowed amount), (2) the taxpayer is protected against loss through guarantees, stop loss agreements, or other similar arrangements, (3) the lender has an interest (other than as a creditor) in the business activity in which the property is used, or (4) the taxpayer is related to the lender within the meaning of §267(b).[4]

There are two exceptions to the tax credit at-risk rule. Amounts borrowed (other than convertible debt) to purchase investment tax credit property are considered at-risk if the taxpayer at all times is at-risk as to an amount equal to at least 20 percent of the basis of the property and the amount is borrowed from or guaranteed by any federal, state or local government or is borrowed from a qualified lender (*i.e.*, a bank, savings and loan, credit union, insurance company, qualified pension trust, or other person actively and regularly engaged in the business of money lending).[5] The qualified lender must not be related to the taxpayer as defined in §168(e)(4), may not be a person who receives a fee with respect to the taxpayer's investment in property (or a person related to that person), and may not be a person from whom the taxpayer acquired the property (or a person related to that person). There is also an exception for certain level payment loans related to qualified energy property.[6] The investment tax credit at-risk rules are applied at the shareholder or partner level for S corporations and partnerships.

The amounts for which a partnership or S corporation are considered at-risk from qualified lenders are allocated among the partners or shareholders according to the rules for allocation of the investment tax credit under §38.[7] This rule, however, does not apply for purposes of determining whether a partner or shareholder has a minimum 20 percent at-risk investment in the property. Thus, to benefit for the qualified lender exception, each partner or shareholder must have an individual 20 percent at-risk investment in the property as determined by the general rules of §465(b). That is, the partner or shareholder will only be considered at-risk for contributed cash and borrowed funds for which he is personally liable.[8] The at-risk limitations for investment tax credit applied to property placed in service on or after February 19, 1981. It did not apply, however, to property placed in service on or after that date if the property was acquired under a binding contract entered into before February 19, 1981.[9]

1. Pass-Through of Investment Tax Credit for Leases

Under existing §48(d), the lessor of new investment tax credit property may elect to transfer (*i.e.*, pass-through) the credit to the lessee, subject to certain conditions. For certain short-term leases, only a portion of the credit may be transferred. Under present law, it is not clear how the at-risk rules apply in the case of a pass-through lease. It appears that some lessees have taken a position that the rules do not apply to them and, have thus rendered the at-risk rules inapplicable to certain lease transactions.

2. Purpose of the At-Risk Rules

The general purpose of the at-risk rules would reduce the incentive for taxpayers to reduce their tax liability by investment in tax shelter activities when they are not subject to a real economic risk. Accordingly, the at-risk rules limit a taxpayer's tax benefits from investment tax credits to funds which the taxpayer has personally used to purchase the property or which the taxpayer has borrowed and is personally liable to repay.

As a corollary, the at-risk rules should prevent investment tax credits from accruing to a purchaser who has no real equity in a property because the value of the property is, or may become, less than the face amount of nonrecourse financing on the property. In this situation, the purchaser may receive the benefit of investment tax credit

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without bearing the economic burden of any decline in the property's value. Similarly, if property is purchased in a seller-financed transaction, there may be some incentive for the parties to inflate the purchase price in order to give the purchaser additional depreciation or interest deductions or an inflated investment tax credit. In these situations, the buyer may be unconcerned about the higher price since the property may simply be repossessed by the seller after the buyer has benefitted from the inflated deductions or credits. The House Ways and Means Committee expressed a concern that the investment tax credit at-risk rules generated significant confusion among taxpayers and inhibited certain nontax shelter transactions. A significant portion of this confusion arose from the interdependence of the loss, limitation at-risk rules contained in §465(b) and the investment tax credit rules. The former are applied on an activity-wide basis and the latter are applied on a property-by-property basis. The Committee felt that an independent rule for the at-risk limitations on investment tax credits would decrease this confusion.[10]

The House Ways and Means Committee believed that the at-risk rule should still apply to those situations where taxpayers will reduce their income tax liability by investing in tax shelter activities in which they are not subject to a real economic risk. However, in those nonrecourse financing situations where the debtor has a real equity interest in property and is likely to make all payments for the property, tax shelter elements are not present and the at-risk rules are not needed. Accordingly, certain active closely-held corporate businesses will be exempt from the at-risk rules for investment tax credit. The changes contained in the Act are designed to eliminate the competitive disadvantages encountered by those closely-held businesses which have been prevented from using legitimate nonrecourse financing or recourse financing through their active subsidiaries.

B. Overview

1. Outline of New Provision

a. Revision of Investment Tax Credit At-Risk Rules

The investment tax credit at-risk rules have been separated from the at-risk rules in §465 and now reduce the credit basis amount of property which qualifies for investment tax credit by the amount of nonrecourse financing excluding certain commercial financing. As under prior law, the general at-risk rules will apply to determine the taxpayers subject to this limitation and to determine the uses of the property which will subject it to the at-risk limitations.

The taxpayer's basis of property for determining the investment tax credit will be reduced by the amount of nonrecourse financing on the property. Nonrecourse financing includes any amount to which the taxpayer is protected against loss — for example, guarantees or stop-loss agreements. Nonrecourse financing also includes amounts borrowed from a person who has interest in the activity in which the property is used or a person related to such person.

There is, however, an exception for qualified commercial nonrecourse financing similar to that under existing law.[11] Qualified commercial financing includes nonrecourse financing provided or guaranteed by any federal, state or local government, or borrowed from a qualified person. A qualified person includes any person actively or regularly engaged in the business of lending money but not any person who is related to the taxpayer, the person from whom the taxpayer acquired the property (or any person related to that person), or any person who receives a fee with respect to the taxpayer's investment in the property (or a person related to such person). The definition of related person, as set forth in §168(e)(4), generally includes family members, fiduciaries, and corporations or partnerships in which a person has at least a 10 percent interest. This exception will not apply if the amount of nonrecourse financing with respect to the property exceeds 80 percent of the taxpayer's basis in the property. In addition, the exception will not apply where the property was acquired by the taxpayer from a related person.

The present safe-harbor rules for certain energy property are continued under the Act.

For partnerships and S corporations, the determination of nonqualified, nonrecourse financing is determined at the partner or shareholder level. If a qualified person provides recourse financing to an S corporation, an allocable share of such financing is treated as recourse to the S corporation's shareholders. Financing of this nature will not count as nonqualified, nonrecourse financing and will not reduce the amount of investment tax credit on this property even though the shareholder may not be personally liable for repayment. Property which qualifies for this exemption must be used by the S corporation in an active trade or business which has at least three full-time nonowner employees during the entire 12 month period ending on the last day of the taxable year, if the services of such individuals are directly related to the business. One full-time employee must also be active in the management of the business. This exception does not apply to master sound recordings or other tangible or intangible assets associated with literary, artistic or musical properties. The amount of any partner's or shareholder's allocable share of financing will be a determined according to the rules for allocation of the investment tax credit as allowed by §38.

Subsequent increases and decreases in nonqualified, nonrecourse financing may increase or decrease the amount of investment tax credit available to a taxpayer. The rules are generally consistent with the rules for changes in the at-risk amount contained in present law.

2. Pass-Through of Investment Tax Credit to Lessees

The Act provides specific at-risk rules for credit pass-through ("§48(d)") leases. Generally, a lessee will be allowed a full investment tax credit only if it is obliged to make rental payments which equal 30 percent of the present value of the amount for which the lessee is treated as having acquired the property by reason of the lessor's election (18 percent of that present value in the case of three-year property). In addition, the lessee's credit is limited to the amount which would have been allowed to the lessor had the lessor's basis in the property been the lessee's acquisition amount and the lessor had not made the pass-through election. Thus, the lessee will receive full credit only if the lessor (who is subject to the at-risk rules) is at-risk with respect to the property.

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The lessee is considered "at-risk" with respect to rental payments which it is required to make under the lease in all events and for which the lessee is not protected against loss through guarantees, stop-loss arrangements or other similar arrangements. The present value of the at-risk rental payments is to be determined by discounting all of the future minimum required rental payments by the interest rate for underpayments of tax in §6621 on the date of the lease.

If the lessee is not entitled to the full investment tax credit under the rules stated above, it may still qualify for a portion of the credit. The amount of the partial credit in any taxable year will equal the full amount of investment tax credit allowable times a fraction, the numerator of which is the aggregate rental payments actually made during the taxable year and the denominator of which is the lessee acquisition amount. Thus, if the lessee makes aggregate rental payments equal to 20 percent of the lessee acquisition amount, 20 percent of the investment tax credit will be allowed in that year.

If investment tax credits are passed through to partnerships and S corporation lessees, the partners or the shareholders must individually be at-risk for their share of the minimum lease payments. Any subsequent reduction in the lessee's at-risk amount through stop-loss or similar arrangements with respect to future rental payments will result in recapture of amounts of the investment tax credit. For purposes of the recapture rule, if the lessee has actually made rental payments, the amount of those payments are considered amounts for which the lessee is at-risk even though they are already paid.

The Treasury has broad authority to prescribe regulations necessary to carry out the purposes of the lessee at-risk rules. The Treasury Department is directed to address the adjustments which may be appropriate where expenses connected with the lease are borne by the lessor and the extent to which contingencies in the lease will be disregarded.

Other sections of the Act revise the activities to which the loss limitation at-risk rules in §465 apply.[12] This provision would exclude certain active businesses conducted by closely-held C corporations from the activities subject to the at-risk rules. Since the investment tax credit at-risk rules are applied to any property which is used in connection with an activity that is subject to a loss limitation under §465, the exclusion of these closely-held C corporations which conduct active businesses from the at-risk activities will also exclude them from the investment tax credit at-risk rules.[13]

3. Effective Date

The revised provisions of the at-risk rules will apply to property placed in service after July 18, 1984 in taxable years ending after that date. The changes will not apply to any property to which §§46(c)(8) and (9) and §47(d) do not apply.[14]

A taxpayer may elect to apply these amendments as if they had been made as part of the Economic Recovery Tax Act of 1981. Such election may only be made as to all property to which the amendments by §211(f) would apply and shall be made in such manner and such time as the Secretary of the Treasury shall prescribe in regulations.[15]

C. Detailed Analysis

1. Revision of At-Risk Rules

a. In General

Section 46(c)(8) is totally revised to incorporate a specific set of at-risk rules applicable solely to the investment tax credit instead of applying the rules contained in §465. As under prior law, the new provision limits the investment tax credit of individuals and any corporation with 50 percent in value of its outstanding stock owned, directly or indirectly, by or for not more than five individuals at any time during the last half of the corporation's taxable year.[16] The limitation applies to qualifying property which is used in connection with a trade or business or for the production of income — the same as under prior law. There is an exclusion for activities which involve the holding of real property, (other than mineral property) and for certain equipment leasing by closely held corporations.[17] The investment tax credit for any property to which the at-risk rules apply will be reduced to account for the nonqualified, nonrecourse financing with respect to such property as of the close of the taxable year in which the property is placed in service. The "credit base" for such property is reduced by the nonqualified, nonrecourse financing on the property, and the appropriate investment tax credit rate is applied to the adjusted credit base.

The credit base for qualified property is defined as the basis of new §38 property or the cost of used §38 property.[18]

b. Nonqualified, Nonrecourse Financing

The new investment tax credit at-risk rules reduce the credit base of property by the amount of nonqualified, nonrecourse financing. Nonrecourse financing for purposes of this section includes typical nonrecourse financing and any amount for which the taxpayer has arranged to protect himself against loss through a guarantee or stop-loss agreement. Nonrecourse financing will also include any amount borrowed from a person who has an interest (other than a creditor) in the activity in which the property is used or if the borrowing is from a person related to the person who has the interest. If a person has an interest in property solely because of his ownership of shares in that corporation, borrowing from that individual, or a person related to that individual, will not be considered nonrecourse financing.[19]

The major exception to the definition of nonqualified nonrecourse financing is for certain "qualified commercial financing." This exception applies to property acquired by taxpayer from a person who is not a related person if the amount of nonrecourse financing on the property does not exceed 80 percent of the property's credit base. A taxpayer may borrow from a "qualified person" or from any federal, state, or local government or instrumentality thereof, or the financing may represent a loan guaranteed by any federal, state or local government. Convertible debt cannot qualify for this exception.[20] Persons who are actively and regularly engaged in the business of lending money are considered qualified persons and may engage in qualified commercial financing as contemplated by this exception. Such qualified persons may not be related to the taxpayer, the person from whom the taxpayer acquired the property (or a person related to such person), or a person who received a fee with

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respect to the taxpayer's investment in the property (or a person related to such person).[21] An example of a person who received a fee with respect to a taxpayer's investment in property would be a promoter or organizer of an investment.[22]

The term "related person" for purposes of determining if borrowing is nonqualified, nonrecourse financing, is defined with reference to §168(e)(4) determined as of the close of the taxable year in which the property is placed in service. If the two persons are related in the following manner, and one of them is a disqualified person, the other person will also be disqualified:

(1) the brothers, sisters, (whether by whole or half blood), spouse, ancestors, and lineal descendants of a person;

(2) a corporation in which the individual owns more than 50 percent of the value of the outstanding stock of that corporation either directly or indirectly;

(3) two corporations if more than 50 percent of the value of the outstanding stock of each corporation is owned directly, or indirectly, by or for the same individual and if either one of such corporations is a personal holding company at the end of the taxable year;

(4) a grantor and a fiduciary of any trust;

(5) fiduciaries of trusts which have the same person as grantor;

(6) fiduciary of a trust and a beneficiary of that trust;

(7) fiduciary of a trust and beneficiary of another trust if the same person is grantor of both trusts;

(8) fiduciary of a trust and a corporation if more than 50 percent in value of the outstanding stock of the corporation is owned directly or indirectly by or for the trust or by or for the grantor of the trust;

(9) an S corporation and a partnership if the same person owns more than 10 percent in value of the outstanding stock of the S corporation and more than 10 percent of the capital interest or the profits interest in the partnership;

(10) an S corporation and another corporation if the same person owns more than 10 percent in value of the outstanding stock of each corporation;

(11) an S corporation and a C corporation if the same individual owns more than 10 percent in value of the outstanding stock of each corporation;

(12) a partnership and a partner owning directly or indirectly more than 10 percent of a capital or the profit interest in such partnership;

(13) two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital interest or profit interest;

(14) both persons are members of a parent-subsidiary controlled group as defined in §1563(a)(1) as modified by §52(a);

(15) both persons are members of a brother-sister controlled group as defined in §1563(a)(2) as modified by §52(a);

(16) both persons are members of a combined group as defined in §1563(a)(3) as modified by §52(a).

The determination of whether a partner's or S corporation shareholder's allocable share of any financing is nonqualified, nonrecourse financing is determined at the partner or shareholder level. Thus, when arranging nonrecourse financing which the purchaser wishes to be qualified commercial financing, the determination of the prohibited relationships is made at a shareholder level. Apparently, depending on the owners of a partnership or S corporation, one owner may have a full credit basis for its investment tax credit property but another owner may have its basis reduced because of a prohibited relationship to the lender.[23] The determination of any partner's or shareholder's allocable share of any financing is made in the same manner as the investment tax credit is allowable under §38.[24] These rules are generally included in §1.46-3(f)(2) of the Treasury Regulations.

If the financing is with recourse at the corporate level of an S corporation, the financing will be considered recourse financing with respect to that shareholder's allocable share of the financing if the property is considered qualified business property even though there is no recourse to the shareholder under state law.[25] "Qualified business property" is any property used by a corporation in the active conduct of a trade or business if the corporation had at least three full-time employees who are not owner-employees [as defined in §465(c)(7)(E)(i)] during the entire twelve month period ending on the last day of the taxable year and if substantially all the services of those three employees are directly related to the active trade or business conducted by the corporation. In addition, during the entire taxable year (consisting of twelve months) the corporation must have at least one full-time employee substantially engaged in the active *management* of the trade or business.[26] This exception will not apply to any master sound recording or other tangible or intangible asset associated with literary, artistic or musical properties.

c. Subsequent Decrease in Nonqualified, Nonrecourse Financing

If a purchaser of property which qualifies for the investment tax credit decreases the amount of nonqualified, nonrecourse financing on that property, the at-risk provisions will allow the taxpayer to take some or all of the additional investment tax credit which was previously disallowed on the property. New §46(c)(9) addresses a subsequent decrease in nonqualified, nonrecourse financing. If, at the close of a taxable year following the taxable year in which the property is placed in service, there is a net decrease in the amount of nonqualified, nonrecourse financing on property, then that decrease will be considered an additional qualified investment by the taxpayer in the year in which the property was first placed in service.[27] However, the credit will be treated as earned only in the year in which the decrease in the amount of nonqualified, nonrecourse financing occurs. Thus, the percentage of credit allowable will be determined on the useful life based on the date the property is placed in service but interest on the

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amount of any refund will run from the year of the decrease in the financing. This is the same rule which is contained in §46(c)(9)(C) prior to the 1984 amendments.

Observation: There is a provision in the statute which provides that nonqualified, nonrecourse financing will not be treated as decreased through the surrender or other use of property financed by nonqualified, nonrecourse financing.[28] There is no clear legislative history on the intent behind this provision. It apparently means that if a taxpayer reduces his nonqualified, nonrecourse financing by surrendering to the borrower, or allowing the borrower to use, property financed by nonqualified, nonrecourse financing, there will be no additional qualified investment allowed with respect to that property.

d. Subsequent Increase in Nonqualified, Nonrecourse Financing

Section 47(d) provides that there is a net increase of nonqualified, nonrecourse financing with respect to any property for which investment tax credit was allowed, the investment tax credit shall be recaptured in an amount equal to the existing investment tax credit allowed with respect to the property less the amount of investment tax credit which would be allowed for the amount of nonqualified, nonrecourse financing outstanding at the end of a current taxable year.[29] The specific language of this section says that the increase in nonqualified, nonrecourse financing will generate a reduction in investment tax credit only if §46(c)(8) applied. That section applies only if there is nonqualified, nonrecourse financing outstanding at the end of the taxable year in which the property is placed in service. Apparently, such financing placed on the property after the close of the taxable in which it is placed in service will not reduce the investment tax credit.

The revision of §47(d)(2) retains the exception that a transfer of any evidence of indebtedness more than one year after the date the indebtedness is incurred will not be considered an increase in the amount of nonqualified, nonrecourse financing. The meaning of this section may be illustrated as follows: if a qualified person transfers qualified commercial financing to a nonqualified person, there would be no increase in nonqualified, nonrecourse financing if the transfer takes place more than one year after the indebtedness was incurred.

2. At-Risk Rules Apply to Pass-Through Leases

a. Lessor Election

The 1984 Act specifies the new at-risk rules which will apply when a lessor makes an election to pass the investment tax credit through to a lessee under §48(d). This paragraph applies the at-risk investment tax credit rules contained in §46(c)(8), discussed above, to the lessor of the property.[30] The at-risk rules do not apply to a lessor who manufactured or produced the property or if the property has a readily ascertainable fair-market value. In addition, the Secretary of the Treasury has discretion to prescribe regulations which outline any other exceptions where this rule is not necessary for the lessor to be subject to the at-risk rules.[31]

b. Limitation on Lessee's Credit

If the at-risk rules apply to a lessor, the lessee's credit will be limited to the amount that the lessee is at-risk as determined in accordance with the rules of §46(c). Specifically, the lessee's credit will be limited to the amount of investment tax credit which would have been allowable to the lessor with respect to the property if the lessor's basis in the property were equal to the lessee's acquisition amount and the lessor had not made an election under this section.[32]

Not only is the lessor subject to the at-risk rules, but the lessee is also subject to the rules. A lessee who is subject to these new rules is now called the "at-risk lessee." An at-risk lessee is any lessee who is a taxpayer subject to the at-risk rules in §465(a)(1).[33] These at-risk rules apply to "at-risk property" which is any property used by an at-risk lessee in connection with an activity which is subject to the at-risk rules of §465.[34] These are the same requirements that were imposed under prior law.

To avoid a reduction in investment tax credit, an at-risk lessee must have a minimum at-risk percentage. The at-risk percentage is determined by dividing the present value (discounted at the §6621 rate in effect at the time the lease is entered into) of the aggregate lease at-risk payments by the lessee acquisition amount.[35] To avoid a reduction of the lessee's investment tax credit, its at-risk percentage must exceed 10 percent plus two times the sum of the percentages of investment tax credit available on the property. If the at-risk property is three year property for purposes of the accelerated cost recovery system (ACRS), the required percentage is only 60 percent of the amount determined in the preceding sentence.[36]

Example: If qualified inter-city buses are placed in service on January 1, 1985, the amount of the credit will equal the sum of the regular percentage, of 10 percent, and the energy percentage of 10 percent for a total of 20 percent. For this type of property, the at-risk percentage of the property must equal or exceed 50 percent (ten percent plus two times 20 percent).

If the property were an automobile which is three year property, the at-risk percentage for that property must exceed 18 percent. That percentage is calculated by doubling the regular percentage of 10 percent, adding 10 percent to that and multiplying that result (30 percent) by 60 percent.

For purposes of determining the at-risk percentage, the lessee acquisition amount is the amount at which the lessee is treated as having acquired the property under the general pass-through rules (*i.e.*, without regard to the amount at-risk).[37] A lessee is determined to be at-risk with respect to any rental payment which the lessee is required to make under the lease in all events and for which the lessee is not protected against loss through nonrecourse financing, guarantees, stop-loss agreements or other similar arrangements.[38]

If the at-risk percentage for a particular piece of lease property is less than the required percentage, only a portion of the investment tax credit will be allowed to the lessee. In any taxable year, the investment tax credit allowed to the taxpayer will be based on the ratio of aggregate rental payments made by the lessee under the lease during the taxable year to the lessee acquisition amount.[39] In the year in which the aggregate rental payments with respect to the property exceed the required percentage, the lessee is al-

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lowed to take the remaining investment tax credit against income.[40]

Example: A lessor and lessee enter into a lease for property which qualifies as five year ACRS property and for which the lease requires equal payments of $20 per year for a five year period. Assuming the present value of the aggregate lease payments is $80, the at-risk percentage in the first year will be 25 percent ($20 divided by $80). Accordingly, the lessee would only receive 25 percent of the investment tax credit available in the first taxable year. In the second taxable year, when the at-risk lease payments ($40) equal 50 percent of the lessee acquisition amount ($80), the remaining amount of investment tax credit will be allowed to the lessee.

If the lessor elects to pass-through the investment tax credit to a lessee, the lessee will only be subject to the at-risk rules contained in §48(d)(6). The lessor, but not the lessee, must comply with the at-risk rules of §§48(c)(8) and (9) and 47(d).[41]

c. Partnerships and S Corporations as Lessees

Lessees which are partnerships and S corporations will be subject to similar rules contained in general investment tax credit at-risk rules. Accordingly, those partners and shareholders must individually be at-risk for their share of the minimum lease payments on investment tax credit that will passed-through to them.[42] This means that the individual shareholders and partners generally must be at-risk for their share of the lease at-risk payment. Presumably, an S corporation shareholder will be considered at-risk for all rental payments which the S corporation is required to make under the lease in all events and which is provided with respect to qualified business property as defined under §46(c)(8)(E)(iii).[43]

If there are subsequent reductions in a lessee's at-risk amount with respect to future lease payment by entering into guarantees or stop-loss arrangements, the Secretary of the Treasury will have the discretion to promulgate regulations which recapture the investment tax credit under principles similar to those in §47(d).[44] For purposes of this rule, any lease payments actually made by the lessee will be considered an at-risk payment in determining the lessee's amount.[45]

d. Treasury Regulations

The Treasury Department is authorized to prescribe regulations necessary to carry out the purposes of the lessee at-risk rules.[46] The Treasury is specifically directed to consider the appropriate adjustments to acquired rental payments where the lessor bears expenses connected with the lease which the lessee typically bears. In addition, the regulations will address which contingencies in a lease will be disregarded for purposes of the at-risk rules. The regulations regarding contingencies are expected to take into account the normal business practices associated with lease transactions. Accordingly, a provision such as forgiveness of rental payments where the property is destroyed or damaged will be disregarded for at-risk purposes. The option of the lessee to unilaterally terminate the lease is not a contingency which should be disregarded for at-risk purposes. However, when the termination of a lease is permitted on payment of a fixed amount, the lessee may be considered at-risk for the lesser of the present value of the termination period or the present value of the future rent payments which would be due after the date on which the lease could be terminated. Also, a lessee's right to substitute other lease property in the future (*e.g.*, a newer model of a leased computer) is a contingency which may be disregarded if the minimum rental payments under the lease are not reduced upon such substitution.[47]

II. Modifications of Rules Governing the Rehabilitation ITC

A. Introduction

Under §46(a)(3) and (b)(4), as revised by the TRA credit simplification provisions,[48] three different investment credit rates are prescribed for qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified building. The investment credit rate is 15 percent of qualified rehabilitation expenditures for buildings that are at least 30 years old, the rate increases to 20 percent of qualified expenditures for buildings at least 40 years old, and the credit is equal to 25 percent of qualified rehabilitation expenditures in the case of a certified historic structure.

Section 48(g) sets forth the requirements that must be satisfied to obtain the rehabilitation investment credit. Under §48(g)(1), a qualified rehabilitated building is a building (i) that has been "substantially rehabilitated", (ii) that was placed in service before the beginning of the rehabilitation, and (iii) that has retained 75 percent or more of the existing external walls as external walls in the rehabilitation process. A building has been "substantially rehabilitated" if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer exceed the greater of (i) the adjusted basis of the building, or (ii) $5,000. A lessee may undertake the rehabilitation of the building and qualify for the rehabilitation investment credit, but only if the remaining term of the lease when rehabilitation is completed, determined without regard to any renewal periods, is less than 15 years.[49] An expenditure is a qualified rehabilitation expenditure, if, among other things, it is incurred for property (or additions or improvements to property) having a recovery period within the meaning of §168 of 15 years, and is incurred in connection with the rehabilitation of a qualified rehabilitated building; a rehabilitation expenditure does not qualify unless the straight-line cost recovery method under §168(b)(3) is elected with respect to the expenditure.[50]

B. Analysis of TRA Changes to Rehabilitation Credit

The TRA amends the requirements for the rehabilitation investment credit in four respects. First, in a change conforming the rehabilitation investment credit rules to the lengthening of the §168 cost recovery period for real property to 18 years, the TRA[51] modifies the definition of a "qualified rehabilitation expenditure" to provide that the expenditure must be incurred for real property (or additions or improvements to real property) having a recovery period of at least 18 years unless the expenditure relates to low-income housing, in which case the recovery period remains at 15 years. In addition, if the expenditure is made

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by a lessee, the expenditure does not qualify for the credit unless the remaining term of the lease is at least 18 years (15 years in the case of low-income housing).[52]

A second change made by the TRA [53] relating to the definition of a qualified expenditure is to provide that an expenditure does not qualify if it is allocable to the portion of the building which is (or may be reasonably be expected to be) tax-exempt use property within the meaning of §168(j)(3). In general, tax-exempt use property is property leased to a tax-exempt entity, governmental entity, or foreign person or government. It should be noted, however, that even if the expenditure allocable to tax-exempt use property does not qualify for the credit, the expenditure will still be counted for purposes of determining whether a building has been substantially rehabilitated. The new tax-exempt leasing rules are analyzed in detail in Chapter 18.

Note: The tax-exempt entity provisions of the TRA amend §48(a)(5) to extend the denial of investment credit property status (§38 property) to property used by a foreign person or entity as well as to property used by the U.S. or a state government or instrumentality thereof. One exception to the denial of §38 status, carried over from pre-TRA law, is provided for a qualified rehabilitated building leased to a governmental unit (or, as expanded by the TRA, to a foreign person or entity). This exception applies to the portion of the building's basis attributable to qualified rehabilitation expenditures. However, an expenditure will not be a qualified rehabilitation expenditure if it will constitute tax-exempt use property. Hence, even though the rehabilitated building will not be disqualified under §48(a)(5), the expenditures must still pass muster under §168(j)(3).

A clarifying change, also made in the tax-exempt leasing portion of the TRA,[54] is to provide that the straightline method of depreciation under §168(b)(3) need not be elected with respect to any expenditure described in §168(j), the tax-exempt entity rules, or §168(f)(12), the tax-exempt financed property rules, since the straight-line method is already required for such expenditures.

The final modification to the rehabilitation investment credit rules enacted by the TRA [55] is to provide an alternative test to the retention of the 75-percent external wall test for purposes of determining whether a building is a qualified rehabilitated building. Under new §48(g)(1)(E), the 75-percent external wall test of §48(g)(1)(A)(iii) is deemed satisfied if, in the rehabilitation process, the following three requirements are met:

(i) at least 50 percent of the building's external walls are retained in place as external walls;

(ii) at least 75 percent of the building's external walls are retained in place as either external walls or internal walls; and

(iii) at least 75 percent of the building's internal structural framework is retained in place.

The reason for the enactment of this alternative test is to facilitate the qualification for the rehabilitation credit by buildings that are not square or rectangular in shape.[56]

The Senate Finance Report [57] provides that the alternative method will continue to follow the present rules for determining the percentage of a building's external walls that are retained and that it is intended that comparable rules will apply under the alternative test in determining what percentage of internal walls (and external walls converted to internal walls) are retained following rehabilitation. The Report further states the intention that all load-bearing internal walls and any other internal structural supports present in the building before rehabilitation begins, including columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building, will be treated as part of the building's internal structural framework.

C. Effective Dates

The TRA provisions conforming the rehabilitation investment credit rules to the 18-year recovery period under §168 are generally effective with respect to property placed in service after March 15, 1984.[58]

The new provisions added in the tax-exempt entity leasing portion of the TRA are generally effective for property placed in service after May 23, 1983, and taxable years ending after that date.[59]

The alternative test to the 75-percent external wall test is effective for qualified rehabilitation expenditures incurred after December 31, 1983, in taxable years ending after that date.[60]

III. Increase in the Amount of Used Property Eligible for the Investment Credit Postponed

A. Introduction

Under §48(c), only a limited amount of "used §38 property" may be taken into account in calculating the investment credit. "Used §38 property" is §38 property that is not new, that is acquired by purchase, and that does not continue to be used after its acquisition by a person who used the property before acquisition (or a person related to the user).

Section 48(c)(2), as amended by the Economic Recovery Tax Act of 1981 (ERTA),[61] increased the amount of used §38 property that can be taken into account in figuring the credit to $125,000 for taxable years beginning in 1981 through 1984. For years beginning subsequent to 1984, ERTA raised the limit on used §38 property to $150,000. The used §38 property limitation for married individuals filing separately is generally one-half of the dollar limitation applicable to other taxpayers.[62]

B. Analysis of TRA Postponement

The TRA [63] amends §48(c) to retain through 1987 the $125,000 used §38 property limitation ($62,500 for married individuals filing separate returns). Accordingly, the $150,000 used §38 property limitation will not become effective until taxable years beginning after 1987.

As tax-raising measures go, the postponement of the increase in the used §38 property limitation is not overly significant but still may have an effect on small business taxpayers, who are more likely to acquire used property for the cost savings. The postponement results in the potential loss of the credit on $25,000 of used property. Assuming used property were eligible for the full 10 percent credit,

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the maximum potential loss of credit is $2,500 for any year affected by the change.

C. Effective Date

The foregoing TRA amendment is effective for taxable years beginning after December 31, 1983.[64]

IV. Categories of Tax-Exempt and Foreign Entities Subject to Nontaxable Use Restriction Expanded [Act §31]

Section 31 of the Act expanded the categories of leased property which are not eligible for the investment tax credit and the rehabilitation credit. For a detailed discussion of this comprehensive set of rules, *see* Chapter 18.

V. Financial Accounting for the Investment Credit [Act §450]

A. Introduction

When the investment credit was first introduced in 1962, there were two methods of accounting for it which were sanctioned by the two authorities which controlled accounting standards, the Accounting Principles Board ("APB"), and the Securities and Exchange Commission ("SEC"). One of those methods was the "flow-through" method. That method allowed the credit as a reduction of income taxes in the year in which the credit was earned. The credit was viewed as a selective tax rate reduction. This provided an immediate reduction of the tax expense and a resulting increase in the reported net income of the taxpayer.

The other method of accounting for the credit was known as the "deferral" method. This method allocated the credit as a ratable reduction of income taxes over the life of the asset involved. It was viewed by some accounting authorities as a more correct application of accounting principles because it treated the credit as a reduction in the purchase price of the asset instead of a reduction in taxes. In fact, the APB issued a discussion draft in 1971 which, if adopted, would have restricted the accounting method for investment credit to the deferral method.

> *Example*: If a taxpayer purchased an asset which qualified for the investment credit and that asset has an estimated useful life of ten years, one-tenth of the tax credit would reduce income taxes in each of the ten years following the purchase of the asset under the deferral method.

As part of the Revenue Act of 1971, which reenacted the investment tax credit, Congress indicated that it viewed the restoration of the investment tax credit as an incentive for modernization and growth of private industry. Accordingly, it included a provision which precluded any governmental agency from compelling a taxpayer to use any particular method of accounting for the investment tax credit.[65] Congress wanted the APB and the SEC to allow taxpayers to use the flow through method of accounting for the investment tax credit.[66] Section 101(c)(1)(C) of the 1971 Act required a taxpayer to use the same method of accounting for the credit in all reports subject to the jurisdiction of any federal agency unless the Treasury Department approved a change to another method. This provision was added in the Conference agreement on the 1971 Act and was intended to produce consistency in reporting the credit.[67]

The 1971 Act contained no standards for the Treasury Department to use in determining when it should allow taxpayers to change their method of accounting for the credit. There was also no penalty provision included for failure to comply with the provision. The Congress does not appear willing to propose penalties for failure to obtain permission or standards by which the Treasury Department should evaluate these requests.

B. Overview and Detailed Analysis

The Act repeals §101(c)(1)(C) of the 1971 Revenue Act. That section imposed a financial accounting consistency requirement on financial reporting by persons who qualified for the investment tax credit. It also required persons who wanted to change their method of accounting for the investment tax credit to apply to the Treasury Department for permission to change their method. A financial consistency requirement will still be imposed on those taxpayers subject to generally accepted accounting principles. Change of the accounting method for financial reporting of investment tax credits will now be approved by the taxpayer's accountants.

The provision is effective as if it had been included in the Revenue Act of 1971.

VI. Technical Correction to the Investment Credit Rules

A. Introduction

1. Credit for Preference Items

Intangible drilling costs that are expensed under §263(c) instead of capitalized are treated as a tax preference for purposes of the §55 alternative minimum tax on noncorporate taxpayers. Under §58(i)(4), a taxpayer may elect to amortize over a five-year period intangible drilling costs not derived from a "limited business interest" to avoid the treatment of such costs as a tax preference for §55 purposes.[68] Section 58(i)(4) also provides that if the election to amortize is made, the qualifying intangible drilling costs will qualify for a 10 percent investment credit.

Section 291(b) provides that corporate taxpayers must reduce their current deductions under §§616(a) and 617 for mineral exploration and development costs by an amount equal to 15 percent of such costs. Under §291(b)(2), the 15 percent portion of such costs disallowed are to be amortized over a five-year period, using the percentages set forth in §291(b)(3). In addition, §291(b)(2) provides that the disallowed 15 percent portion of such costs qualifies for the 10 percent investment credit. Section 291(b) was enacted by TEFRA,[69] effective with respect to expenditures incurred after 1982 in taxable years ending after 1982.

2. Investment Credit Basis Reduction

TEFRA [70] enacted new §48(q), requiring the reduction of the basis of an asset on which an investment credit is claimed. In general, the basis reduction is equal to 50 percent of the credit, except that in the case of qualified rehabilitated buildings (other than certified historic struc-

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tures) the basis reduction is equal to 100 percent of the amount of the credit. The reduced basis applies for all purposes of the income tax provisions. Thus, the reduced basis is used in computing ACRS deductions and in computing gain or loss on the disposition of investment credit property. If property whose basis has been reduced due to an investment credit is disposed of, and all or part of the investment credit is recaptured, §48(q)(2) provides that the basis of such property (immediately before the event resulting in recapture) is increased by 50 percent of the amount of the credit recaptured. The basis reduction is generally effective for property placed in service after 1982.

B. Analysis of Technical Corrections

1. U.S. Location Requirement for Preference Credits

In order to conform the investment credit provided under §§58(i)(4) for intangible drilling costs and 291(b)(2)(B) for disallowed mining exploration and development costs to the general investment credit rule, contained in §48(a)(2), that eligible property be used predominantly in the U.S., the TRA amends §58(i)(4) [71] to allow the credit for intangible drilling costs only with respect to wells located in the U.S., and it amends §291(b)(2)(B) [72] in a similar fashion to require that mineral deposits be located in the U.S. in order for exploration and development costs to be eligible for the credit. It should also be noted that the TRA [73] increases the §291(b) preference cutback from 15 to 20 percent. Thus, the disallowed portion of mineral exploration and development costs for which a credit is provided under §291(b)(2)(B) will be 20 percent, assuming the deposits are located in the U.S.

2. Partnership and Subchapter S Basis Adjustment

Under new §48(q)(6), the adjusted basis of a partner's interest in the partnership, or the adjusted basis of a shareholder's stock in a Subchapter S corporation, must be appropriately adjusted to take into account the basis adjustments made under §48(q) in the basis of property held by the partnership or Subchapter S corporation. Of course, if the partnership or corporation elects a reduced credit (in the case of the regular investment credit) under §48(q)(4) in lieu of the §48(q)(1) basis reduction, a reduction will not be required in the basis of a partner's or Subchapter S shareholder's interest in the partnership or corporation.

C. Effective Dates

Since the foregoing amendments are technical corrections, they are effective as if they had been included in TEFRA.[74] Consequently, the amendment to §58(i)(4) applies to tax years beginning after December 31, 1982. The amendment of §291(b)(2)(B) applies to mining exploration and development expenditures after December 31, 1982, in taxable years ending after such date. Note, however, that the increase in the corporate preference cutback in §291(b) to 20 percent is applicable for expenditures after December 31, 1984, in taxable years ending after that date. Finally, the addition of §48(q)(6), requiring basis adjustments in partnership and Subchapter S corporation interests, is generally effective for property acquired and placed in service after 1982; for property under construction before 1983 but completed after 1982, §48(q)(6) will apply to the extent basis is attributable to post-1982 construction.

VII. New or Modified Investment Credit Rules for Movies, Tapes, and Sound Recordings

A. Introduction

Section 48(a)(1) provides that tangible personal property generally qualifies as "§38 property" if either it is recovery property within the meaning of §168 without regard to useful life, or it is other depreciable property having a useful life of 3 years or more at the time the property is placed in service. However, property will not qualify as "§38 property" if it falls within one of the exceptions to such classification in §48(a)(2) through §48(a)(10), such as for property used predominantly outside the U.S., for property used by tax-exempt organizations, or for property used by governmental units.[75] Under §46(a) and (b), as revised by the TRA credit simplification rules,[76] and §46(c)(7), an investment credit of 6 percent is effectively provided for recovery property qualifying as 3-year property; for all other §38 tangible personal property that is classified as 5-year property under ACRS, the investment credit is equal to 10 percent.

In general, most tangible depreciable property placed in service after 1980 qualifies as recovery property. However, under §168(e), certain property is excluded as recovery property, even though placed in service after 1980, if the taxpayer elects to depreciate the property under the income forecast method or other depreciation method not expressed in terms of years. The income forecast method has been held to be an appropriate method of depreciation for movies, television films and tapes, and master sound recordings.[77] Section 38 property that is not recovery property is provided with an investment credit of 3⅓ percent, if the property's useful life is at least 3 years but less than 5 years, with an investment credit of 6⅔ percent if its useful life is at least 5 years but less than 7 years, and with an investment credit of 10 percent if its useful life is at least 7 years.[78]

As previously mentioned, property that is not recovery property qualifies as §38 property only if it is tangible property. A long-standing controversy has existed between the Service and taxpayers as to whether movies, tapes, and sound recordings constitute tangible property. The Service's position has been that movies, tapes, and master sound recordings do not qualify for the investment credit because they are intangible property.[79] However, the courts have generally sided with taxpayers.[80]

In order to resolve the foregoing controversy in the case of qualified films, Congress in the 1976 Tax Reform Act [81] enacted §48(k) to provide generally a credit equal to 6⅔ percent without regard to the qualified film's useful life. A qualified film is generally any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. It does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.[82] The §48(k) credit is available only if the film is new §38 property and only to the extent the taxpayer has an ownership interest in the film.[83] In determining the amount of the credit under §48(k), only qualified United States production cost may be taken into account, but the predominant U.S. use test of §48(a)(2) does not apply. Under Regs. §1.48-8(a)(4)(i)

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implementing the §48(k) credit, a taxpayer's ownership interest in a qualified film must be determined on the basis of the amount of the taxpayer's capital at risk on the film. Thus, an at-risk rule is essentially built into the §48(k) credit.

In lieu of taking the reduced 6⅔ percent credit for a qualified film under §48(k)(2), a taxpayer may elect under §48(k)(3) to apply the rules of §46(c)(2), which look to the property's useful life in determining the credit rates. If this election is made, the useful life of the qualified film is considered to end at the close of the taxable year the aggregate amount of depreciation deductions under §167 would equal or exceed 90 percent of the basis of the film.

No special investment credit rules have been provided under present law for sound recordings.

B. Analysis of TRA Changes

1. Movies and Tapes

According to the Senate Finance Committee Report accompanying the TRA,[84] present law is unclear as to whether movies or tapes qualify for the ACRS or the general investment credit, since both ACRS and the general investment credit are available only for tangible personal property. The Report further notes that some taxpayers have taken the position that although movies and tapes depreciated under the income forecast method are not recovery property for ACRS purposes, they nevertheless are eligible for the general investment credit and are not subject to §48(k). Accordingly, to "clarify" present law, the TRA[85] enacts new §168(e)(5) to exclude any motion picture film or video tape from the definition of "recovery property," and it amends §168(e) to provide that the exceptions listed in §168(e) to the definition of recovery property, including new §168(e)(5), will not be treated as recovery property for all purposes of the Internal Revenue Code, and not just for purposes of §168.

The principal effect of this change is that taxpayers may no longer take the position that the 6 or 10 percent investment credit provided for recovery property is available for property excluded under §168(e) since those exceptions apply only for §168 purposes.

Observation: As noted above, the Senate Finance Committee Report describes the §168(e) amendments as making it clear that movies and video tapes cannot qualify as recovery property for either depreciation or investment credit purposes. If merely a "clarification," it would appear that the only reason such property could not have been recovery property prior to the TRA was that it did not constitute tangible property. However, the Conference Committee clearly states that no inference is intended as to the property treatment under present law, for investment credit as well as depreciation purposes.[86] It should also be noted that none of the statutory amendments directly or indirectly addresses the issue of whether such property is tangible.

The TRA makes two additional significant changes in the investment credit rules for qualified films eligible for the §48(k) investment credit. First, §48(k)(4) is amended to provide that the at-risk rules of §46(c)(8) and (c)(9) do not apply to qualified films.[87] Since, as discussed above, Regs. §1.48-8(a)(4)(i) establishes an independent at-risk rule for qualified films, the general at-risk rules of §46(c)(8) and (9) are unnecessary.

Second, the TRA[88] enacts new §48(q)(6) to coordinate the basis reduction rules of §48(q) with the §48(k) rules for qualified films. The basic rule of §48(q)(6) is that, in lieu of the basis reduction under §48(q)(1), the basis of a taxpayer's ownership interest in a qualified film must generally be reduced by 50 percent of the amount of the credit determined under §48(k).[89] However, contingent amounts described in §48(k)(5)(B)(v) and (vi) for which a credit is allowable and which are currently deductible as well, namely, residuals payable under contracts with labor organizations and participations payable as compensation to actors, production personnel, directors, and producers, are subject to a separate reduction. The amount of the current deduction for such contingent payments must be reduced by 50 percent of the credit determined with respect to such contingent amounts.[90] Since these contingent amounts are not capitalized but are deducted currently, and §46(q)(6) reduces the taxpayer's current deduction by 50 percent of the credit, the taxpayer's ownership interest in the qualified film is not to be reduced by 50 percent of the amount of the credit allowed with respect to such contingent cost.[91]

Lastly, it should be noted that new §168(j)(4)(B)(ii), added by the TRA provisions relating to tax-exempt entity leasing,[92] specifically provides that qualified films used by foreign persons are not to be treated as used by tax-exempt entities. However, no comparable exception is provided for use by the U.S. or a state government or by a tax-exempt organization. Consequently, the income forecast method of depreciation will continue to remain available for the capitalized production costs of qualified films leased by foreign persons; the straight-line write-off over a 12-year recovery period otherwise required under §168(j)(1) for property leased to tax-exempt entities will not apply to qualified films leased to foreign persons.

2. Sound Recordings

The TRA[93] enacts new §48(r) to provide taxpayers with two alternatives with respect to sound recordings for purposes of both depreciation and investment credit. Under §48(r)(1), if the sound recording is new property, the taxpayer is granted an election to treat such recording as recovery property that is 3-year property to the extent the taxpayer has an "ownership interest" in the recording. Accordingly, a 6-percent investment credit will be available with respect to the sound recording under this election.[94] The election must be made separately with respect to each sound recording.[95] In addition, the election will not be effective unless all taxpayers having an interest in the sound recording make the election.[96]

Section 48(r)(2) provides that, if a taxpayer does not make an election with respect to any sound recording under §48(r)(1), the recording does not qualify for the investment credit and is not to be treated as recovery property. Presumably, the same result follows as to a taxpayer who endeavors to elect §48(r)(1) treatment where other taxpayers having an interest in the same sound recording do not make the election.

Observation: The Conference Report,[97] in fact, states that the second option will apply unless all taxpayers

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having an ownership interest in the recording elect the first option. It should also be noted that both the Conference Report [98] and the Senate Finance Report [99] state that no inference is intended as to whether sound recordings qualify as tangible personal property, including whether they otherwise qualify for the investment credit, under present law.

Comment: Although it is not entirely clear in the statute,[100] it appears that a used sound recording will be subject to the second alternative since an election under §48(r)(1) is clearly denied for a sound recording that constitutes used property.[101]

Under §48(r)(4), ownership interests in a sound recording are determined according to loss-sharing ratios. This is in contrast to the general investment credit rule providing that the investment credit is allocated according to profit-sharing ratios [102] rather than on the basis of loss-sharing percentages.

Neither §48(a)(2), which denies the investment credit for property used predominantly overseas, nor §§46(c)(8) and 46(c)(9), which prescribe at-risk rules for investment credit purposes, apply in the case of a sound recording.[103] However, since the term "ownership interest" is employed in substantially the same manner in §48(r) as it is in §48(k) for purposes of determining the investment credit for qualified films, and the regulations under §48(k) provide an at-risk test, as previously mentioned,[104] it is likely that regulations implementing §48(r) will prescribe a similar at-risk test limiting the credit under §48(r)(1) to the amount of capital the taxpayer has at-risk in the sound recording.

Comment: It should be noted, however, that the legislative history of §48(r) makes no mention of limiting the taxpayer's investment credit under §48(r)(1) to the amount of capital the taxpayer has at-risk in the recording. Moreover, when §48(k) was enacted and the regulations thereunder promulgated, the Treasury had general authority to issue legislative regulations in the investment credit area under former §38. However, as discussed in Chapter 14, former §38 and the legislative authority contained therein was repealed in the TRA credit simplification rules. Accordingly, the issuance of regulations under §48(r) prescribing an at-risk rule might be subject to challenge.

In determining the amount of an investment credit that may be claimed with respect to a sound recording, only production costs allocable to the U.S. (including possessions of the U.S.) may be taken into account.[105] Production costs include:

(i) a reasonable allocation of overhead,

(ii) compensation paid to songwriters, artists, production personnel, directors, producers, and similar personnel,

(iii) costs of "first" distribution of records or tapes, and

(iv) costs of the material being recorded.

Production costs do not include contingent amounts, such as residuals payable under contracts with labor organizations or participations or royalties payable to the song writers, artists, *etc.*, unless such contingent amounts are "incurred" in the taxpayer year the recording is placed in service or in the ensuing taxable year.

Production costs are to be allocated to the U.S. in accordance with rules similar to those under §48(k)(5)(D). Detailed rules prescribing the allocation of production costs for purposes of §48(k)(5) may be found in Regs. §1.48-8(f)(2).

Accordingly, for the first year that a sound recording is placed in service, a 6 percent investment credit may be claimed with respect to production costs allocable to the U.S., including contingent amounts incurred in the first year the recording is placed in service. Contingent amounts allocable to the U.S. and incurred in the subsequent taxable year are also eligible for the 6 percent credit. No investment credit is available for contingent amounts incurred after the first two years, but they may continue to be deducted when paid or accrued to the extent deductible when paid or incurred under present law.[106]

The basis adjustment rules for §48(q) apply to sound recordings.[107]

C. Effective Dates

1. Films and Tapes

The TRA provisions excluding films and tapes as recovery property for investment credit purposes apply to films and tapes placed in service before, on, or after July 18, 1984, which is the date the TRA was signed into law.[108] However, any qualified film placed in service by the taxpayer before March 15, 1984, will be treated as recovery property if the taxpayer treated such film as recovery property for purposes of §168 on a tax return filed before March 16, 1984. The Conference Report [109] states that this provision does not itself operate to disallow investment credits with respect to any such movie. Moreover, a qualified film placed in service by a taxpayer before January 1, 1985, will be treated as recovery property if 20 percent or more of the production costs of such film were incurred before March 16, 1984, and the taxpayer treats such film as recovery property for purposes of §168. However, in the latter case, the investment credit can be claimed only to the extent provided in §48(k).[110]

The amendment to §168(e) providing that the exceptions listed in §168(e) to the definition of recovery property apply for all Code purposes is effective as if included in the Economic Recovery Tax Act of 1981, so that it is effective for property placed in service after 1980.[111]

Comment: This latter provision is, consequently, retroactive in effect and will operate to deny any investment credit of 10 percent claimed by any taxpayer who utilized the income-forecast method of depreciation, or any other method of depreciation not expressed in terms of years such as the unit-of-production method, yet took the position that such property was 5-year property for investment credit purposes.

The clarification that the general investment credit at-risk rules do not apply to qualified films is effective as if included in the provisions of ERTA of 1981 that enacted at-risk rules for investment credit.

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The special rule in new §48(q)(6), relating to the special basis adjustments for qualified films, is effective as if enacted in §48(q) by the Tax Equity and Fiscal Responsibility Act of 1982.

2. Sound Recordings

The TRA amendments for sound recording apply to sound recordings placed in service after March 15, 1984, in taxable years ending after that date.[112]

VIII. Treatment of Certain Leased Property as New Investment Credit Property Restricted

A. Introduction

As described above in III, a limit is placed on the dollar amount of new §38 property for which a taxpayer is allowed a credit for the taxable year. Under §48(c)(2)(A), as amended by the TRA,[113] the dollar limit will remain at $125,000 for taxable years beginning before 1988. Section 48(c)(1) defines "used §38 property" as §38 property acquired by purchase that is not "new §38 property." Section 48(b) defines "new §38 property" to be §38 property the construction, reconstruction or erection of which is completed by the taxpayer after 1961, or is acquired after 1961, if the original use of such property commences with the taxpayer and commences after such date. A special rule in §48(b) provides that, for purposes of determining whether §38 property subject to a lease is new §38 property, the leased property is treated as originally placed in service not earlier than the date the property is used under the lease, but only if the property is leased within three months after the property is placed in service.

B. Analysis

The TRA [114] revises §48(b) to eliminate deadwood language and to restrict the special three-month rule for property that is leased. New §48(b)(1) provides that the term "new §38 property" means §38 property the original use of which commences with the taxpayer. Under new §48(b)(2), the three-month rule applies only if the §38 property is originally placed in service by the taxpayer, and the property is sold and leased back by the taxpayer, or is leased to the taxpayer, within three months of the date such property was originally placed in service. According to the Conference Report,[115] the three-month rule, in addition to applying to sales and leasebacks within three months, is intended to apply to a taxpayer who buys property from a manufacturer, takes delivery of it, and places it in service before financing is in place; shortly after the taxpayer places the property in service, the property may be sold (or the purchase order assigned) by such taxpayer to another person who then leases it to the first taxpayer.

Under §48(b)(3), the three-month rule is made applicable for purposes of determining whether property is new for purposes of the energy investment credit.

C. Effective Dates

The revision of §48(b) is effective for property originally placed in service after April 11, 1984 (determined without regard to the TRA revision).[116]

IX. Section 280F Limitations for Luxury Automobiles and Other Listed Property

Section 179 of the TRA of 1984 adds Code §280F, limiting the investment tax credit which may be claimed with respect to a passenger automobile to a maximum of $1,000. This limitation precedes any reduction for personal use of the automobile or any reduction under §48(q)(4). In addition, certain "listed property" (including passenger automobiles) ceases to be §38 property if the percentage of use in a trade or business does not exceed 50 percent in any one year. This will lead to recapture of the credit if the reduction occurs before the end of the normal recovery period. This provision applies to property placed in service after June 18, 1984.

The new investment tax credit limitations are described in detail in Chapter 40.

X. No Investment Credit Recapture for Transfers Between Spouses or Incident to Divorce

A. Introduction

Section 47(a) provides for the recapture of an investment credit if the property with respect to which the credit was claimed is disposed of or ceases to be §38 property during a specified recapture period. In the case of §38 property which is 3-year recovery property, any investment credit claimed with respect to such property is subject to full or partial recapture if it ceases to be §38 property at any time during the first full three years after the property is placed in service. In the case of any other recovery property, the investment credit claimed with respect to such property is subject to recapture for the first five full years after the date the property is placed in service.

Under present law,[117] a transfer by reason of death, a transaction to which §381(a) applies, or a transfer that is part of a transaction representing a "mere change in form" of a business will not be treated as a disposition giving rise to recapture of an investment credit. However, a transfer from one spouse to another, except by reason of death, is a disposition that may cause recapture under §47.

B. Analysis

As part of the divorce simplification provisions of the TRA,[118] new §47(e) has been enacted to provide that, in the case of any transfer described in §1041(a), investment credit with respect to the property transferred will not be subject to recapture under §47(a). Section 1041(a) describes two types of transfers:

> (i) a transfer by an individual directly to (or in trust for the benefit of) a spouse, or
>
> (ii) a transfer by an individual directly to (or in trust for the benefit of) a former spouse, but only if the transfer is incident to the divorce.

Under §47(e)(2), the transferee effectively steps into the shoes of the transferor with respect to the transferred property for purposes of §47. Thus, the transferee-spouse may tack the holding period of the transferor spouse in

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determining whether there is recapture, or the amount of the recapture if the transferor and transferee spouses did not hold the property for a sufficient period of time to avoid recapture of the investment credit completely.

C. *Effective Dates*

In general, new §47(e) applies to transfers after July 18, 1984, in taxable years ending after such date.[119] For the transitional rules and exceptions that apply to §1041, and thus, to §47(e), *see* Chapter 13, I, *supra.*

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[1] P.L. 97-34 (1981). Hereinafter sometimes referred to as "ERTA."
[2] §46(c)(8) prior to amendment by the 1984 Act.
[3] §465(a); §465(c).
[4] §§465(c)(2), (3) and (4).
[5] §§46(c)(8)(B)(ii) and 46(c)(8)(D) prior to the 1984 Act amendments.
[6] §46(c)(8)(F).
[7] §46(c)(8)(C) prior to the 1984 amendments.
[8] §465(b)(1).
[9] ERTA §211(i) *supra,* note 1.
[10] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1509-10 (1984).
[11] §46(c)(8)(B) prior to the 1984 Act amendments.
[12] Act §432.
[13] *See* Chapter 24 for a fuller discussion of this change.
[14] Act §431(e)(1). *See* ERTA §211(f).
[15] Act §431(e)(2).
[16] §46(c)(8)(B)(i). *See* §542(a)(2).
[17] §46(c)(8)(B)(ii). *See* §465(c)(4).
[18] §46(c)(8)(C).
[19] §46(c)(8)(D)(iii).
[20] §46(c)(8)(D)(ii).
[21] §46(c)(8)(D)(iv).
[22] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1510 (1984).
[23] §46(c)(8)(E)(i).
[24] §46(c)(8)(E)(iv).
[25] §46(c)(8)(E)(ii).
[26] §46(c)(8)(E)(iii).
[27] §46(c)(9)(C)(i).
[28] §46(c)(9)(B).
[29] §47(d)(1).
[30] §48(d)(6)(A)(i).
[31] §48(d)(6)(A)(ii).
[32] §48(d)(6)(B).
[33] §48(d)(6)(E)(i).
[34] §48(d)(6)(E)(ii).
[35] §48(d)(6)(C)(ii).
[36] §48(d)(6)(C)(iii).
[37] §48(d)(6)(C)(iv). *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1511 (1984).
[38] §48(d)(6)(C)(v).
[39] §48(d)(6)(D)(i).
[40] §48(d)(6)(D)(ii).
[41] §48(d)(6)(F)(i).
[42] §48(d)(6)(F)(ii).
[43] *See* discussion in text at note 25, *supra.*
[44] §48(d)(6)(F)(iii).
[45] §H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1512 (1984).
[46] §48(d)(6)(G).
[47] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1513 (1984).
[48] Act §474(o); *see* Chapter 14, II, E, 1, for a description of the conforming amendments made to §46 to reflect the new credit simplification rules.
[49] §§48(g)(1)(C)(iii) and (2)(D)(v) prior to amendment by the TRA.
[50] §48(g)(2).
[51] Act §111(e)(8).
[52] §48(g)(2)(B)(v).
[53] Act §31(c), adding §48(g)(2)(vi).
[54] Act §31(c), amending §48(g)(2)(B)(i).
[55] Act §1043(a).
[56] S. Rep. No. 169, 98th Cong., 2d Sess. 822 (1984).
[57] *Id.*
[58] Act §111(g); *see* Chapter 6, I, *supra,* for the exceptions to the 18-year recovery period.
[59] Act §31(g), but numerous exceptions may apply.
[60] Act §1043(b).
[61] P.L. 97-34, §213(a), as amended by P.L. 97-448, §102(g) (the Technical Corrections Act of 1982).
[62] §48(c)(2)(B).
[63] Act §11.
[64] Act §18.
[65] Revenue Act of 1971, P.L. 92-178 §101(c)(1)(A).
[66] Joint Committee on Taxation, General Explanation of the Revenue Act of 1971, 4 (1972).
[67] H.R. Rep. 708, 92nd Cong., 1st Sess. 33 (1971).
[68] §58(i)(4) was enacted by TEFRA, §201(c)(1), effective for taxable years beginning after December 31, 1982.
[69] TEFRA, §204(a).
[70] TEFRA, §205.
[71] Act §711(a)(2).
[72] Act §712(a)(2).
[73] Act §68(a).
[74] Act §715.
[75] §§48(a)(2), (4), and (5), respectively.
[76] Act §474(o); *see* Chapter 14.
[77] Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 79-285, 1979-2 C.B. 135.
[78] §§46(c)(2), and 46(a) and (b).
[79] *See* Regs. §1.48-1(f); PLR 7802004.
[80] *Walt Disney Productions v. U.S.,* 549 F. 2d 576 (9th Cir. 1977) (negatives of feature motion picture films qualify for the investment credit); *EMI North America, Inc. v. U.S.,* 675 F. 2d 1068 (9th Cir. 1982) (master sound recordings qualify for the investment credit).
[81] P.L. 94-455, §804.
[82] §48(k)(1)(D).
[83] §48(k)(1)(A).
[84] S. Rep. No. 169, *supra,* fn. 56, at 467-468.
[85] Act §113(b)(1).
[86] Conference Report, H.R. Rep. No. 861, 1009-1010, 98th Cong., 2d Sess. 1984.
[87] Act §113(b)(3).
[88] Act §113(b)(4).
[89] §48(q)(6)(B)(i).
[90] §48(q)(6)(A).
[91] §48(q)(6)(B).
[92] Act §331(a).
[93] Act §113(a).
[94] *See* §46(c)(7).
[95] §48(r)(7).
[96] *Id.*
[97] H.R. Rep. No. 861, *supra,* fn. 86, at 1010.
[98] *Id.,* at 1011.
[99] S. Rep. No. 169, *supra,* fn. 56, at 471.
[100] §48(r)(1) reads, "For purposes of this title, in the case of any sound recording, the original use of which commences with the taxpayer, . . ." Conceivably, the original use requirement in §48(r)(1), since it can be viewed as modifying "any sound recording," might also be regarded as applying for purposes of §48(r)(2).
[101] Interestingly, neither the Senate Finance Committee Report nor the Conference Committee Report mention the original use requirement with respect to the §48(r)(1) election.
[102] Regs. §1.46-3(f)(1).
[103] §48(r)(3)(A).
[104] *See* Regs. §1.48-8(a)(4).
[105] §48(r)(3)(B).
[106] S. Rep. No. 169, *supra.*
[107] *Id.,* at 471; H.R. Rep. No. 861, *supra.*
[108] Act §113(c)(2)(A).
[109] H.R. Rep. No. 861, *supra,* at 1009.
[110] Act §113(c)(2).
[111] Act §113(c)(2)(B).
[112] Act §113(c)(1).
[113] Act §11.
[114] Act §114(a).
[115] H.R. Rep. No. 861, *supra,* fn. 86, at 1253.
[116] Act §114(b).
[117] §47(b).
[118] Act §421(b)(7).
[119] Act §421(d).

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CHAPTER 16

INCLUSION OF TAX BENEFIT ITEMS IN INCOME CODE SECTION 111

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I. Background

A. Statutory and Judicial Background

Generally, a taxpayer who recovers an amount which was deducted in a prior taxable year must include that amount in income in the year of recovery.[1] This is a judicially created doctrine and includes a judicially created exception that allows a person to exclude an amount from income to the extent that the original deduction did not produce a tax benefit.[2] Thus, the tax benefit rule works in two ways — including recovered amounts in income when the taxpayer has had a previous tax benefit from deducting them, and excluding amounts from income when a deduction allowable in a prior period did not produce an income tax benefit. The rationale of this rule is the taxpayer should be in the same economic position after taxes, more or less, as if the correct amount had been initially reported on its income tax return.

Example: In the simplest case, an individual receives a refund of state income taxes which he had paid in a prior taxable year. In that year, the taxpayer did not have enough deductions to exceed his zero bracket amount and thus any reduction in his state income taxes would not have affected his taxable income for that year. Accordingly, the taxpayer would not be required to include that amount in income.

The tax benefit rule was codified to some extent in §111 of the Code. Prior to its amendment, that section provided that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts was excluded from gross income to the extent of the "recovery exclusion" which was defined as the amount equal to the portion of items deducted or credited in the prior year which did not result in an income tax benefit to the taxpayer. For the purpose of determining whether an item produced an income tax benefit in a prior year, the accumulated earnings and personal holding company tax were not considered income tax. Accordingly, an item in a prior year could have reduced the accumulated or personal holding company tax and still be an item entering into the computation of the recovery exclusion.

Existing law included a special provision for tax benefits applicable to the accumulated earnings and the personal holding company taxes. An item which qualified as part of the recovery exclusion also qualified to enter into the determination of the accumulated earnings and personal holding company tax in the year of recovery notwithstanding that the item involved did not reduce the accumulated earnings or personal holding company tax in the prior year. In addition, if a §111 item was deductible from the personal holding company and accumulated earnings taxes in a prior taxable year but did not produce a reduction in those taxes, then the recovery of such items could be excluded for purposes of determining the personal holding company and accumulated earnings taxes in the current year even though the item was not deductible for purposes of the regular income tax in a prior taxable year.[4]

The Internal Revenue Service allows an individual taxpayer to recover, on a tax-free basis, an itemized deduction up to the amount by which the taxpayer's zero bracket amount exceeds his other itemized deductions for the year.[5]

Example: In 1983, a married couple reported itemized deductions of $3,700 (*i.e.*, excess itemized deductions of $300), of which $500 was for state income taxes paid in 1983. In 1984, they received a $200 refund of state income taxes. The entire amount of this refund was excludable from income in 1984. An exclusion results because the couple's zero bracket amount ($3,400) exceeds the amount of their itemized deductions other than state income taxes ($3,200) and because Rev. Rul. 79-15 assumes that the amount which was not subject to tax was recovered first. If they had received a $300 refund, $100 would have been includable in income because the amount of the refund exceeded the amount by which their zero bracket amount exceeds their remaining itemized deductions ($3,400 − $3,200 = $200).

B. Legislative Background

The Congressional committees indicated that the exclusion in the above example failed to reflect the economic reality of the situation. The regulations amplifying the statute assume that the amount which the couple first recovered was that which did not produce any tax benefit. This may not be correct in certain cases and may produce a windfall to the taxpayer.[6]

Example: In the immediately preceding example above, if the couple had not overpaid their income taxes but had paid the correct amount, they would have had $200 less in itemized deductions. Thus their income tax would have increased by the tax on $200.

This interpretation of the tax benefit rule allows certain taxpayers who take a deduction in one year and then recover a portion in a subsequent year to have more

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favorable tax results than taxpayers who deduct the correct amount initially. Thus the tax benefit rule has not accomplished its objective of putting taxpayers in the same position as if they had taken initially the correct deduction. Congress intended to amend the statute to more clearly reflect the tax benefit rule.

II. Overview

A. In General

The Act rephrases the statutory tax benefit rule so as to exclude from income recoveries of any deduction taken in a prior year to the extent that the deduction did not reduce income subject to tax. One purpose of the legislation was to phrase the tax benefit rule in a more general way and another was to change the result in one of the examples in Rev. Rul. 79-15. Section 111 now provides for an increase in income taxes by the amount of income tax credits previously allowed (other than the investment tax credit and the foreign tax credit) when there is a downward price adjustment which would have affected the amount of the credit. A price adjustment which affects a credit which did not reduce income taxes will not increase income taxes, however.

An increase in a carryover which has not expired before the beginning of the taxable year in which a recovery takes place is treated as a reduction of income tax as under prior law. The exceptions to the tax benefit rule as previously applied to the accumulated earnings and personal holding company taxes are preserved in new §111.

B. Effective Date

Revised §111 will apply to amounts recovered after December 31, 1983 in taxable years ending after that date.[7] Accordingly, the revision currently affects all taxpayers.

III. Detailed Analysis

A. All Deductions Subject to Statutory Tax Benefit Rule

As expanded, §111 excludes from gross income any recovery of a deduction taken in a prior year to the extent such amount did not reduce income subject to tax.[9] The intent of this section was to statutorily recognize a broad tax benefit rule and reverse the conclusion in one example in Rev. Rul. 79-15.[9] Accordingly, in the second example above, the married couple would report income of $200 upon receipt of the state tax refund. If a deduction increases a carryover which has not expired before the beginning of the year of the recovery, the deduction will be considered to have reduced a tax as it did under prior law.[10]

The tax benefit rule has been applied by the courts to such diverse items as insurance recoveries of amounts previously deducted as losses, refund of prepaid interest, and cancellation of previously accrued liabilities.[11] The Conference Committee Report indicates that it does not intend to change present law as to what constitutes the recovery of an item previously deducted. Thus the scope of this rule will remain broad.[12]

B. Tax Credits Now Subject to Tax Benefit Rule

The revision of §111 now imposes the tax benefit rule upon all tax credits other than the investment tax credit which already has a recapture provision and the foreign tax credit.[13] The statute requires an increase in the tax imposed in any taxable year in which there is a downward price adjustment with respect to an amount for which a credit was allowable in a previous year.

Example: Suppose an individual makes a purchase of $100 which qualifies for the 15 percent residential energy credit. Though this amount is paid to the retail seller of the property, the manufacturer will rebate a portion of the purchase price direct to the purchaser. A rebate is received in a future year; the income tax of the purchaser will be increased by 15 percent of the amount refunded.

The revision of §111 retains the same special rules, described above, for applying the tax benefit rule to the accumulated earnings and personal holding company taxes.[14]

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[1] *Estate of Block v. Comr.*, 39 B.T.A. 338 (1939).
[2] *Amsco-Wire Products Corp. v. Comr.*, 44 B.T.A. 717 (1941).
[3] A delinquency amount is an amount of a deduction or credit available to a taxpayer which arose from the failure to file a return with respect to a tax or to pay a tax. Section 111(b)(3).
[4] Old §111(c).
[5] Rev. Rul. 79-15, 1979-1 C.B. 80 (example of state income tax refunds). This interpretation is supported by the legislative history. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 70 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 80 (1942). *See also* Rev. Rul. 56-447, 1956-2 C.B. 102 held obsolete by Rev. Rul. 79-15, 1979-1 C.B. 80.
[6] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1368-9 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 472-3 (1984).
[7] Act Section 171(c).
[8] §111(a).
[9] 1979-1 C.B. 80.
[10] §111(c). *See* Treas. Regs. §1.111-1(b)(2)(ii). H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1369 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 473 (1984).
[11] *Valspar Corp. v. Comr.*, 5 T.C.M. 1110 (1946), rev'd on other issue, 172 F.2d 171 (2nd Cir. 1949); *Unvert v. Comr.*, 72 T.C. 807 (1979); and *Peabody Coal Co. v. Comr.*, 18 B.T.A. 1081 (1930), aff'd, 55 F.2d 7 (7th Cir. 1931).
[12] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1011 (1984).
[13] §111(b).
[14] §111(d).

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Chapter 17

MISCELLANEOUS CHANGES AFFECTING CREDITS

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I. Targeted Jobs Credit — Extension and Technical Changes [§§1041, 712(n)]

A. Introduction

Under present law, an employer may elect to credit against its tax liability part of the wages paid to certain new employees.[1] The credit generally is equal to 50 percent of the first $6,000 of the employee's wages paid during the first year of employment and 25 percent of such wages for the second year.[2] Thus, the total maximum credit per employee is $4,500 ($3,000 + $1,500). With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000, or a total maximum credit of $2,550. Eligible employees are individuals who are members of one of the "targeted groups" of individuals including those economically disadvantaged, handicapped, or who receive public assistance.[3] This credit was intended to be available only with respect to wages other than those paid or accrued to an individual who begins work for the employer after December 31, 1984.[4]

In general, an individual must be "certified" as being a member of a targeted group. The employer must receive, or have requested in writing, a certification of the individual's eligibility before the day on which the individual begins work for the employer.[5]

The funds necessary to adequately administer the certification system were to be appropriated for fiscal years 1983 and 1984.[6]

The targeted jobs credit was enacted in the Revenue Act of 1978 [7] as a substitute for the expiring credit for increased employment (the "new jobs credit"). The "new jobs credit" was available in 1977 and 1978. As initially enacted, the targeted jobs credit was intended to be available for qualified wages paid before 1982. The Economic Recovery Tax Act of 1981 extended the availability of the targeted jobs credit to qualified wages paid to individuals beginning work for the employer before 1983. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) extended the availability of the credit to qualified wages paid to individuals who begin work for the taxpayer before 1985.

The TRA of 1984 amendments to the targeted jobs credit were originally included in the Senate Bill [8] which proposed to extend the availability of the tax credit and the authorization for administrative funds for three more years. The Senate Finance Committee estimated that the experience with the targeted jobs credit was sufficiently promising to warrant this extension. A three-year extension would have given certainty to employers and employees of the availability of the credit and would have enabled Congress and the Treasury Department to gather more information on the effectiveness of the credit. The Conference agreement [9] follows the Senate amendment with a number of changes. In particular, it extends the credit for only one year.

B. Detailed Analysis

Sections 712(n) and 1041 of TRA 1984 amend Code §51 regarding the targeted jobs tax credit, extending the credit for one more year, and introducing a number of minor provisions. In addition, §1041 TRA 1984 makes a technical correction in Code §51(b)(2) by eliminating an obsolete provision which related to the beginning of the one-year credit eligibility period for vocational rehabilitation referrals, and §712(n) of TRA 1984 effects a technical correction to §233 of TEFRA. Section 474(p)(3) incorporates the election to claim the targeted jobs credit formerly provided in Code §44B (which was repealed by the TRA) into subsection (j) under Code §51. However, the taxpayer must now elect not to have this section apply.[10]

1. Extension of the Credit

The targeted jobs tax credit is available for an additional year. Code §51(c)(3), as amended by §1041 of TRA 1984, provides that qualified wages for purposes of the targeted jobs credit shall not include any amounts paid or incurred with respect to individuals hired after December 31, 1985. Section 261(f)(2) of ERTA is amended to authorize the appropriation of funds to administer the tax credit through fiscal year 1985.

2. Successor Employer

Section 1041 of TRA 1984 adds subsection (j) [11] to Code §51. Paragraph (1) thereof provides that a successor employer will be treated as his predecessor to compute the amount of the credit. A "successor employer" is defined in Code §3306(b)(1) as an employer who acquires substantially all the property used in the trade or business, or a separate unit of the trade or business, of another employer

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and who immediately after the acquisition hires an employee who was working for the predecessor.

3. Employee Performing Services for Other Persons

Paragraph (2) of Code §51(j) [12] provides that the credit will not be allowed with respect to remuneration paid to an employee who is rendering services to a person other than his employer, if the payment by the other person to the employer is not expected to exceed the amount of the remuneration paid to the employee by his employer. The purported purpose of this provision, as stated in the Conference Report,[13] is to prevent the shifting of the credit from organizations which need the services of employees, but which do not have sufficient tax liability to take advantage of the credit, to employers who could benefit from the tax credit and for this purpose hire the employees and then loan them out or donate them to the organizations which need them.

4. Certification Provisions

a. Preliminary Determination

Section 1041(c)(2) of TRA 1984, grants additional time to employers to request or receive the certification required by Code §51(d)(16) under certain circumstances. Code §51(d)(16), as amended, provides that an employer will be able to request in writing or obtain certification that an individual hired by him is a member of a targeted group until the fifth day after the day on which such individual begins work for the employer, if on or before the individual commences work, the employee obtains from a designated local agency (or other organization designated by the agency), a written preliminary determination that the employee is a member of a targeted group. Prior to TRA 1984, employers had to obtain or request in writing a certification no later than the day the employee commenced work.

b. Qualifying Youth Certification

Section 712(n) of TRA 1984 makes a technical correction to §233 of TEFRA by adding a provision to Code §51(d)(11) which makes it clear that the original determination that a qualified summer youth or cooperative education youth is economically disadvantaged continues to be valid with respect to the eligibility of the individual as a member of another targeted group, if the individual continues to work for the same employer. A new certification will not, therefore, be necessary when the qualified summer youth or cooperative education youth continues to work for the same employer.

5. Age Requirement for Summer Youth Employee

Section 1041(c)(3) of TRA 1984 amends the test for determining the age required to qualify as a summer youth. Code §51(d)(12)(ii) as amended, provides that a summer youth must be certified by a designated local agency as being at least 16 years old but under 18 either on the hiring date or, if the hiring date is after May 1, on May 1 of the calendar year involved. Prior to the TRA 1984 amendment, the individual had to be over 16 but under 18 years old on the date he was hired.

6. Effective Dates

The amendments with respect to treatment of employees performing services for other people and with respect to the age requirement for qualified summer youth employees take effect with respect to individuals who begin work after December 31, 1984. All other amendments are effective after July 18, 1984.

II. Increase in Earned Income Credit [Act §1042]

A. Introduction

Under present law the Code grants a refundable tax credit to eligible low income individuals with families. The credit is equal to 10 percent of the first $5,000 of earned income or a maximum of $500. The credit is refunded to the individual to the extent that it exceeds tax liability. The maximum credit is phased down for income in excess of $6,000 and it is completely phased out for families with income over $10,000. The credit is phased down at the rate of 12.5 percent of the excess of adjusted gross income (or earned income, if greater) over $6,000. The exact amount of the credit allowed is determined under tables prescribed by the Secretary of the Treasury.

Eligible individuals [14] are married individuals filing joint returns who are entitled to an exemption for dependents, surviving spouses who by definition [15] must maintain a household for a dependent child, and heads of household who must also, by definition,[16] maintain a household for a dependent child. The child must reside with the taxpayer in the U.S. Individuals who claim benefits under Code §§911 (relating to U.S. citizens or residents living abroad) or 931 (relating to income from sources within possessions of the U.S.) are not entitled to the credit.[17]

Earned income for purposes of this credit comprises wages, salaries, tips, and other employee compensation plus net earnings from self-employment. Earned income must be computed without regard to any community property laws. In addition, earned income does not include pensions or annuities, nor income not connected with a U.S. trade or business of nonresident aliens.[18]

The credit is only allowed with respect to taxable years which cover a period of at least 12 months, unless the taxable year was closed following the death of the taxpayer.[19]

The TRA 1984 amendments to the earned income provisions of the Code were originally introduced in the Senate bill.[20] The Committee on Finance stated that it believed the earned income credit was an effective way to provide relief from social security and income taxes to low-income families who might otherwise need large welfare payments. It therefore, proposed to increase the amount of the credit to take into account increases in social security taxes since 1978, when the amount of the credit was last increased. The committee also proposed to increase the income level at which the credit is completely phased out to take inflation into account.

The Conference agreement followed the Senate amendment increasing even further the rate of the credit and the level of income at which the credit is completely phased out and it introduced other minor provisions.

B. Detailed Analysis

Section 1042 of TRA 1984 amends Code §32, as redesignated by TRA 1984, relating to the earned income

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credit.[21] It also makes conforming amendments to another section of the Code which relates to the advance payment of the earned income credit.[22]

1. Increased Credit

Code §32(a) (as redesignated) is amended to provide that an eligible individual is allowed a credit equal to 11 percent of so much of his earned income for the taxable year as does not exceed $5,000. The maximum credit is therefore equal to $550.

2. Increased Limitation

Code §32(b) (as redesignated) is amended to provide that the allowable credit may not exceed the excess of $550 over 12 2/9 percent of the excess of adjusted gross income (or, if greater, the earned income) over $6,500.

For example, a taxpayer who has earned income of $7,500 in 1985 will be entitled to a maximum credit of $427.78 (*i.e.*, 550 - 12 2/9 percent of $1,000 = $550 - 122.22).

The credit will be completely phased out for taxpayers with earned income or adjusted gross income exceeding $11,000.

3. Offset of Minimum Tax

Subsection (h) is added to Code §32(as redesignated) to provide that the credit is reduced by the alternative minimum tax liability of the taxpayer imposed under Code §55.

4. Effective Date

The provisions of §1042, TRA 1984 are effective for taxable years beginning after December 31, 1984.

III. New Credit for Interest on Mortgages Certified Under Mortgage Credit Certificates

Commencing in 1985, taxpayers who are recipients of a mortgage credit certificate issued by a state or local agency are eligible to claim a credit under §25 for interest paid on mortgages certified under the mortgage credit certificate. A mortgage credit certificate can be utilized only for interest paid or accrued after December 31, 1984, on indebtedness incurred after December 31, 1984. The credit may range from 10 to 50 percent of the mortgage interest paid by a taxpayer each year, depending upon the credit rate specified in the mortgage certificate.

The mortgage credit certificate program is a substitute for financing provided by state or local agencies through the issuance of tax-exempt qualified mortgage bonds. In order to issue mortgage credit certificates, a state or locality must surrender all or a portion of its authority to issue qualified mortgage bonds.

For a complete analysis of the new mortgage credit certificate program and the credit provided under such certificates, see Chapter 20, I, C, 5 *infra*.

IV. Employee Stock Ownership Credit (Act §14)

A. Introduction

An employee stock ownership plan (ESOP) is a qualified retirement plan designed to invest primarily in stock of the employer, thereby enabling the participants to acquire an ownership interest in the corporation for which they work.

There are two basic types of ESOPs — an employee stock ownership plan (commonly known as an ESOP) and a tax credit employee stock ownership plan (commonly known as a tax credit ESOP).[23] A tax credit ESOP is defined in §409A as a defined contribution plan that meets the requirements of §401(a) and is designed to invest primarily in employer securities. Additionally, §409A provides rules relating to the allocation of employer securities, employee nonforfeitable rights, distribution of employer securities, time for plan establishment, redetermination or recapture of investment credit, and the provision of put options with regard to employer securities.[24]

The Tax Reduction Act of 1975 provided an additional, elective, 1 percent investment tax credit to employers that transferred to a then-TRASOP (now tax credit ESOP) employer securities having an aggregate value equal to 1 percent of the qualified investment for the taxable year.[25] This provision remained applicable, with minor amendments, until it was repealed by the Economic Recovery Tax Act of 1981 (ERTA) [26] in favor of an ESOP a tax credit that was based on the sponsoring employer's payroll, rather than upon the level of §38 investment during the taxable year. These ESOPs, where the sponsoring employer's tax credit is based on a percentage of covered payroll are commonly known as "PAYSOPs."

The PAYSOP credit is limited, under §44G, to a prescribed percentage of the aggregate compensation of participating employees.[27] For compensation paid or accrued in calendar years 1983 and 1984, the tax credit was limited to one-half of 1 percent of covered payroll. With respect to compensation paid or accrued in 1985-7 the limit would have been three-quarters of 1 percent. No credit would have been provided with respect to compensation paid or accrued after September 31, 1987.

B. Detailed Analysis

1. TRA Amendment

The Act amends §44G(a)(2)(B) (as in effect prior to the amendments made by Title IV of the Act [28]) to freeze the income tax credit for contributions to a PAYSOP at one-half of 1 percent with respect to compensation paid or accrued in 1985-7. No credit is allowed for compensation paid in 1988 or thereafter, unless the provision is specifically extended by Congress.

Note: TRA §471(c)(1) redesignates former Code §44G as §41. TRA §491(e) redesignates Code §409A as §409.

2. Effective Dates

The new schedule of rates for the PAYSOP credit applies to taxable years ending after 1983. The TRA changes do not apply, however, if the PAYSOP was approved by employees on September 23, 1983, and (2) not later than January 11, 1984, the employer of such employees was 100 percent owned by the plan.[29]

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[1] §44B.
[2] §51(a).
[3] These groups are listed in §51(d).
[4] §51(c)(3).
[5] §51(d)(16)(A).
[6] §261(f)(2) of Economic Recovery Tax Act 1981, P.L. 97-34.
[7] P.L. 95-600.
[8] S. Rep. No. 98-169, Vol II.
[9] H.R. Rep. No. 861, 98th Cong. 2d Sess., June 23, 1984.
[10] *See* Chapter 14, II, E, 2, *supra*.
[11] Section 1041 of the Act contains a technical error: This subsection should be (k) because Act §474(p)(3) already introduced a subsection (j) under Code §51.
[12] Because of a technical error in Act §1041, this section should be Code §51(k).
[13] *See* footnote 9.
[14] Code §43(c)(1).
[15] Code §2(a).
[16] Code §2(b).
[17] Code §43(c)(1)(C).
[18] Code §43(c)(2).
[19] Code §43(e).
[20] S. Rep. No. 98-169, Vol. II.
[21] Section 471 of TRA 1984, relating to the simplification of income tax credits, redesignated Code §43 (relating to earned income credit) as §32.
[22] Code §3507(c)(2)(C).
[23] The tax credit ESOP was created by the Tax Reduction Act of 1975, P.L. 94-12, under the name TRASOP. The Revenue Act of 1978, P.L. 95-600, renamed it "tax credit ESOP."
[24] IRC §409A. For a detailed discussion of these requirements, *see* 354 T.M., *ESOPs*.
[25] Tax Reduction Act of 1975, P.L. 94-12, §301(d)(6).
[26] P.L. 97-34, §332(a)(1).
[27] IRC §44G(a)(2).
[28] For an explanation of the provisions simplifying income tax credits, *see* Chapter 14. For an explanation of the provisions relating to changes in ESOPs in general, *see* Chapter 48.
[29] TRA §18(a), (b).

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Chapter 18

TAX-EXEMPT ENTITY LEASING — NEW RESTRICTIONS

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I. Introduction

In recent years, Congress has become increasingly concerned about the tax policy and revenue implications of leasing arrangements involving nontaxable entities, such as tax exempt organizations and foreign entities. On February 28, 1983, the Subcommittee on Oversight of the House Ways and Means Committee conducted a well-publicized hearing investigating leasing practices of this type.[1] At this hearing, and in subsequent investigations, it became apparent that state and local governments were responding to budgetary problems by leasing facilities, such as convention centers, from investor syndications rather than constructing the facilities. Other types of nontaxable entities were equally active in leasing transactions. One particularly notorious example that was brought to light by the subcommittee hearings involved a college which approved a plan to sell its campus to an investor group and then lease it back from the group. It also became apparent that even the federal government found the leasing market attractive, as evidenced by a series of transactions in which the Navy chartered cargo and personnel transport ships from private parties.

Under the tax laws as they existed before the enactment of the 1984 TRA, a lessor of property leased to a nontaxable entity was, as owner of the property, generally entitled to claim the tax benefits associated with such property, provided the lessor could demonstrate that it owned the property for tax purposes. The criteria for determining tax ownership of property evolved from a series of judicial decisions and IRS pronouncements. Basically, these authorities required a purported owner of property to demonstrate that he possessed a substantial economic ownership interest in the property.[2] This analysis generally required a lessor to demonstrate that he had retained significant "benefits and burdens" of ownership with respect to an item of leased property.

If a lessor could establish that he owned a piece of leased property under the benefits and burdens test and that his leasing activities were conducted with a profit motive, the lessor generally could claim ACRS deductions and the investment tax credit with respect to the leased property. A number of exceptions to this general rule existed, however. For example, property leased to a tax-exempt organization or a federal or state governmental entity did not qualify for the investment tax credit.[3] Further, property used predominantly outside the U.S. was not eligible for the investment tax credit and was subject to reduced ACRS deductions.[4] The Code established, however, a number of exceptions to these limitations applicable to certain types of property used predominantly outside the U.S., such as aircraft and ships.[5]

Congress articulated a number of reasons to support a comprehensive restructuring of the Code as it applies to leases to nontaxable entities. A primary factor cited by the committee reports was the fact that, although tax-exempt entities were generally not eligible to claim the tax benefits arising from the ownership of property because they paid no tax, lessors could indirectly make these benefits available to tax-exempt entities by way of reduced rents. Congress viewed this result as an unintended distortion of the tax system because leases provided a tax-exempt lessee with benefits that were enacted to reduce the tax imposed upon taxable entities.[6] Further, Congress expressed concern over the fact that the Code was encouraging tax-exempt entities to dispose of their property and give up ownership control of their assets. The legislative history also reflects Congress' concern with the public's perception of leasing transactions, the revenue loss resulting from such leasing, and the lack of congressional budgetary control over the resulting indirect rent subsidies made available to tax-exempt entities through leases.[7]

II. Overview

The TRA enacted a comprehensive set of rules governing the tax benefits that may be reported by taxpayers who lease property to "tax-exempt entities." Basically, property leased to tax-exempt entities (referred to in the statute as "tax-exempt use property") is not eligible for the investment credit and must be depreciated under less generous schedules than those established by ACRS.

There are a number of significant exceptions to the rules defining tax-exempt use property. First, real property is not treated as tax-exempt use property unless at least 35 percent of the property is leased under "disqualified leases," as defined by the statute. Further, the TRA creates exceptions from the leasing rules for short-term leases and leases of certain high technology equipment. Finally, the statute codifies the concept of a service contract and provides a number of guidelines for distinguishing a lease of property from a contract to provide services.

The tax-exempt entity leasing rules generally apply to leases entered into after May 23, 1983. Thus, although the statute creates a number of exceptions to the general effective date, the TRA rules apply retroactively to a significant number of transactions.

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III. Detailed Analysis

A. Definition of Tax-Exempt Entity

1. General Definition

Post-TRA §168(j)(4) defines Post-TRA "tax-exempt entity" to include governmental entities and tax-exempt organizations, as well as certain foreign persons and entities. The definition of "tax-exempt entity" is the same for both the ACRS and investment credit rules enacted by the TRA. The definitions basically draw upon the rules previously established by §48(a)(4) and §48(a)(5).

Governmental entities that fall within the definition of "tax-exempt entity" are the United States, any state or political subdivision of the U.S., any U.S.A. possession, and any agency or instrumentality of the foregoing.[8] A corporation which would otherwise qualify as an instrumentality of the U.S. or of any state or political subdivision thereof will not be treated as a tax-exempt entity if all the activities of the corporation are subject to income tax and a majority of the corporation's directors are not selected by the U.S. or any state or political subdivision thereof.

Note: It is unclear whether "mixed ownership" corporations, such as Amtrak, the Federal Deposit Insurance Corporation and other entities listed in 31 U.S.C. §9101(2), are governmental instrumentalities for purposes of the leasing rules. The Senate Report clarified that fully taxable corporate instrumentalities of the U.S. or any state are not tax-exempt entities. *See* Senate Report at 127. Thus, under the Senate version of the bill, mixed ownership corporations would not be tax-exempt entities since they are taxable. In contrast, the House bill provided generally that government instrumentalities were tax-exempt entities, but that a corporation would not be treated as an instrumentality if all its activities were taxable and a majority of its board was not selected by the federal or a state government or a political subdivision thereof. The latter provision, which was adopted by the conferees, does not apply to most mixed ownership corporations because the federal government generally appoints a majority of their boards. Thus, the question of whether a mixed ownership corporation is a tax-exempt entity turns upon whether it can be viewed as an instrumentality of the federal government within the meaning of §168(j)(4)(A)(i). Although the Conference Report states that the conferees adopted the House bill with respect to the tax treatment of corporate instrumentalities of the U.S., it can be argued that mixed ownership corporations do not operate as instrumentalities of the federal government and, thus, do not fall within the basic definition of tax-exempt entity established by §168(j)(4)(A)(i). Alternatively, it could be inferred from the action of the conferees (*i.e.*, adopting the House version) that they implicitly included all government corporations within the definition of "tax-exempt entity" other than those that fall within the specific exemption in §168(j)(4)(D).

Organizations which are exempt from income tax (other than cooperatives described in §521) also fall within the definition of "tax-exempt entity." An identical rule previously applied under the investment credit limitation of §48(a)(4).

Notwithstanding the foregoing, property predominantly used by a tax-exempt organization in an activity subject to the tax on unrelated trade or business income is not covered by the leasing rules.[9] The rules delineating the foreign persons and entities that are included in the definition of "tax-exempt entity" are somewhat more complicated. Section 168(j)(4)(A)(ii) provides, generally, that any foreign person or entity is a tax-exempt entity. The statute clarifies that "foreign person or entity" means any foreign government, international organization, or any agency or instrumentality of either of the foregoing, and "any person who is not a United States person."[10] A foreign partnership or other foreign pass-through entity, however, does not fall within the definition of "tax-exempt entity."[11]

The TRA narrowed the potential reach of the definition of "tax-exempt entity" by providing that a foreign person or entity is a tax-exempt entity only as to property where 50 percent or less of the gross income derived by the foreign person or entity from the property is subject to U.S. income tax in the hands of the foreign person or entity.[12] Thus, if more than 50 percent of the gross income realized by the foreign lessee from a piece of property is subject to U.S. income tax, the property does not fall within the leasing rules. For these purposes, income taxed to a U.S. shareholder under §951 (relating to amounts included in the gross income of U.S. shareholders in controlled foreign corporations) for the shareholder's taxable year in which or with which the taxable year of a foreign lessee ends will be treated as being subject to U.S. income tax.[13] Further, to determine whether the 50-percent threshold is satisfied, the portion of the gross income subject to U.S. tax derived by a foreign lessee from property must be determined after taking into account all exclusions and exemptions, whether established by statute, treaty, or otherwise. In contrast, the total gross income from the use of property (*i.e.*, the denominator of the fraction) is to be determined without regard to any of the exclusions or exemptions described above.[14]

Comment: The income threshold described above was the subject of considerable controversy throughout the legislative consideration of the TRA. The House version of the bill included the 50-percent limitation described above. In response to an intense lobbying effort by taxpayers who lease property overseas, the Senate lowered the threshold to 20 percent, thereby increasing the potential class of property eligible for the exclusion from the definition of "tax-exempt entity." In resolving this conflict between the two bills, the Conference Committee adopted the House approach.

Note: Neither the statute nor the legislative history expressly states at what point in time the income threshold is to be applied to property leased to a foreign person or entity. For example, the statute could be interpreted as requiring taxpayers to apply the 50-percent threshold test on an annual basis. Under this interpretation, property leased to a foreign person or entity could be subject to the leasing rules in some years but not in others. Alternatively, the status of property leased to a foreign person or entity could be conclusively determined in the year the property is placed in service based on an application of the 50-percent test at that time. The investment tax credit regulations

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apply the latter approach in determining whether property is used predominantly outside the U.S. *See* Regs. §1.48-1(g)(1)(ii). This approach is mandated, however, by the fact that the determination of whether the property qualifies for the investment credit is made in the year the property is placed in service and, no doubt, an identical rule will apply for purposes of the investment credit limitations of the TRA leasing rules. In contrast, it seems that the 50-percent threshold of §168(j)(4)(B) could be applied annually to determine the appropriate ACRS deduction for a lessor of tax-exempt use property. The proposed ACRS regulations anticipate that property used predominately outside the U.S. (and therefore eligible only for the less generous ACRS deductions) may be converted, in a later year, to recovery property eligible for the full ACRS deductions. *See* Prop. Regs. §1.168-2(j)(3). Thus, the proposed ACRS regulations suggest that the 50-percent threshold test in the foreign leasing rules should be applied annually. In any event, the legislative history directs the Treasury to promulgate regulations pursuant to its authority under §168(f)(13) which will apply to property the tax ownership of which has not changed but which either becomes, or ceases to be, tax-exempt use property after it is placed in service by the taxpayer. House Report at 1151.

The rules defining "tax-exempt entity" contain a provision applicable to movies and sound recordings used by a foreign person or entity. A foreign person or entity that leases or uses a "qualified film," as defined in §48(k)(1)(B), or a "sound recording," as defined in §48(r), is not a "tax-exempt entity" with respect to the qualified film or sound recording.

2. Five-Year Lookback Rule

The definitional sections also contain a rule applicable to former tax-exempt organizations. If an organization (other than a cooperative described in §521) was tax exempt at any time during the five-year period ending on the date it enters into a lease, the organization shall be treated as a tax-exempt entity with respect to the property which is the subject of the lease.[15] The statute also provides that the five-year lookback rule applies to a successor organization engaged in substantially similar activities as those of its predecessor.[16] For example, if a tax-exempt hospital creates a wholly-owned taxable subsidiary which leases property and provides services to the hospital, any property leased by the subsidiary under leases entered into within five years of the date on which it was organized potentially will be classified as tax-exempt use property.[17] The five-year lookback rule, however, applies only to property leased (as opposed to owned) by the subsidiary. Property leased under a lease that extends beyond the five-year period will continue to be classified as tax-exempt use property because the determination under the lookback rule hinges upon whether the lease was entered into during the lookback period.

The statute also creates several exceptions to the lookback rule. First, the lookback rule does not apply to the Federal Home Loan Mortgage Corporation, a government corporation which loses its federal tax exemption effective January 1, 1985.[18] Rural electric cooperatives and other organizations formerly exempt from tax under §501(c)(12) at any time during the five-year lookback period will not be treated as tax-exempt entities if they elect to be taxed for the period beginning with the taxable year the leased property is placed in service and ending with the close of the fifteenth taxable year following the last taxable year of the recovery period for such property.[19] To qualify for the exception, however, former §501(c)(12) organizations also must elect to pay tax on the exempt arbitrage they earn, or have earned, on that portion of the proceeds of any tax-exempt obligations used by the organization to finance the leased property. The Conference Committee devised this latter requirement, and it is described in some detail in the Conference Report.[20]

3. Pass-Through Entity Leases

In the case of any property that is leased to a partnership (or other pass-through entity) having a tax-exempt entity as a partner (a beneficiary), such entity's proportionate share of the property is treated as being leased to such entity.[21] The method of computing the tax-exempt entity's proportionate share of property is discussed in III, I, *infra*.

The statute establishes a presumption with regard to foreign partnerships. Unless otherwise established to the satisfaction of the Secretary of the Treasury, the partners of a foreign partnership (or, the beneficiaries of any other foreign pass-through entity) are treated as foreign persons.[22]

B. Tax-Exempt Use Property

The statute creates two basic classes of "tax-exempt use property," "15-year tax exempt use property," and tax-exempt use property other than 15-year real property. Throughout this Chapter, the two classes of property are referred to as "tax-exempt real property" and "tax-exempt personal property," respectively. The rules defining the former class of property are somewhat more complex, and there are several exceptions to both classes as well.

1. Personal Property

"Tax-exempt use property" includes that portion of any tangible personal property leased to a tax-exempt entity.[23] In contrast to the definitional rules applicable to tax-exempt real property, the Code creates a blanket rule covering personal property. The definition of tax-exempt use personal property is limited, however, to property "leased to a tax-exempt entity." This language contrasts with the terms of the Senate and House bills, which provided that tax-exempt use personal property included all tangible property "used by a tax-exempt entity."[24] Consequently, under the earlier versions of the bill, if a tax-exempt entity owned a partial interest in personal property, the entire property constituted tax-exempt use property. The statute as enacted, however, treats only that portion of personal property leased to a tax-exempt entity as tax-exempt use property. Notwithstanding the foregoing, property owned by a partnership in which a tax exempt entity is a partner is subject to a different set of rules, which are discussed below in III, G.

2. Fifteen-Year Real Property

"Tax-exempt use property" also includes that portion of real property "leased to a tax exempt entity in a disqualified lease."[25] The statute creates a 35-percent threshold test, however, and real property will constitute tax-exempt use property only where more than 35 percent of the property is leased to tax-exempt entities in disqualified

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leases.[26] For this purpose, a "disqualified lease" is a lease of real property to a tax-exempt entity where one of the following four conditions is satisfied:

(i) All or part of the property was financed directly or indirectly with tax-exempt obligations and the tax-exempt entity (or a related entity) participated in the financing.

(ii) The lease contains a fixed or determinable purchase price or sale option exercisable by the tax-exempt entity or a related entity.

(iii) The lease term exceeds 20 years.

(iv) The lease occurs after a sale or other transfer of the property by, or a lease of the property from, the tax-exempt entity (or a related entity) and such property was used by the entity (or a related entity) before the sale, transfer, or lease.[27]

To determine whether the 35 percent threshold test has been exceeded in the case of a particular piece of real property, all disqualified use of the property is considered.

Example: Each of two tax-exempt entities leases 20 percent of a building, and the term of each lease exceeds 20 years. Forty percent of the building is tax-exempt use property. This result follows because, although the 35-percent ceiling was exceeded, "tax-exempt use property" includes only that portion of the real property leased under a disqualified lease. In contrast, if only one tax-exempt entity leased 20 percent of the building under a 20-year lease, no portion of the property would be treated as tax-exempt use property, assuming no other disqualified lease existed.

The legislative history specifies that, generally, separate buildings will be treated as separate properties for purposes of applying the definition of tax-exempt use property. Where two or more buildings are part of a single "project," however, the entire project is one property.[28] Further, in calculating the amount of space leased by a tax-exempt entity, the net rentable floor space leased by the entity should be compared to the total net rentable floor space in the building. Net rentable floor space does not include common areas.[29]

a. Participation in Tax-Exempt Financing

The question of whether a tax-exempt entity (or a related party) participates in financing a property with tax-exempt obligations requires a factual determination based on all the circumstances in a particular case. The legislative history provides several examples of cases in which a tax-exempt entity will be deemed to have participated in the financing of a property. For example, a tax-exempt entity participates in the financing if it (or a related entity) issues the tax-exempt obligations used to finance the property and it is reasonable, as of the date of issuance, to expect that the issuer will lease a portion of the property. A tax-exempt entity also will be viewed as having participated in the financing if it makes a commitment to lease space in a building before the owner has obtained its tax-exempt financing.[30] This latter example suggests that a low level of activity by a tax-exempt entity can amount to participation in financing a property.

b. Purchase or Sale Options

A lease is a "disqualified lease" if it contains a fixed or determinable purchase price or sale option exercisable by the tax-exempt lessee or a related entity. A lessor's "put," as well as a lessee's purchase option, is subject to this rule, provided the lessor's put right runs to a tax-exempt entity or a related party.

The legislative history clarifies that a "determinable price" option includes an option fixed at a pre-established price or at a price calculated pursuant to a formula. An option to purchase at fair market value on the date of exercise, however, is not a fixed or determinable price option. Likewise, if the parties adopt, at the time they enter into the lease, a formula that they reasonably expect will calculate the fair market value of the property on the exercise date, the option will not be treated as a determinable price option.

Example: A purchase option providing the lessee the right to purchase the property at some date in the future at a price equal to a percentage of original cost is a determinable price option. An option price based upon a formula which incorporates market rate rents and prevailing interest rates is not a determinable price option.

Arrangements which have the effect of a fixed or determinable price option are treated as such.[31] Examples of arrangements that may be treated as equivalent to fixed price options include options to purchase the stock (or other equity interests) of the lessor, and lease provisions that require the lessee to pay the lessor a specified amount upon the termination of the lease or destruction of the leased property.[32]

c. Use After Transfer

A lease will be considered a "disqualified lease" if the lease occurs after a sale or other transfer of the property by, or a lease of the property from, the tax-exempt lessee (or a related entity), provided the property was used by the tax-exempt lessee (or related entity) before the sale, transfer, or lease. The basic thrust of this provision is to include within the term "disqualified lease" sale-leasebacks by tax-exempt entities. As evidenced by the legislative history, Congress intended to include within this form of disqualified lease a variety of transactions that have the effect of a sale-leaseback.[33] The statute provides, however, that a transaction will not be treated as a disqualified sale-leaseback if the tax-exempt entity leases the property within three months after the date on which the entity (or a related entity) first uses the property.[34]

Note: The Senate Finance Committee added the three-month window to the House version of the TRA. The provision parallels the three-month window established by §48(b). This latter provision allows certain property which is the subject of a sale-leaseback to qualify as "new §38 property."

d. Renewal Options

For a discussion of the rules for determining whether a renewal option counts toward the maximum 20-year lease term allowed under the leasing rules, *see* III, E, below.

e. Improvements

For purposes of determining whether a property constitutes tax-exempt use property, improvements to a property (other than land) shall not be treated as a separate property.[35] For example, the legislative history describes a case in

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which a taxpayer purchases a building shell from a tax-exempt entity, rehabilitates the building, and leases the renovated property back to the tax-exempt entity.[36] On these facts, the statute will treat the renovated building as a single piece of tax-exempt use property because the building was the subject of a sale-leaseback. Alternatively, if a taxpayer leases unimproved land from a tax-exempt entity, constructs a building on the land, and leases the improved real estate to the tax-exempt entity, the building will not be treated as tax-exempt use property unless it otherwise falls within one of the "disqualified lease" provisions. That is, the building will not be deemed to be the subject of a sale-leaseback under §168(j)(3)(B)(ii)(IV). Similarly, the legislative history confirms that a building constructed on land leased from a tax-exempt entity will not constitute tax-exempt use property solely by reason of the underlying lease.

C. *Operating Rules for ACRS Deductions*

1. *Personal Property*

Prior to the TRA, the Code did not generally limit ACRS deductions with respect to property leased to tax-exempt entities. Section 168(f)(2), however, contains rules which decrease the ACRS deductions for property used predominantly outside the U.S. In the case of personal property used predominantly outside the U.S., §168(f)(2) allows taxpayers to recover their costs over a recovery period equal to the asset's present class life (ADR life). An asset without a present class life is subject to a 12-year recovery period for this purpose. In the case of real property used predominantly outside the U.S., ACRS prescribes a 35-year recovery period. Certain types of property excluded from the foreign use restrictions under the investment credit rules of §48(a)(2)(B) are eligible for standard ACRS deductions, notwithstanding any foreign use.

Under the rules enacted by the TRA, tax-exempt use personal property must be depreciated using the straight-line method over a period equal to the greater of (i) the property's present class life, or (ii) 125 percent of the lease term. The statute treats personal property which has no class life under the ADR system as having a 12-year class life for these purposes. Further, the statute adopts a half-year convention for personal property.

Note: the TRA amended §168(g)(2) to authorize the Treasury to establish class lives for properties that were not covered by the ADR rules. This grant of regulatory authority is significant not only for purposes of the leasing rules, but also for ACRS generally. For example, assets that presently fall within the five-year class because they do not have a class life of four years or less potentially can be included in the three-year class if they are issued a four-year class life under the regulations.

Section 168(j)(2)(E) explicitly provides that, where tax-exempt use property is financed with the proceeds of an industrial development bond, the taxpayer shall compute recovery deductions under §168(j) rather than §168(f)(12). Section 168(f)(12) generally requires that the recovery deductions for property financed with industrial development bonds be calculated under the straight-line method. In contrast to §168(j), however, §168(f)(12) does not increase the period over which the taxpayer may recover its costs.

2. *Real Property*

Prior to the enactment of the TRA, real property leased to tax-exempt entities generally was eligible for the 15-year recovery period (subject to §168(f)(2)). After the TRA, tax-exempt use real property must be depreciated using the straight-line method (without regard to salvage value) over the longer of (i) 40 years or (ii) 125 percent of the lease term. For the year in which tax-exempt real property is placed in service, the deduction shall be calculated on a pro rata basis with reference to the month in which the property is placed in service. Moreover, although §168(j)(1) refers to "15-year real property" in establishing the applicable recovery periods for tax-exempt use property, the statute specifies that "15-year real property" includes the class of 18-year real property (as enacted by the TRA), as well as real property which is not recovery property. Consequently, real estate that might otherwise be ineligible for ACRS because of the anti-churning rules is treated no differently under §168(j) than real estate that falls within ACRS.

D. *Exception for Short-Term Leases*

Prior to the enactment of the TRA, §§48(a)(4) and (5) generally denied an investment credit for property used by a tax-exempt organization or by a governmental unit. The regulations and case law, however, recognized exceptions to this general rule for casual or short-term leases of property.[37] These authorities defined "casual lease" to mean a lease that lacks the formalities typical of a written lease. A casual lease includes the lease of an automobile from a car rental company by a government employee traveling on government business.[38] The exception for short-term leases evolved in order to allow the government to fulfill an unforeseen or extraordinary need to lease property on a short-term basis. In these limited circumstances, the exception allowed a lessor to fulfill this unforeseen need of the tax-exempt or government entity without causing the taxpayer-lessor to lose the investment credit with respect to the leased property.[39]

The ACRS and investment credit provisions in the leasing rules follow the general approach of pre-TRA law by providing an exception from the definition of tax-exempt use property for property leased to a tax-exempt entity under a short-term lease. Specifically, §168(j)(3)(C)(i) provides that property shall not be treated as tax-exempt use property for purposes of the ACRS rules merely by reason of a short-term lease. The statute defines "short-term lease" to mean any lease the term of which is (i) less than three years, and (ii) less than the greater of one year or 30 percent of the property's present class life. In the case of real property and property without a present class life, however, the 30 percent requirement does not apply, and the lease term need only be less than three years to qualify for the exception.

Although the statutory language is somewhat ambiguous, the legislative history expressly states that property which qualifies under the short-term lease exception will not be subject to any of the ACRS provisions of §168(j).[40] Consequently, even if a building is financed with tax-exempt bonds or is the subject of a sale-leaseback, §168(j) will not apply if the lease term is less than three years.[41]

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Note: The leasing rules limiting the availability of the investment credit for tax-exempt use property also create a short-term lease exception, which is discussed below.

E. Property Used in an Unrelated Trade or Business

Under §168(j), tax-exempt use property does not include any portion of property used predominantly by a tax-exempt entity in an unrelated trade or business the income of which is subject to tax under Code §511 or §514. This exception also applies to property predominantly used by a tax-exempt entity in a trade or business through a partnership in which the entity is a partner. Although the legislative history does not expressly address the reason for this exception, presumably Congress concluded that, to the extent the property leased by a tax-exempt entity is used in an activity subject to tax, the property should not be distinguished from property leased by a taxable entity.

F. Special Rules for Certain High Technology Equipment

Congress adopted a special set of rules applicable to certain high technology equipment which would otherwise be treated as tax-exempt use property. Congress excluded these types of property from the more stringent rules of §168(j), presumably on the theory that, because of rapid technological advances that can be expected in the near future, this equipment is likely to become obsolete before the expiration of its physical useful life, or perhaps even before the expiration of the five-year ACRS recovery period.[42] Thus, "qualified technological equipment," which meets certain requirements, is eligible for a five-year recovery period even if it is leased to a tax-exempt entity.

1. Definition of Qualified Technical Equipment

Section 168(j)(5) generally defines "qualified technological equipment" to mean (i) any computer or peripheral equipment, (ii) any high technology telephone station equipment installed on the customer's premises, and (iii) any high technology medical equipment. The statute also includes rather specific technical definitions of all three categories of qualified technological equipment, and the legislative history provides numerous examples of specific types of equipment that fall within the definitions.[43]

The statute authorizes the Secretary of the Treasury to issue regulations identifying items of high technology telephone station equipment and high technology medical equipment which are not subject to rapid obsolescence. Any such items ultimately listed in regulations and placed in service after the date on which the final regulations are issued will not be treated as "qualified technological equipment" notwithstanding the fact that the items meet the other statutory requirements.[44]

The definitional provisions relating to telephone station equipment present several interpretive issues. First, the statute requires that, to qualify as "qualified technological equipment," telephone station equipment must be installed on the customer's premises. The legislative history sheds no light on the meaning of "customer's premises." It is not clear whether a customer's premises include any site at which it regularly conducts its activities or whether the term includes only locations which the customer actually owns or leases. Moreover, it is not clear whether a mobile telephone would be viewed as being used on a customer's premises. Further, it is ironic that, in commenting on the definition of high technology telephone station equipment, the legislative history may have excluded from the definition items of equipment which are particularly subject to rapid obsolescence. Specifically, the House Report explicitly states that only equipment included in ADR class 48.13 may qualify as high technology telephone station equipment.[45] The Report also identifies telephones which have features such as an abbreviated dialing program, an automatic callback, or a conference call feature as qualified telephone station equipment. Although a conference call feature does not seem to incorporate a particularly high level of technology and might be considered a candidate for inclusion in the future regulations identifying equipment not subject to rapid obsolescence, it appears that the specific reference in the House Report may be sufficient to insure the qualified status of conference call telephones. In contrast, certain microwave transmitters and relay equipment apparently will not qualify as high technology equipment because those items fall within ADR classes other than 48.13 (for example, ADR class 48.32).

Comment: Rather than identify industry-specific items of equipment that qualify for an exception from the leasing rules, the Senate bill contained a general exception to §168(j) for property having an ADR mid-point life of six years or less (provided the lease term for the equipment did not exceed a specified limit). Inasmuch as the final version of the TRA followed the House approach, it appears that the references in the Ways and Means Committee Report discussed above should be persuasive in resolving uncertainties over the definition of qualified high technology equipment.

2. Other Restrictions

To be eligible for the exception for qualified technological equipment, an item of equipment must not be leased to a tax-exempt entity for a term of more than five years. Notwithstanding the foregoing, even if the lease term exceeds five years, the property is eligible for slightly less generous ACRS deductions, provided the property is predominantly used outside the U.S. For these purposes, property which qualifies for the exceptions in §48(a)(2)(B) cannot be treated as used predominantly outside the U.S.

Section 168(j)(5)(C)(ii) also provides that property leased to a tax-exempt entity will not fall within the definition of "qualified technological equipment" if the property is financed by a tax-exempt obligation or if the lease is part of a sale-leaseback transaction. The statutory language imposing these two restrictions is identical to the language in the sections defining "disqualified lease" for purposes of real property and consequently, the detailed discussion in the legislative history regarding the term "disqualified lease" should be relevant in defining the scope of these two limitations on high technology equipment. As in the case of the disqualified lease rules, the sale-leaseback restriction applicable to qualified technological property will not apply to property which is leased to a tax-exempt entity within three months of first being used by that entity (or a related entity). Finally, §168(j)(5)(C)(ii) establishes a third limit on the definition of qualified technological equipment by providing that such equipment may not be leased to the U.S. or any of its agencies or instrumentalities.

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As noted in the legislative history, the rapid technological obsolescence experienced by qualified technological equipment may create problems for lessors independent of the specific limitations in §168(j). The House Report notes that the standards that have evolved under pre-TRA law apply to leases of high technology equipment and, thus, the purported lessor of such equipment may not be treated as the tax owner of the property if the lease term equals the property's economic useful life.[46] Consequently, even where property falls within the definition of qualified technological equipment in §168(j) and is subject to a lease of five years or less, the tax-exempt lessee may be viewed as the owner of the property if the property is unlikely to have residual value at the end of the lease term because of technological obsolescence.[47]

3. Operating Rules

Property which satisfies the requirements applicable to qualified technological equipment, as described above, may be leased to a tax-exempt entity (other than the U.S. government or its agencies or instrumentalities) without falling subject to the limitations generally imposed by §168(j) upon tax-exempt use property. That is, the tax consequences relating to a lease of qualified technological equipment will be governed by the general ACRS and investment credit rules.

If leased property would qualify as high technology equipment but for the fact that it is leased to a tax-exempt entity pursuant to a lease with a term greater than five years, it is eligible for recovery deductions calculated under the straight-line method (without regard to salvage value) over a recovery period of five years.[48] This rule should not be particularly burdensome inasmuch as qualified high technology equipment presumably would only be eligible for the five-year accelerated recovery period generally available under ACRS. The five-year straight-line rate, however, does not apply to property used predominantly outside of the United States and not eligible for an exception in §48(a)(2)(B). Property used predominantly outside the U.S. and leased to a tax-exempt entity for a term in excess of five years is subject to the full range of limitations imposed upon tax-exempt use property by §168(j).

G. Special Rules for Defining Lease Term

Section 168(j)(6) provides that the term "lease" includes any grant of a right to use property. The statute also provides that, for purposes of the rules in §168(j) the term of a lease is calculated by including all extensions for which the lessee (or a related party) has a legally enforceable option to renew, or for which the lessor has a legally enforceable option to compel the lessee to renew. The lease term of tax-exempt use property includes renewal periods regardless of whether the lease is, in fact, renewed and regardless of the term of the renewal periods. Notwithstanding these general rules, however, the statute does not automatically include a renewal as part of the lease term where the rent during the renewal period is a fair market rent determined as of the renewal date.[49] The Conferees, however, stated that the fair market renewal exception is subject to the principles that have evolved in the case law discussed below which has considered issues regarding the term of a lease.[50] Thus, the exception in §168(j)(6)(C) does not provide absolute protection for a real estate lease with a fair market value renewal option.

The legislative history also states that §168(j)(6) incorporates a facts and circumstances test for purposes of determining whether a subsequent lease (negotiated independent of a renewal option) should be included in the original lease term.[51] Thus, if the parties extend a lease at a rental rate differing materially from market rates at the time of the extension, this fact would suggest that the parties had agreed informally to the extension when they originally entered the lease. Under these circumstances, the second lease term would be added to the original term of the lease. The legislative history indicates that rules such as those which have evolved under §46(e)(3) will be relevant in determining whether subsequent lease terms should be included in the original term.[52]

Finally, the statute and legislative history clarify that if, at substantially the same time or as part of one arrangement, a tax-exempt entity (or a related party) enters into several leases covering the same or substantially similar property and the leases have different terms, each lease will be treated as having a term equal to the term of the longest lease.[53]

H. Related Entities

As noted herein, many of the rules applicable to tax-exempt use property turn upon not only the role of a tax-exempt entity in a transaction, but also on the role of entities related to a tax-exempt entity. For example, real property will generally be treated as tax-exempt use property if a tax-exempt entity or a related party assists the lessor in obtaining tax-exempt financing for the property or sells the property and leases it back from the lessor.[54] Accordingly, §168(j)(7) establishes a series of rules that define the concept of related entities. The definitions vary, moreover, depending upon the identity of the tax-exempt entity in question (*e.g.*, a governmental instrumentality as opposed to a foreign entity).

In the case of governmental units, each agency or instrumentality of a governmental unit is related to all other units, agencies, or instrumentalities which, directly or indirectly, derive their powers, rights, and duties, in whole or in part, from the same sovereign authority.[55] For this purpose, the U.S., each state, and each U.S. possession is considered a separate sovereign authority. Consequently, each member state of a multi-state commission is related to the commission inasmuch as the commission derives its authority from the members.[56] Two cities located in the same state, however, are not related entities, presumably on the theory that each city is a separate sovereign authority and does not derive its powers from the state. The legislative history also states, without explanation, that all cities located in a foreign country are related to each governmental unit, agency, or instrumentality (and presumably all cities) in the foreign country.[57]

With respect to non-governmental tax-exempt entities, the statute provides that tax-exempt entities are related if they have (i) "significant common purposes and substantial common membership," or (ii) "directly or indirectly substantial common direction or control." As examples of

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entities that fall within this rule, the legislative history cites a national fraternity and its local chapters and the Red Cross and its local organizations.[58] The statute establishes another rule applicable to entities that are related through common ownership. Specifically, a tax-exempt entity is related to another entity if either entity owns (directly or through one or more entities) a 50 percent interest in the capital or profits or the other entity. Further, for this purpose, two entities that are treated as related under the "governmental unit" or the "common purposes or control" rules described above, are treated as a single entity for purposes of applying the 50 percent common ownership rule. The result of these rules is that a foreign corporation is deemed to be related to any corporation in which it owns 50 percent or more of the value of the stock, regardless of the jurisdiction in which the subsidiary is organized. Similarly, a charitable organization is related to any corporation in which it owns 50 percent or more of the stock.[59]

Finally, the statute creates a broad anti-abuse section which provides that parties to a transaction will be treated as related entities for purposes of the transaction if it is part of an attempt by the parties to avoid the tax-exempt entity leasing rules.

I. Property Owned by Partnerships and Other Pass-Through Entities

The Act prescribes a set of rules intended to prevent the use of partnerships, other pass-through entities (*e.g.*, S corporations) and tiered arrangements to allocate disproportionately the tax burdens and benefits of property owned by such entities. For example, a partnership that includes a tax-exempt partner may be used to obtain substantially the same results as a pre-Act tax-exempt entity leasing arrangement if the partners are free to allocate a disproportionate share of tax benefits to the taxable partners, while allocating, directly or indirectly, a disproportionate share of tax burdens (*i.e.*, taxable income) to the tax-exempt partner. The Act mandates that all allocations to a tax-exempt entity partner (or other beneficiary, such as an S corporation shareholder) meet certain specific consistency standards. Failure to comply with these standards will result in a proportionate share of the partnership's property being treated as tax-exempt use property, with a commensurate reduction in available depreciation (or investment tax credits).

In general, if any property that is not otherwise treated as tax-exempt use property is owned by a partnership that has both tax-exempt and taxable partners, the tax-exempt partners' "proportionate share" of the property will be treated as tax-exempt use property unless any allocation of partnership items to the tax-exempt partner is a "qualified allocation," or unless the portion is predominantly used by the tax-exempt partners, through the partnership, in an unrelated trade or business the income from which is subject to taxation under §511.[60] An allocation is a qualified allocation for this purpose if it is consistent with the tax-exempt partner being allocated the same share of the partnership's income, gains, loss, deduction, credit and basis during the entire period in which the tax-exempt entity is a partner. Moreover, the allocation must also have "substantial economic effect" as required under §704(b).[61] For this purpose, allocations under §704(c) (relating to the manner in which partners share the tax incidents of property that are attributable to periods before the property is contributed to the partnership) are disregarded.

In the event that an allocation to a tax-exempt partner is not a qualified allocation, such partner's proportionate share of the partnership's property must be computed. This computation must be made based on the partner's share of partnership income or gain, whichever results in the largest proportionate share.[62] The share of gain is to be determined without regard to gain allocated in accordance with §704(c). If, under the partnership agreement, the tax-exempt partner's share of income or gain may vary over time, the highest possible share will be the "proportionate share."[63]

The Conference Report illuminates these rules in several respects. First, and most importantly, the restrictions apply notwithstanding any other provision of the TRA tax-exempt entity leasing rules. Thus, even if only 10 percent of a building is deemed to be tax-exempt use property, that portion will be so treated irrespective of the 35 percent threshold provided in §168(j)(3)(B)(iii). Second, the consequence of an improper allocation will be a reduction in otherwise available depreciation deductions (*i.e.*, the tax-exempt partner's proportionate share of the property will be subject to an extended write-off period under post-TRA §168(j)).

Comment: The statute, by its terms, also applies to §§48(a)(4) and (5). These sections preclude an investment tax credit with respect to property "used" by tax-exempt entities (*see* discussion in III, J below). Since the qualified allocation rules apply to property *owned* by a partnership that includes tax-exempt partners, their application in the context of investment credits is unclear. Presumably, a "proportionate share" of otherwise available credit will be disallowed to the partnership, since current regulations under §48 treat property owned by a tax-exempt entity as used by such entity.

Third, the Conference Report clarifies that property may be tax-exempt use property under both the qualified allocation rules and the general tax-exempt entity leasing provisions.

Example: A §501(c)(3) organization (A) is a 50-percent partner in a partnership that owns an office building. Fifty percent of the rentable space is leased to another §501(c)(3) organization, rendering this portion subject to the depreciation and investment tax credit limitations under §168(j) and §48. A receives a special allocation of 75 percent of the income generated by the remaining rentable space. That space is deemed to be tax-exempt use property, since the allocation to A with respect to the space is not a qualified allocation.

For purposes of the qualified allocation rules, §168(j)(9)(E) requires that the regulations implementing the tax-exempt entity leasing provisions (to be promulgated under §168(j)(10)) set forth the appropriate treatment for guaranteed payments. The statute also states that these regulations may provide for the exclusion or segregation of items. The Conference Report clarifies that priority cash distributions to partners that constitute guaranteed payments under §707(c) should not affect an otherwise quali-

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fied allocation if they are (1) reasonable in amount (*i.e.*, equal to the appropriate federal rate) and (2) made to all partners in proportion to their capital in the partnership. Disproportionately large payments to tax-exempt partners, which would circumvent the qualified allocation requirements, will not be treated as qualified.[65] Such payments would have the effect of shifting taxable income from taxable partners to tax-exempt partners.

With regard to the segregation or exclusion of certain items, the Conference Report sets out two examples of instances in which abatement of the qualified allocation requirements would be appropriate. Thus, in the case of a partnership consisting of a domestic corporation and foreign country, the allocation to the corporation of U.S. tax expenses imposed on the partnership would not constitute a disqualified allocation, since the tax burden is borne solely by the corporation. Similarly, varying allocations to reflect varying capital interests in separate oil or gas wells may satisfy the qualified allocation rules.

All pass-through and tiered entities will be subject to the qualified allocation provisions.[66]

J. Limitations on Investment Tax Credits

1. General

As previously discussed, pre-TRA §48(a) generally denied any investment tax credit with respect to property used by a tax-exempt organization, property used predominantly outside the U.S., and property used by a federal or state political subdivision (or agency or instrumentality thereof).[67] Section 31(b) of the Act expands the list of disqualifying uses to include use by any U.S. possession and by any foreign person or entity.[68] For purposes of the latter exclusion, the definitions provided in post-TRA §168(j) apply. Thus, the term "foreign person or entity" does not encompass a foreign partnership or other foreign pass–through entity.[69] Moreover, property used by a foreign person or entity is eligible for the investment tax credit if more than 50 percent of the gross income for the taxable year derived from use of the property is subject to U.S. income tax or is included in gross income by a U.S. shareholder under §951.[70]

Property otherwise eligible for the investment tax credit ("§38 property") will cease to be §38 property at the time it becomes tax-exempt use property. Under the investment tax credit recapture rules of §47, the conversion to tax-exempt use may trigger recapture of all or part of the investment credit.

The Act provides two exceptions to the general exclusion of property used by governmental units or foreign entities or persons. First, the exclusion does not apply to certain property that is subject to a short-term lease. No property is considered tax-exempt use property merely because it is leased for a term of less than six months.[71] In the case of property leased to a foreign person or entity for use in offshore drilling for oil and gas (including drilling vessels, barges, platforms, drilling equipment and support vessels), or property so leased which is a container, container chassis or trailer having a present class life of six years or less, the exclusion does not apply if the term of the lease is less than three years and less than the greater of one year or 30 percent of the present class life of the property.[72] These special exceptions for drilling equipment, containers and leases of less than six months are also available for property that is used by tax-exempt organizations (*i.e.*, property described in §48(a)(4)). Finally, any new aircraft is eligible for the investment credit if it is leased prior to January 1, 1990 to a foreign person or entity for use outside the U.S., and the lease term is less than three years.[73]

The second exception relates to qualified rehabilitation expenditures, which are defined in §48(g) as capital expenditures incurred in connection with rehabilitation of a "qualified rehabilitated building." A qualified rehabilitated building is any building (and its structural components) that has been substantially rehabilitated, that was placed in service prior to the rehabilitation and 75 percent of the external walls of which have been preserved.[74] Under the Act, as under pre-TRA law, that part of the basis of such a building that is attributable to qualified rehabilitation expenditures qualifies for the investment tax credit, even if the building is leased to a governmental unit or foreign person or entity.[75]

The Conference Report emphasizes that, unless one of the foregoing exceptions applies, no investment credit is allowed even if the property in question would be eligible for the credit under §48(a)(2)(B), which permits the credit for certain property used predominately outside the U.S.

Example: Taxpayer leases a communications satellite to a French corporation that is a controlled foreign corporation. Forty percent of the gross income derived by the corporation from use of the satellite is includible in the gross income of U.S. shareholders of the corporation under §951. Because less than 50 percent of gross income generated by the satellite is included in income by the U.S. shareholders and no other exception applies, no investment credit is available with respect to the satellite.

2. Rehabilitation Tax Credit

Code §46(a) provides a generous tax credit for investment in the rehabilitation of certain buildings. The amount of the credit is a percentage of qualified rehabilitation expenditures incurred with respect to a qualified rehabilitated building.[76] One of the characteristics of a qualified rehabilitated building is that a certain amount of rehabilitation expenditures are incurred during a two-year period in the rehabilitation process.[77]

The definition of "qualified rehabilitation expenditures" appears at §48(g)(2). Section 31(c) of the 1984 Act amends §48(g)(2) to exclude from eligibility for the rehabilitation credit expenditures allocable to any portion of a building that is, or "may reasonably be expected to be," tax-exempt use property.[78] For this purpose, "tax-exempt use property" has the meaning given in §168(j)(3).[79]

Example: Taxpayer incurs $100,000 of qualified rehabilitation expenditures in rehabilitating a row house. One half of these expenditures are allocable to a portion of the row house (approximately 50 percent of the total rentable space) that is expected to be leased to a tax-exempt entity under circumstances that will make the portion tax-exempt use property. Only $50,000 of the expenditures are qualified rehabilitation expenditures. Under §168(j)(3), if 35 percent or less of the rentable space of the building is expected to be leased to tax-exempt entities in disqualified

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leases (*see* III, B, 2, *supra*), all $100,000 of the expenditures would qualify for the credit.

Comment: The statute fails to specify how rehabilitation expenditures are to be allocated among tax-exempt use and non-tax-exempt use portions of a building. Examples in the legislative history suggest that the expenditures should be allocated on a straight percentage basis, as in the above example. Thus, if 36 percent of a building is subject to a disqualified lease, it matters not if all of the expenditures with respect to a building relate solely to portions that are not tax-exempt use property.

Under the TRA rules, expenditures may be included in determining whether a building is a qualified rehabilitated building even if the expenditures relate to tax-exempt use property and are therefore ineligible for the rehabilitation credit.[80] Thus, the exclusion of expenditures attributable to tax-exempt use property from the credit computation will not jeopardize the status of qualifying expenditures incurred in the rehabilitation.

3. Thrift Institutions

Code §46(e)(1) effectively limits mutual savings banks, and other thrift institutions described in §593, to 50 percent of the investment tax credit otherwise available with respect to property owned by such institutions. The reason for this limitation is that §593 provides thrift institutions with generous deductions for additions to bad debt reserves, which reduce taxable income.[81] Prior to the TRA, property leased to a thrift institution qualified for the entire amount of allowable credit.

To prevent thrift institutions from circumventing the §46(e) limitations through the use of leasing arrangements, the Act provides that the lessor of property leased to a thrift institution will be treated as a thrift institution.[82] Thus, only 50 percent of the credit will be available to the lessor, and there will be no otherwise unavailable benefits to pass on to the thrift institution by means of a rental adjustment or other arrangement.

As in the case of the general rule denying the investment credit for property used by tax-exempt entities, the Act excepts property used under a lease with a term of less than six months (computed under §168(j)(6)).[83] Additionally, a thrift institution may elect to compute its bad debt reserve deduction on the basis of actual experience (rather than in the manner provided in §593(b).[84] In the event of such election, a taxpayer leasing property to the electing institution may claim a full investment credit for the property. An election, once made, is irrevocable and will apply to any successor organization engaged in substantially similar activities.[85]

K. Definition of Service Contracts

1. Background and General Rules

The TRA limitations on depreciation and investment tax credits apply only if the property in question is leased to, or used by, a tax-exempt entity or entities. As noted above, §48(a)(4) and pre-TRA §48(a)(5) have excluded property "used" by a governmental unit or tax-exempt organization from eligibility for the investment tax credit.

In a line of IRS rulings and court decisions, the Service and the courts have developed a significant exception to the general rule that denies investment credits for property "used by" a governmental unit or exempt organization.[86] Under this so-called "services" exception, when a taxpayer provides equipment to a tax-exempt entity as part of an integrated package of services and equipment, the equipment qualifies for the investment credit.

In the leading case of *Xerox Corp. v. U.S.*,[87] the taxpayer entered into agreements with federal, state and local governments and tax-exempt organization (hereafter "customers") by which the customers obtained from the taxpayer various types of photocopying and printing machines. Under the terms of the agreements, the taxpayer retained ownership of the machines (including accessories), bore the risk of machine loss or damage, and was obligated to provide maintenance and repair service for the machines and to train the customers' personnel to operate the machines. It was also the taxpayer's practice to replace undependable machines with an identical model and to upgrade all existing machines by installing newly developed parts and accessories. The customers generally agreed to pay the taxpayer a fixed fee plus a charge based upon the number of copies produced. The customers also purchased from the taxpayer supplies for their machine, performed minor maintenance duties, and provided employees to operate the machines. The customers were prohibited from altering or physically moving their machines without the taxpayer's permission.

On these facts, the Trial Division of the Court of Claims held that the taxpayer was entitled to the credit. The court based its conclusion on the following facts:

(1) under the terms of the agreement, the taxpayer retained ownership of the machines and assumed the risk of loss;

(2) the agreement prohibited the customer from altering or physically moving the machine;

(3) the contract required the taxpayer to provide full maintenance and repair service at no additional cost to its customer;

(4) the taxpayer performed maintenance and repair work on the machines and trained the customers' personnel to use the machines;

(5) the taxpayer replaced defective machines with identical models, often in lieu of repairing the original machine;

(6) the taxpayer upgraded the machines by periodically installing newly developed parts ("retrofits"); and

(7) under the terms of the agreement, a customer generally paid a charge to the taxpayer based upon the number of copies produced.

In summarily affirming this decision, the full Court of Claims adopted *in toto* the analysis undertaken by the Trial Division.

As is often the case with issues resolved by application of a "totality-of-the-circumstances" test, no consistent and workable criteria for distinguishing service contracts from leases and other arrangements has emerged from the rulings and case law. For example, many of the specific facts relied upon in *Xerox* are present in many typical equipment

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leasing arrangements. A lessor of equipment almost always retains ownership of the leased equipment, and is often responsible for maintenance and repair. Moreover, the equipment in *Xerox* was used by the customers rather than the taxpayer in the production of copies. The same situation probably would exist under a lease.

To provide statutory guidance for distinguishing leases and similar arrangements from service contracts, and to prevent the "economically insubstantial restructuring" [88] of leases as service contracts, the Act codifies a facts and circumstances test and prescribes a number of specific factors applicable to purported service contracts. The characterization of a contract (or other arrangement, including a pass-through entity) depends upon whether or not:

(1) the service recipient is in physical possession of the property;

(2) the service recipient controls the property;

(3) the service recipient has a significant economic or possessory interest in the property;

(4) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;

(5) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and

(6) the total contract price does not substantially exceed the rental value of the property for the contract period.[89]

If some or all of these factors are present, the transaction will be regarded as a lease, regardless of the label affixed by the parties.

In addition, the House and Senate Reports provide a number of detailed examples illustrating the proper application of the statutory factors. The following example from the Senate Report was specifically adopted by the conferees:[90]

Example: E, a school district, and T, a privately owned school bus company, enter into a multi-year agreement (up to four years) under which T will provide transportation for all enrolled school children within the district. T was awarded the contract under competitive bid and is paid, so long as it performs under the contract, at a fixed monthly rate. Under the agreement, T has the exclusive authority to designate bus stops and establish pickup and delivery schedules although it does consult with E. E designates the children to be transported and the time they are to be at school.

T has sole title to the buses, which generally have an economic useful life of 9.5 years, and has total discretion regarding the number and types of vehicles to be used. The agreement requires that all vehicles, equipment, and drivers must comply with applicable state and federal safety regulations. Under the terms of the contract, T is responsible, subject to state requirements, for maintaining insurance coverage within specified limits. T is also responsible for the training and employing of drivers, and for the storage, repair, and maintenance, which is significant, of all vehicles. In addition, T decides when a bus should be replaced, determines what models should be purchased and what features they should have, and exercises discretion over substitution. It is unlikely the buses will be used for other purposes during the school year.

Absent other factors to the contrary, the agreement is a service contract under the bill. The following facts provide the basis for that conclusion: (a) T has physical possession of the buses; (b) T has control of the buses; (c) T bears a substantial risk of nonperformance in that, among other things, it will not get paid unless it performs; and (d) the monthly rate substantially exceeds the rental value of the property. The facts that the buses likely will not be used for other purposes during the school year, that the agreement is for up to four years (which is not a substantial portion of their useful lives), and that T must comply with applicable regulations do not, by themselves, support a conclusion that the agreement is a lease.[91]

The TRA service contract provision applies for all purposes of the Code, not just the nontaxable use restrictions on the investment credit and the depreciation provisions of the Act. For example, the definition probably applies in determining whether equipment or services are furnished by one member of a controlled group to another group member for purposes of establishing an arm's-length charge under §482. Similarly, a purported service contract, if recharacterized as a lease under the service contract definition, will give rise to rents constituting personal holding company income under §543(a)(2).

2. Exceptions and Special Rules

The TRA carves out limited exceptions to the service contract provisions for certain specific types of property. Generally, any contract or other arrangement with respect to the operation of a "qualified solid waste disposal facility" or "water treatment works facility," or the sale of electrical or thermal energy produced at a cogeneration or alternative energy facility, which purports to be a service contract, will be treated as such notwithstanding the general service contract provision.[92] In addition, the definition does not apply to low income housing (as defined in §168) if the property is operated by or for a §501(c)(3) or (c)(4) organization and at least 80 percent of the housing units are rented to low income tenants (as defined in §167(k)(3)(B).[93]

Under certain circumstances, the exception for waste disposal, energy and water treatment facilities will not be available. If the service recipient (or a related entity) (1) operates the facility, (2) bears an significant financial burden if there is nonperformance (other than for reasons beyond the control of the service provider), (3) receives any significant financial benefit in the event of reduced operating costs, or (4) may purchase (or be required to purchase) all or a part of the facility at a fixed and determinable price (other than fair market value), the contract or other purported service arrangement will be subject to recharacterization under the service contract definition.[94] Whether entities are related for purposes of this rule will probably be determined under the principles of §168(j)(7). For a discussion of this provision, *see* III, H, *supra*.

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Still another set of rules describes certain contractual rights and events that are disregarded in determining whether a facility is eligible for the exception from the general service contract provision. For purposes of ascertaining whether, under (1) above, the recipient of services is operating the facility, any right of the recipient to inspect the facility, exercise its sovereign powers (if any) or act in the event of a breach of the contract, is not taken into account.[95] Similarly, any allocation under the contract of financial benefits or burdens attributable to a change in any law is disregarded.[96] In determining whether the recipient bears a risk of nonperformance, any temporary shutdown for repairs, maintenance or improvement, or any financial burden caused by the financial difficulty of the service provider, is deemed irrelevant.[97] Finally, the mere fact that a recipient's payments decrease as a result of increased production or efficiency is not taken into account for purposes of the reduced operating cost determination ((3) above).[98] The House and Senate Reports provide an example of the operation of these rules on the case of a qualified solid waste disposal facility.[99]

IV. Effective Dates

A. General Rules

The tax-exempt entity leasing provisions generally apply to property placed in service after May 23, 1983, in taxable years ending after that date, and to property placed in service on or before that date if the lease is entered into thereafter.[100] A lease in effect on May 23, 1983 is not treated as entered into after May 23, 1983 merely because it is renewed or extended after that date, provided the renewal or extension is pursuant to a binding option held by the tax-exempt entity on that date.[101] Moreover, property will not become tax-exempt use property if the lessee, under a lease in effect on May 23, 1983, subleases the property after that date.[102] The Senate Report clarifies that the status of property under these rules will not be affected by a transfer of the property by the lessor after May 23, 1983, so long as the party obligated to lease the property remains the same.[103]

Example: On June 1, 1982, T, a corporation, enters into an agreement under which T will lease an office building to W, a tax-exempt organization, for one year. The agreement grants W an option to renew for an additional year at the expiration of the original lease term. On May 24, 1983, T assigns all of its rights and obligations under the agreement to V. On May 25, 1983, W exercises its option to renew. The office building will not be treated as tax-exempt use property.

For purposes of the effective date provisions, an improvement to property is not treated as a separate property unless it is substantial. An improvement is substantial if capital expenditures related thereto, incurred during any two-year period, equal or exceed 20 percent of the adjusted basis of the improved property (computed without regard to deduction for depreciation and the like).[104] An insubstantial improvement will not be subject to the TRA leasing restrictions if the underlying property qualifies under a transitional rule.

B. Transitional Rules

The Act contains a plethora of special effective dates and transitional rules, many of which apply exclusively to specific projects. This discussion will be limited to those rules considered as having widespread applicability.

1. Binding Contracts

Under the TRA, the tax-exempt entity leasing rules do not apply to property subject to a binding written contract or contracts that, on May 23, 1983 and at all times thereafter, required (a) that the taxpayer (or his predecessor in interest) acquire, construct, reconstruct or rehabilitate the property, and that (b) the tax-exempt entity (or its tax-exempt predecessor) lease the property.[105] The rules are also inapplicable to property owned by a partnership if the partnership acquired the property on or before October 21, 1983 or entered into a binding contract that, at all times on or after that date, obligated the partnership to acquire or construct the property.[106] Also excepted is property leased to a tax-exempt entity (other than a foreign person or entity) if (a) the taxpayer (or his predecessor in interest) or the tax-exempt entity (i) entered into a binding contract to acquire, etc., the property and the property was not previously used by the tax-exempt entity, or (ii) acquired the property between June 30, 1982 and May 23, 1983, or completed construction, etc., between January 1 and May 23, 1983, and (b) the lease is pursuant to a binding contract, entered into before the end of 1984, that requires the tax-exempt entity to lease the property.

For purposes of this transitional rule, a contract is binding only if it is enforceable against the taxpayer under applicable state law and does not limit damages (as by a liquidated damages clause) to an amount that is less than five percent of the contract price.[107] A contract, however, is treated as binding despite the presence of one or more of the following circumstances:

(1) performance under the contract is subject to a condition, so long as the condition is beyond the parties' control;

(2) the parties make insignificant changes in the terms of the contract;

(3) any term of the contract is subject to a standard beyond the parties' control; or

(4) some terms of the contract have not been established (provided that the contract imposes significant obligations on the taxpayer).[108]

Comment: The binding contract provisions raise a number of issues, some of which may be resolved by reference to legislative history and judicial and IRS interpretations under the investment tax credit suspension and termination rules.[109] For example, the proper treatment of a contractual condition that the buyer use its best efforts to obtain any necessary financing is unclear. There is also a question at to how complete a contract must be to be considered binding. Presumably, if the absence of certain terms does not vitiate the agreement under state law, it will be deemed binding for purposes of the Act.

The legislative history specifies that a binding contract to purchase part of a piece of property is not a binding

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contract to purchase the entire property.[110] For instance, a binding contract to purchase an aircraft engine does not constitute a contract to purchase an aircraft.

2. Official Governmental Action

Property leased to a tax-exempt entity (other than a foreign person or entity, or any federal governmental unit) is exempt from the TRA leasing restrictions if (a) on or before November 1, 1983, there was "significant official governmental action" with respect to the property or its design, and (b) the lease is pursuant to a binding contract entered into before January 1, 1985, that requires the tax-exempt entity to lease the property.[111]

The statute defines "significant official government action" only by reference to what it is not. Specifically, the term does not include granting of permits, zoning changes, environmental impact statements, or similar governmental actions.[112] The House and Conference Reports provide fairly explicit guidance, however, as to what types of action will satisfy the "significant official government action" requirement.[113] The action must meet three distinct tests. First, it must be an official action; that is, sanctioned by law, evidenced by a writing and not withdrawn. For example, minutes of a proceeding reflecting the adoption of an ordinance or resolution will suffice. Second, the action must be specific action relating to a particular (*i.e.*, identifiable) project and indicative of an intent to proceed to consummation. Examples of such action include the hiring of bond counsel or underwriters to assist in financing a particular project, filing a grant application and the recommendation by a planning authority to proceed based on an authorized feasibility study of the specific project. Third, the acting body must have the authority to commit the tax-exempt entity to the project, provide funding, or approve the project under government law. Such authority may exist even though a decision may later be rescinded, or completion of the project requires some other, additional governmental action.

The Conference Report supplies the following examples of qualifying governmental actions:

> *Example:* The enactment of a state law authorizing the sale, lease, or construction of the property; the appropriation of funds for the property or authorization of a feasibility study or a development services contract with respect to it; the approval of financing arrangements by a regulatory agency; the enactment of a state law designed to provide funding for a project; or the endorsement of the application for a certification of need with respect of a medical facility by a regulatory agency other than the agency empowered to issue such a certificate.[114]

3. Certain Partnerships

Section 168(j)(9) (relating to the treatment of property held by a partnership having both tax-exempt and taxable partners) will not apply to property acquired prior to January 1, 1985 by certain partnerships, or prior to January 1, 1986[115] in the case of certain other partnerships. A partnership falls within the first category if (a) the partnership, prior to October 21, 1983, (i) was organized, (ii) filed an exemption request with the Department of Labor,[116] and (iii) circulated a private placement memorandum stating the maximum number of units offered; (b) the private placement memorandum described the property to be acquired, and (c) the sale of units is completed not later than July 18, 1986 or two years after the date of Federal Register publication of the Department of Labor exemption (whichever is later), and no units in addition to those offered in the memorandum are sold.[117] A partnership falls into the second category if (a) prior to March 6, 1984, the partnership was organized and publicly announced the maximum amount of interests in the partnership that were offered for sale, and (b) the partnership completed the offering (without additional sales) not later than October 17, 1984.[118]

4. Service Contracts

The TRA rules for distinguishing service contracts from other arrangements do not apply in the case of a contract or arrangement with respect to which no tax-exempt entity is a party, if the contract was entered into before November 5, 1983.[119] This rule applies to any renewal or extension pursuant to an option in such a contract or arrangement.[120]

5. Property Used Abroad

The TRA leasing restrictions do not apply to tax-exempt use property used by a foreign person or entity if the property was placed in service prior to January 1, 1984 and the use is pursuant to a lease entered into before that date.[121] If the property is subject to a sublease under a covered lease, the property is exempt only if it was used under the lease by any foreign person or entity before January 1, 1984.[122]

6. Other Special Transitional Rules

The Act sets forth a number of other special transitional rules pertaining to certain narrowly-defined categories of property and specific projects. These should be reviewed carefully by all taxpayers who own property subject to the TRA tax-exempt entity leasing restrictions. They appear as §31(g) of the Act.

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[1] The findings of the Subcommittee on Oversight are summarized in Staff of the Joint Committee on Taxation, 83rd Cong., 1st Sess., *Tax Aspects of Federal Leasing Arrangements* (JCS Committee Print 1983).

[2] *See Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978).

[3] *See* §§48(a)(4), 48(a)(5). All section references herein are to the 1954 Internal Revenue Code as amended and the regulations promulgated thereunder unless otherwise specified. As discussed below in more detail, the courts and the Service recognized an exception to the investment credit limitations for service contract arrangements.

[4] *See* §48(a)(2), §168(f)(2).

[5] *See* §48(a)(2)(B).

[6] *See* S. Rep. No. 169 (Vol. I), 98th Cong. 2d Sess. 123 (1984) (hereafter "Senate Report"); H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 138 (1984) (hereafter "House Report").

[7] *See* Senate Report at 123, 125-27; House Report at 1140-41.

[8] The TRA expanded upon the list of governmental entities in §48(a)(5) by adding U.S. possessions to the definition of "tax-exempt entity."

[9] §168(j)(3)(D).

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[10] *See* §168(j)(4)(C).
[11] *Id.*
[12] §168(j)(4)(B)(i).
[13] Senate Report at 128.
[14] Senate Report at 128; House Report at 1143.
[15] §168(j)(4)(E)(i).
[16] §168(j)(4)(E)(iii).
[17] Senate Report at 127-28.
[18] Act §177.
[19] §168(j)(4)(B)(ii).
[20] H.R. Rep. No. 861, 98th Cong., 2d Sess. 781-82 (1984) (hereafter "Conference Report").
[21] §168(j)(8)(A).
[22] §168(j)(8)(C).
[23] §168(j)(3)(A).

[24] The House and Senate Committee Reports emphasize that personal property owned by, leased to, or otherwise used by a tax-exempt entity would qualify as tax-exempt use property. *See* Senate Report at 128; House Report at 1143.
[25] §168(j)(3)(B)(i).
[26] §168(j)(3)(B)(iii).
[27] §168(j)(3)(B)(ii).
[28] Senate Report at 129.
[29] *Id.*
[30] Senate Report at 130.
[31] §168(j)(3)(B)(ii)(II).
[32] Senate Report at 131.
[33] *See* Senate Report at 131-32.
[34] §168(j)(3)(B)(v).
[35] §168(j)(3)(B)(iii).
[36] *See* Senate Report at 132.
[37] *See* Regs. §§1.48-1(j) and (k).
[38] *See Xerox Corp. v. U.S.*, 656 F.2d 659 (Ct.Cl. 1981).
[39] *See World Airways, Inc. v. Comr.*, 564 F.2d 886 (9th Cir. 1977), aff'g 62 T.C. 786 (1974).
[40] *See* Senate Report at 149.
[41] House Report at 1161.
[42] *See* House Report at 1150; Governmental Leasing Tax Act of 1984; Hearings on H.R. 3110 before Committee on Ways and Means, 98th Cong., 1st Sess. 177 (1983) (Statement of Paul Oosterhuis).

[43] *See* §§168(j)(5)(C)(i), 168(j)(5)(D), 168(j)(5)(E); House Report at 1149-50.
[44] §168(j)(5)(C)(iv).
[45] *See* House Report at 1149.
[46] *See* House Report at 1149.
[47] *Cf.* Rev. Proc. 75-21, §4(1)(C), 1975-10 C.B. 715 (providing rules applicable to leveraged leases.)
[48] §168(j)(5)(B).
[49] §168(j)(6)(C).
[50] Conference Report at 788.
[51] *See* Senate Report at 150.

[52] *See Hokanson v Comr.*, 730 F.2d 45 (9th Cir. 1984) aff'g 44 T.C.M. 550 (1982). In *Hokanson*, the court concluded that, even though both parties to a lease had the annual right to cancel the lease on 30 days' notice, the parties' "realistic contemplation" at the time of entering into the lease was that the lease would extend for more than 50 percent of the property's useful life, in contravention of §46(e)(3)(B).

[53] *See* §168(j)(6)(B)(ii); Senate Report at 150.
[54] *See* §168(j)(3)(B)(ii).
[55] §168(j)(7)(A)(i).
[56] House Report at 1162.
[57] *Id.*
[58] House Report at 1162.
[59] House Report at 1162.
[60] §168(j)(9)(A).
[61] §168(j)(9)(B).
[62] §168(j)(9)(C)(i).
[63] §168(j)(9)(C)(ii).
[64] Conference Report at 792.
[65] *Id.*
[66] §168(j)(9)(D).
[67] §§48(a)(2), (4) and (5), as in effect prior to the TRA.
[68] §48(a)(5)(A).
[69] §168(j)(4)(C).
[70] §168(j)(4)(B)(i). For an extended discussion of the 50-percent test, *see* III, A, 1, *supra.*

[71] §48(a)(5)(B)(i). The lease term is to be computed by application of §168(j)(6). *See* III, G, *supra.*
[72] §48(a)(5)(B)(ii).
[73] §48(a)(5)(B)(iii). For purposes of this rule, the recapture period otherwise applicable to the aircraft under §47 is extended by the term of the lease. §48(a)(5)(B)(iii).
[74] §48(g)(1). The TRA added an alternative definition of this term. *See* §48(g)(1)(E).
[75] §48(a)(5)(C).
[76] §§46(a)(2)(F); 48(a)(1)(E).
[77] §48(g)(1)(C).
[78] §48(g)(2)(B)(vi).
[79] *See* III, B, *supra*, for a detailed description of tax-exempt use property.
[80] §48(g)(2)(B)(vi)(II).
[81] *See* §593(b).
[82] §46(e)(4)(A).
[83] §48(e)(4)(B).
[84] §48(e)(4)(C).
[85] *Id.*
[86] *See Xerox Corp. v. U.S.*, 80-2 USTC 9530 (Ct. Cl. Tr. Div. 1980) aff'd *per curiam*, 656 F.2d 659 (Ct. Cl. 1981); Rev. Rul. 71-397, 1971-2 C.B. 63; Rev. Rul. 70-313, 1970-1 C.B. 9; PLRs 8217040; 7847075.
[87] *Supra*, footnote 86.
[88] Senate Report at 125.
[89] §§7701(e)(1) and (2).
[90] Senate Report at 142; Conference Report at 790.
[91] Senate Report at 142.
[92] §7701(e)(3). Section 7701(e)(3) provides the following definitions: (1) qualified solid waste disposal facility - any facility providing solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the processed waste is collected from the general public. (The Senate Report, at 142, states that the general public includes commercial businesses to the extent that the waste is collected from them in their capacities as members of the general public (*i.e.*, the waste requires no special processing)); (2) cogeneration facility - a facility using the same energy source for the sequential generation of electrical or mechanical power in combination with steam, heat or other forms of useful energy; (3) alternative energy facility - a facility for producing electrical or thermal energy, if the primary fuel source is not oil, natural gas, coal or nuclear power; and (4) water treatment works facility - a facility described in §212(2) of the Federal Water Pollution Control Act, 33 U.S.C. §1292(2).
[93] §7701(e)(5).
[94] §7701(e)(4).
[95] §7701(e)(4)(B)(i).
[96] §7701(e)(4)(B)(ii).
[97] §7701(e)(4)(C)(i).
[98] §7701(e)(4)(C)(ii).
[99] House Report at 1158; Senate Report at 144.
[100] Act §31(g).
[101] Act §31(g)(2)(B).
[102] Act §31(g)(2)(A).
[103] Senate Report at 152.
[104] Act §31(g)(20)(B).
[105] Act §31(g)(3)(A).
[106] Act §31(g)(3)(B).
[107] House Report at 1164; Senate Report at 153.
[108] *Id.*
[109] *See* 192 T.M., *Investment Credit - Application; Suspension; Termination*, S. Rep. No. 91-522, 91st Cong., 1st Sess. 230 (1969).
[110] Senate Report at 153.
[111] Act §31(g)(4)(A).
[112] Act §31(g)(4)(B).
[113] House Report at 1166-68; Conference Report at 796.
[114] Conference Report at 796.
[115] Property will be deemed to have been acquired before January 1, 1986 if the partnership entered into a binding contract prior to that date and closing takes place within six months (24 months in the case of new construction). Act §31(g)(11)(C).
[116] Presumably, this requirement applies when a pension or profit sharing plan, or other entity subject to ERISA, is involved in a project.
[117] Act §31(g)(11)(B).
[118] Act §31(g)(11)(D).
[119] Act §31(g)(13).
[120] *Id.*
[121] Act §31(g)(15).
[122] Act §31(g)(B).

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CHAPTER 19

MISCELLANEOUS LEASING PROVISIONS

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I. Finance Lease Provisions Postponed [Act §12]

A. Introduction

TEFRA (P.L. 97-248) generally repealed the safe harbor equipment leasing rules enacted by ERTA (P.L. 97-34). In their place, TEFRA substituted a modified form of safe harbor leasing called "finance leasing."[1] Under the finance leasing rules, the IRS is effectively prohibited from denying lease status to certain arrangements even though: (1) the lessee has the right to purchase the leased property at a fixed price, which is not less than 10 percent of the original cost of the property to the lessor; and/or (2) the agreement provides for the lease of limited use property, *i.e.*, property the use of which is commercially feasible only for the lessee.[2] Thus, in a finance lease transaction, the parties are still, to some extent, able to "sell" tax benefits with respect to property while retaining economic benefits and burdens of ownership, as they were able to do under ERTA's safe harbor rules.

As originally enacted by TEFRA, the finance lease rules generally were applicable to agreements entered into after December 31, 1983, with the following restrictions operative for finance leases entered into before January 1, 1986:

(1) A 40 percent "lessee cap" was imposed on the amount of the lessee's property that may qualify for finance lease treatment in any calendar year.[3]

(2) A 50 percent "lessor cap" was imposed on the amount by which a lessor may reduce its tax liability by means of finance leases.[4]

(3) TEFRA provided a requirement that the lessor's investment tax credits attributable to finance lease property be taken ratably over a five-year period.[5]

(4) The taxable income of a finance lease lessee had to be computed as if the lessee owned the property for purposes of percentage depletion deductions under §§613 or 613(a).[6]

Prior to the Tax Reform Act of 1984, the 50 percent tax benefit cap and the five-year investment tax credit spread requirement would not have applied to property placed in service after September 30, 1985, and the 40 percent lessee cap on eligible lease property would have expired on January 1, 1986. The percentage depletion restriction is permanent.

TEFRA provided an exception to the general effective date and restrictions for agreements relating to certain farm property. Under this exception, the finance lease rules are available for up to $150,000 of a lessee's foreign property, for agreements entered into after July 1, 1982 and before 1984. Further, the 40 percent lessee cap, the 50 percent lessor cap, and the five-year spread requirement for the investment tax credit are inapplicable to this farm property.[7]

Regulations have yet to be issued under the finance lease provisions.

B. Overview

1. Summary of Amendment

The Tax Reform Act of 1984 generally postpones for four years the availability of finance leasing. Thus, these rules will generally apply only to agreements entered into after December 31, 1987, and the three restrictions that were scheduled to apply in 1984-5 will apply in 1988-9. The pre-TRA rules relating to the availability of finance leasing for up to $150,000 of a lessee's farm property are extended to cover agreements entered into before 1988.

Transitional rules which exempt certain automotive and cogeneration property from the four-year postponement apply.

2. Effective Date

The amendments postponing the effective dates are generally effective March 7, 1984. The postponement of the finance lease provisions, however does not apply to agreements concerning property with respect to which the lessee had entered into a binding contract to acquire or construct prior to March 7, 1984. Similarly, the postponment does not apply to agreements covering property if the property was acquired by, or if construction of the property was begun by or for, the lessee before March 7, 1984. Special rules are also provided for certain automotive property and certain cogeneration facilities.

C. Detailed Analysis

1. General

The Act postpones for four years the effective dates of the finance lease rules.[8] These rules generally apply, therefore, only to agreements entered into after December 31, 1987, and the three restrictions that, before the Act, were scheduled to apply in 1984-5 apply insted in 1988-9.

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First, the 40 percent lessee cap is extended to cover property placed in service by a lessee during any calendar year beginning before 1990.[9] Second, the 50 percent lessor cap is extended through September 30, 1989.[10] Third, the five-year spread of investment credit for property subject to a finance lease is extended to cover property placed in service on or before September 30, 1989.[11]

2. Farm Property

Pre-TRA law rules relating to the availability of finance leasing for up to $150,000 of a lessee's farm property are extended to cover agreements entered into before 1988.[12]

3. Transitional Rules

The Act provides transitional rules which exempt certain property from the four-year postponement. Under these rules, finance leasing remains available for otherwise qualified property if, before March 7, 1984: (1) a binding contract to acquire or to construct the property was entered into by or for the lessee; (2) the property was acquired by the lessee; or (3) construction of the property was begun by or for the lessee.[13]

4. Certain Automotive Property

In addition to the general transitional rules, the Act exempts from the four-year postponement of the finance leasing rules up to $150,000,000 of a "qualified lessee's" automotive manufacturing property.[14]

The TRA invokes TEFRA §208(d)(6) to define a "qualified lessee." A lessee with respect to a finance lease agreement under §168(f)(8)(A) is "qualified" if it:

(a) had net operating losses in each of the three most recent taxable years ending before July 1, 1982, and had an aggregate net operating loss for the five most recent taxable years ending before July 1, 1982, and

(b) uses the property subject to the agreement to manufacture and produce within the United States a class of products in an industry with respect to which —

(1) the taxpayer produced less than 5 percent of the total number of units (or value) of such products during the period covering the three most recent taxable years of the taxpayer ending before July 1, 1982, and

(2) four or fewer United States persons (including as one person an affiliated group under §1504(a)) other than the taxpayer manufactured 85 percent or more of the total number of all units (or value) within such class of products manufactured and produced within the United States during such period.[15]

The $150,000,000 ceiling applies to the aggregate cost basis of all property with respect to which the taxpayer, or any related person within the meaning of §168(e)(4)(D), is the lessee.[16]

Note: If the aggregate cost basis of property with respect to which the taxpayer (or a related person) is a lessee were to exceed the ceiling, the finance lease provisions would be unavailable for the entire disqualifying agreement, and not just for that amount of property with basis in excess of the ceiling.

Automotive manufacturing property [17] is:

(a) property used principally by the taxpayer directly in connection with the manufacture of cars or trucks (other than truck tractors) with a gross weight of 13,000 pounds or less;

(b) machinery, equipment, and special tools of the type included in CLADR asset guideline classes 37.11 and 37.12;[18] and

(c) any special tools owned by the taxpayer which are used by a vendor solely for the production of component parts for sale to the taxpayer.

5. Certain Cogeneration Facilities

The Act also exempts from the general four-year postponement of the finance leasing rules property that is part of a coal-fired cogeneration facility placed in service before January 1, 1988 for which an application for certification was filed with the Federal Energy Regulatory Commission on December 30, 1983, and for which an application for a construction permit was filed with a state environmental protection agency on February 20, 1984.[19]

II. Motor Vehicle Operating Leases

A. Introduction

In *Swift Dodge v. Comr.*,[20] the Ninth Circuit reversed the Tax Court and held that a motor vehicle lease which contained a terminal rental adjustment clause ("TRAC") was, for tax purposes, a conditional sale rather than a lease. The TRAC at issue required the lessee to reimburse the lessor, at the termination of the lease, for any difference between the actual value of the vehicle and a projected value calculated at the outset of the lease.

When Congress enacted TEFRA (P.L. 97-248) the Tax Court's decision in *Swift Dodge* was on appeal to the Ninth Circuit. Section 210 of TEFRA provided that, until regulations were promulgated addressing the issue, the Service was precluded from recharacterizing a motor vehicle lease as a conditional sale by reason of the fact that the lease contained a TRAC. TEFRA §210 applied only to operating leases in which the lessee used the vehicle for business, as opposed to personal, purposes. Further, the Service was not prohibited from recharacterizing a lease as a conditional sale where the lessor acquired the vehicle with nonrecourse debt. In November, 1982, the Treasury proposed regulations restating the Service's historical position that a motor vehicle lease which includes a TRAC will be recharacterized as a conditional sale.

In contrast to the temporary moratorium enacted by TEFRA, Congress acted more decisively in the 1984 TRA and adopted rules providing that a "qualified motor vehicle operating agreement" that otherwise qualifies as a lease will not be treated as a conditional sale because it contains a TRAC. The legislative history indicates that Congress adopted the favorable treatment for TRACs because such clauses have been widely used in the motor vehicle leasing industry for more than 30 years and serve a significant, nontax, business purpose.[21] Specifically, Congress determined that a TRAC provides a financial incentive for the lessee to maintain the leased vehicle properly since the lessee bears the cost of any reduction in the vehicle's value

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resulting from improper maintenance during the lease term.

B. Overview

TRA §32 amends §168(f) of the Code by adding a new paragraph specifying the tax treatment of motor vehicle operating leases that contain a TRAC. Basically, post-TRA §168(f)(13) provides that, if a motor vehicle lease otherwise would be treated as a lease for tax purposes, it will not be recharacterized as a conditional sale by reason of a TRAC. Only "qualified motor vehicle operating agreements" qualify for the safe harbor under §168(f)(13). Under a qualified agreement, the lessor must be personally liable for repayment of all amounts borrowed to finance the acquisition of the leased vehicle or must pledge unrelated property as security for the debt. Further, the lessee must certify in writing, under penalty of perjury, that it intends that more than 50 percent of the use of the motor vehicle will be in a trade or business of the lessee and that the lessee has been advised that it will not be treated as the tax owner of the vehicle.

The provisions enacted by TRA §32 apply to leases entered into more than 90 days after the date of enactment of the TRA (July 18, 1984).

C. Detailed Analysis

1. Background

Automobile dealers that also operate leasing businesses often lease motor vehicles under an agreement that contains a TRAC. A TRAC generally provides that, upon termination of the lease, the lessee is obligated to pay the lessor the difference between the actual wholesale value of the automobile on the termination date and a "depreciated value" established by the agreement for the vehicle as of the same date.[22] The "depreciated value" schedule reflects the lessor's estimate, as of the date of the lease, of the vehicle's value at the future dates specified in the schedule. Thus, because the lessee is required to reimburse the lessor for any shortfall in the actual wholesale value of the vehicle at the termination date, the economic effect of a TRAC is to shift to the lessee the risk that the vehicle will depreciate in value more quickly than the parties originally believed.

In *Swift Dodge*, the Ninth Circuit held that an automobile dealer's lease agreement which contained a TRAC was a conditional sales contract rather than a lease. That is, the court viewed the purported lease as a means of financing the nominal lessee's purchase of the vehicle, which purchase occurred at the time the parties entered into their initial agreement. The Court of Appeals based its decision on its conclusion that the terms of the lease, including the TRAC, shifted all risks of ownership and loss to the lessee. Because the nominal lessor did not qualify as the tax owner of the automobile in the court's view, the lessor could not claim the investment tax credit and depreciation with respect to the vehicle.[23]

As noted above, the issue regarding the effect of a TRAC on an automobile lease also was the subject of Congressional review during the enactment of TEFRA. TEFRA §210 prohibited the Service, until regulations were issued, from recharacterizing a motor vehicle lease as a conditional sale solely because the lease contained a TRAC. Accepting the implicit invitation presented by TEFRA,the Treasury proposed regulations in November, 1982 which adopted the position that a motor vehicle lease which included a TRAC is a conditional sale.

2. Definition of TRAC

Post-TRA §168(f)(13)(C)(i) defines a TRAC as a "provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property." The definition in the statute is clearly broad enough to cover provisions such as the one at issue in *Swift Dodge*, which required the lessee to pay the lessor, upon termination of the lease, the difference between the vehicle's actual wholesale value and a value projected at the outset of the lease. The statute also creates a special rule applicable to dealer-lessees which provides that the term "TRAC" includes a provision in an agreement requiring a dealer-lessee to purchase the leased motor vehicle for a predetermined price and then resell it under circumstances in which the provision achieves substantially the same results as a TRAC.

3. Qualified Motor Vehicle Operating Agreement

A "qualified motor vehicle operating agreement" is potentially eligible for the favorable tax treatment established by §168(f)(13). The Code defines "qualified motor vehicle operating agreement" as any agreement regarding a motor vehicle (including a trailer) which meets three basic requirements.

First, in the case of a qualified agreement, amounts borrowed by the lessor to finance the leased motor vehicle must not exceed the sum of the lessor's recourse debt and the fair market value of the lessor's property pledged as security for the debt.[24] For purposes of the latter standard, however, property will not count as qualified security if it is subject to the lease agreement or is property directly or indirectly financed by indebtedness secured by the leased motor vehicle. Thus, if the lessor finances the acquisition of the leased motor vehicle, the lessor's debt must be recourse debt or secured by property unrelated to the lease agreement.

The second requirement is that the agreement must contain a separate written statement signed by the lessee certifying, under penalty of perjury, that (i) the lessee intends that more than 50 percent of the use of the motor vehicle shall be in the lessee's trade or business and (ii) that the lessee has been advised that it will not be treated as the owner of the motor vehicle for federal income tax purposes.[25]

The final requirement is that the lessor must not be aware of any inaccuracies in the certificate provided by the lessee.[26] The statute imposes no duty upon the lessor to verify that the lessee, in fact, meets the 50-percent business use test. If, however, the lessor later becomes aware that the lessee does not satisfy the test, the lessor apparently will lose the protection of §168(f)(13).

4. Tax Treatment of Qualified Agreements

If a motor vehicle lease is a qualified motor vehicle operating agreement, the agreement shall be respected as a lease for tax purposes if, absent the TRAC, the agreement would be characterized as a lease under general tax principles. That is, if an analysis of all of the facts and circumstances (ignoring the TRAC) indicates that the lessor has retained sufficient benefits and burdens of ownership with respect to the leased property, the lessor will be treated as the tax owner of the motor vehicle.[27] As tax owner of the leased property, the lessor will be entitled to take the investment tax credit and ACRS deductions.

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Although the effect of §168(f)(13) is to neutralize the impact of a TRAC on the characterization of a qualified motor vehicle operating agreement, it is not absolutely clear that a typical dealer lease will, after the TRA, automatically be respected as a lease for tax purposes. In this regard, the Ninth Circuit, in *Swift Dodge*, appeared to draw negative inferences from a number of facts including the fact that the lessee was required to insure the automobile and perform all maintenance. In the court's view, these factors indicated that the lessee, rather than the lessor, bore the risks of ownership. Indeed, inasmuch as the Ninth Circuit concluded that the only risk borne by the lessor was the risk that the lessee might default under the lease, it may be questioned whether the Ninth Circuit would treat the lease at issue in *Swift Dodge* as a true lease even if it were to ignore the TRAC. As a practical matter, however, it seems that a court faced with a case identical to *Swift Dodge* after the TRA might interpret post-TRA §168(f)(13) as providing some positive Congressional confirmation of the efficacy of a lease containing a TRAC.

Section 168(f)(13) also clarifies the tax treatment of a lessee under a qualified motor vehicle operating agreement. Once a qualified agreement satisfies the applicable standards (*e.g.*, the lessee certification requirement), the statute provides that under no circumstances will the lessee be treated as the tax owner of the motor vehicle during the term of the agreement.[28] This result follows even if the qualified agreement is later found to be a conditional sale because the agreement's terms (other than the TRAC) preclude lease treatment. In these circumstances, the investment credit and ACRS deductions allocable to the motor vehicle will not be available to either party.[29] Congress, presumably, believed that this result was warranted because, by signing the necessary certification, the lessee gives up any claim to the tax benefits allocable to the leased motor vehicle.

The legislative history also states that the lessee's right to deduct rent paid under the qualified agreement is determined under general Code provisions, including provisions added by the TRA such as the accounting changes included in post-TRA §467. If the terms of a qualified agreement (other than a TRAC) dictate that the agreement be recharacterized as a conditional sale, the lessee would be entitled to no rent deductions, but presumably could treat a portion of the "rent" as interest on deferred purchase payments. The determination of the amount of the lessee's interest deduction generally should be governed by post-TRA §§1271-75.[30]

5. Amendments to TEFRA Section 210

As noted previously, TEFRA §210 precluded the Service, until regulations were issued, from recharacterizing a motor vehicle lease as a conditional sale solely by reason of the fact that the lease contained a TRAC. TRA §712(d) added two amendments to TEFRA §210. The first expands the definition of "qualified motor vehicle agreement" to include leases which require dealer-lessees to purchase and resell leased motor vehicles under circumstances in which the lease term achieves substantially the same result as a TRAC. This provision is identical to the special rule applicable to dealer-lessees in §168(f)(13)(C)(ii). TRA §712(d) also clarifies that the rules of TEFRA §210 shall not operate to deny an interest deduction claimed by a lessee with respect to a qualified motor vehicle agreement on a tax return filed before July 18, 1984. Further, TEFRA §210 will not deny a credit for investment in depreciable property claimed by a lessee on such a tax return in accordance with an agreement with the lessor that the lessor would not claim the credit.

TRA §32(b) effectively terminates the application of TEFRA §210 for leases entered into more than 90 days after July 18, 1984. This termination date corresponds to the effective date of the post-TRA §168(f)(13). Thus, the amendments to TEFRA §210 described above will be of limited practical significance.

III. Special Leasing Rules for Certain Coal Gasification Facilities [Act §1067]

A. Introduction

As previously indicated, TEFRA repealed ERTA's safe harbor leasing for transactions entered into after December 31, 1983 and substantially modified the tax treatment of safe harbor leases entered into between July 1, 1982 and January 1, 1984. Most of the modifications adopted by TEFRA, however, do not apply to leases of property placed in service before January 1, 1983, provided that one of the following events occurred after December 31, 1980 and before July 2, 1982: (i) the property was acquired by the lessee or construction of the property was commenced by or for the lessee, or (ii) a binding contract to acquire or construct the property was entered into by the lessee.

Note: For a detailed discussion of the effective dates and transition rules applicable to the TEFRA amendments to safe harbor leasing, *see* 12 T.M., *Equipment Leasing*.

Because the construction period for coal gasification facilities is particularly lengthy, Congress determined that a special safe harbor leasing transition rule was appropriate for these facilities. Basically, a coal gasification facility will qualify as transitional safe harbor lease property provided the property is placed in service before July 1, 1984 and the other conditions described above are satisfied. This modification to the safe harbor leasing transition rules is effective as if it had been enacted in the original transition rule of TEFRA §208(d)(3).

B. Detailed Analysis

Section §1067 of the 1984 Tax Reform Act amended the safe harbor leasing transition rules enacted by TEFRA and added a special rule applicable to coal gasification facilities. A coal gasification facility is a facility used "directly in connection with the manufacture or production of low sulfur gaseous fuel from coal." [31] In the case of a coal gasification facility, most of the safe harbor leasing amendments enacted by TEFRA will not apply to a lease of property placed in service before July 1, 1984, provided one of the following conditions is satisfied between December 31, 1980 and July 2, 1982: (i) the property was acquired by the lessee or construction of the property was commenced by or for the lessee, or (ii) a binding contract to acquire or construct the property was entered into by the lessee.

Act §1067(a) and the legislative history contain several elaborations on the transition rule described above. First, a coal gasification facility will be treated as having been placed in service when the taxpayer received an operating permit for the facility from a state environmental protection agency. Further, the Conference Report states that a coal gasification facility placed in service prior to July 1, 1984 may be leased in a safe harbor lease within three

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months after it is placed in service by the lessee without losing its status as transitional safe harbor lease property.[32] Finally, the Act clarifies that, in the case of a coal gasification facility, the facility will be treated as having been acquired between December 31, 1980 and July 2, 1982 (as required in the rule cited in the previous paragraph) if at least 20 percent of the cost is paid during that period.

The special transition rule enacted by the TRA for coal gasification facilities applies only to a lease of an undivided interest in the facility in an amount which does not exceed the lesser of 50 percent of the cost basis of the facility or $67,500,000. The special transition rule also provides that the term of a lease which qualifies for the transition rule shall be treated as being five years.[33] Congress apparently added this provision to enable certain coal gasification facilities to satisfy the safe harbor lease rule regarding minimum lease terms even where the facilities are subject to leases of less than five years. The temporary safe harbor lease regulations provide that the term of a safe harbor lease must equal, at a minimum, the ACRS recovery period of the leased property.[34] Unless a coal gasification facility constituted public utility property, it presumably would have an ACRS recovery period of five years.

Act §1067 also establishes a special investment tax credit recapture provision for coal gasification facilities that qualify as transitional safe harbor lease property. Specifically, §1067(b) provides that the recapture rules for progress expenditures shall apply only to the percentage of the cost basis of a coal gasification facility which qualifies for the safe harbor leasing transition rule. This rule ensures that investment credit recapture for progress expenditures will occur only with respect to the interest in a coal gasification facility which is the subject of a safe harbor lease and not with respect to the portion which is retained by the lessee.

IV. Section 280F: Limitations on Tax Benefits for Luxury Automobiles and Other Listed Property

Section 179 of the 1984 Tax Reform Act, enacted Code §280F which limits the ACRS and depreciation deductions which may be claimed with respect to a passenger automobile in any one year to $4,000 in the first year of service and $6,000 in any year thereafter until the cost of the automobile is recovered. The section also limits the investment tax credit that may be taken on any passenger automobile to $1,000. These limitations are applied before any reduction to the ITC or ACRS or depreciation deductions for nonbusiness use of the automobile. In addition, a taxpayer may not use ACRS or take the investment tax credit if the percentage of use in a trade or business fails to exceed 50 percent in any taxable year. Where ACRS is not available, the taxpayer must use the straight-line method over the automobile's earnings and profits life determined under the principles of §312(k)(3). *See* §280F(b)(4)(B). If the business use percentage initially exceeds 50 percent and thereafter declines to 50 percent or less, the investment tax credit and the excess of ACRS deductions over the amount which would have been deductible under the straight-line method over the automobile's earnings and profits life is recaptured in the year of the decline.

If the automobile's basis is not completely recovered at the end of the recovery period, §280F(a)(2)(B)(i) allows the taxpayer to treat the unrecovered amount as an expense in the first taxable year after the expiration of the recovery period to the extent of $6,000. Any further unrecovered basis may be treated as an expense in the next succeeding taxable year.

Under §280F(a)(4), if the taxpayer elects to take a reduced investment tax credit under §48(q)(4), the investment credit limit of §280F(a)(1) is reduced to two-thirds of the otherwise allowable amount.

Section 280F(c) provides special rules for the treatment of leased automobiles. Section 280F(d) provides rules for the coordination of §280F with §179.

The new limitation provisions are discussed in detail in Chapter 40.

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[1] §168(f)(8). All section references herein are to the Internal Revenue Code of 1954 as amended and the regulations promulgated thereunder unless otherwise specified. For a detailed analysis of the safe harbor and finance leasing rules, *see* 12 T.M., *Equipment Leasing*.

[2] The existence of either of these two conditions would be precluded under the traditional rules for characterizing leveraged leases set forth generally in Rev. Proc. 75-21, 1975-1 C.B. 715.

[3] §168(f)(8)(B)(ii).

[4] §168(i)(1).

[5] §168(i)(2).

[6] §168(i)(3).

[7] §168(i)(4)(B).

[8] TRA §12(a)(1) amends TEFRA §209(d)(1)(A), the general effective date provision relating to finance leasing. TEFRA §209 effectively repealed safe harbor leasing by replacing the safe harbor leasing rules of §168(f)(8) with a new §168(f)(8), which contained the finance leasing rules. Because a four-year deferral of the effective date of TEFRA §209 would also technically defer the repeal of safe harbor leasing by preventing post-TEFRA §168(f)(8) from becoming operative, TRA §12(b) provides that the safe harbor leasing rules of "old" §168(f)(8) shall not apply to agreements entered into after December 31, 1983.

[9] TRA §12(a)(1); §168(f)(8)(B)(ii)(I).

[10] TRA §12(a)(3)(B); §168(i)(4)(A)(i).

[11] TRA §12(a)(3)(B); §168(i)(4)(A)(ii).

[12] TRA §12(a)(2) amends TEFRA §209(d)(1)(B)(i), the general effective date provision relating to finance leasing of certain farm property. Farm property is defined in §168(i)(4)(B).

[13] TRA §12(c)(1).

[14] TRA §12(c)(2).

[15] TEFRA §208(d)(6).

[16] TRA §12(c)(2)(B).

[17] TRA §12(c)(2)(C).

[18] *See* Rev.Proc. 83-35, 1983-1 C.B. 745.

[19] TRA §12(c)(3).

[20] 692 F.2d 651 (9th Cir. 1982), rev'g 76 T.C. 547 (1981).

[21] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 865 (1984).

[22] *See Swift Dodge v. Comr.*, 692 F.2d 651 (9th Cir. 1982).

[23] The Ninth Circuit's decision in *Swift Dodge* reversed the Tax Court decision in favor of the taxpayer. *Swift Dodge v. Comr.*, 76 T.C. 547 (1981). For a discussion of the Tax Court decision, *see*, Mathison, "Swift Dodge v. Commissioner: Judicial Equivalent of the New Equipment Leasing Rules?" 1981-24 Tax Management Memorandum 3.

[24] §168(f)(13)(B)(ii).

[25] §168(f)(13)(B)(iii).

[26] §168(f)(13)(B)(iv).

[27] *See Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978).

[28] §168(f)(13)(A)(ii).

[29] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 802 (1984).

[30] Section 467 and §§1271-1275 are discussed in Chapters 21 and 22, respectively.

[31] P.L. 98-369, §1067(a).

[32] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1272 (1984).

[33] P.L. 98-369, §1067(a).

[34] Temp. Regs. §5c.168(f)(8)-5(c).

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CHAPTER 20

CHANGES AFFECTING TAX EXEMPT BONDS

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I. Mortgage Subsidy Bonds

A. Introduction

The Mortgage Subsidy Bond Tax Act of 1980 [1] enacted §103A to set forth rules restricting the issuance of tax-exempt bonds to finance mortgages on owner-occupied residences. Under §103A, a mortgage subsidy bond does not qualify for the tax exemption unless it is a "qualified mortgage bond" or a "qualified veterans' mortgage bond."

1. Qualified Mortgage Bonds

A qualified mortgage bond must meet various requirements. It must be issued to provide owner-financing with respect to single-family residences that can reasonably be expected to become the principal residences of their owners.[2] Under §103A(l)(10), dwelling units within a cooperative can also qualify for mortgages financed with the proceeds of a mortgage subsidy bond. In general, at least 90 percent of the lendable proceeds of a qualified mortgage bond must be used to finance the residences of individuals who had no present ownership interest in a principal residence within the preceding three years.[3] The proceeds of a qualified mortgage bond cannot be used to finance the acquisition of a residence whose cost exceeds 110 percent (120 percent in certain targeted areas) of the average purchase price within the area.[4] Further, at least 20 percent of the bond's lendable proceeds must be made available for financing in targeted areas for at least one year.[5]

Section 103A(g) places an annual cap on the amount of qualified mortgage bonds that can be issued within a state. The cap is equal to the greater of (i) nine percent of the average annual aggregate principal amount of mortgages executed during the preceding three calendar years for single-family, owner-occupied residences in the state, or (ii) $20,000,000.00. This cap is allocated 50 percent to the state housing agency and 50 percent to local issuers. Alternatively, the state may provide a different means of allocating the cap among local governmental units.

In general, a mortgage bond does not qualify unless the effective rate of interest on mortgages provided under the issue does not exceed the yield on the bonds by more than 1.125 percentage points.[6] Also, a mortgage subsidy bond does not qualify unless its proceeds are used to provide new mortgages, rather than to replace existing mortgages.[7]

Although the Tax Equity and Fiscal Responsibility Act of 1982 [8] imposed reporting requirements for certain private activity, tax-exempt bonds, no reporting requirements exist for qualified mortgage subsidy bonds.

The authority to issue qualified mortgage bonds terminated on December 31, 1983.

2. Qualified Veterans' Mortgage Bonds

Qualified veterans' mortgage bonds are subject to far fewer restrictions than qualified mortgage bonds. A qualified veterans' mortgage bond is a general obligation bond (*i.e.*, payment of principal and interest guaranteed by a state) that is issued as part of an issue substantially all of the proceeds of which are to be used to provide residences for veterans. The proceeds of such bonds must be used to provide new mortgages. In contrast to qualified mortgage bonds, no ceiling is placed on the amount of qualified veterans mortgage bonds that can be issued. Moreover, the authority to issue such bonds did not expire on December 31, 1983.

B. Outline of New Provisions

The TRA 1984 extends the authority to issue qualified mortgage bonds for four years to December 31, 1987. It also imposes information reporting requirements on issuers of qualified mortgage bonds and qualified veterans' mortgage bonds. Under the TRA 1984, a state official must certify that the ceiling requirement on qualified mortgage bonds has not been exceeded. In addition, an annual policy statement must be supplied setting forth the housing, development, and income distribution policies that each governmental issuer will follow in issuing qualified mortgage bonds.

New requirements are placed on qualified veterans' mortgage bonds. These new requirements include placing a limitation on the annual volume of qualified veterans' mortgage bonds equal to the average annual volume of such bonds issued for the period 1979 through 1983. The TRA 1984 further restricts the authority to issue qualified veterans' mortgage bonds to programs that issued such bonds before June 22, 1984. The TRA 1984 also restricts the categories of veterans who can qualify for mortgages issued with the proceeds of such bonds to veterans who served on active duty before 1977 and who apply for such mortgages no later than (i) January 31, 1985, or (ii) 30 years after the date of discharge from service.

The TRA 1984 provides a new form of subsidy, mortgage credit certificates, that states may issue in lieu of issuing qualified mortgage bonds. A recipient of a mortgage credit certificate issued by a state or locality is entitled to a nonrefundable income tax credit equal to a percentage (specified by the state or local issuer) of the

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interest the recipient will pay during the taxable year on the mortgage used to acquire a principal residence. The percentage specified by the state must be at least 10 percent but no more than 50 percent of the interest on the qualifying indebtedness. The credit reduces the recipient's deduction for mortgage interest on a dollar-for-dollar basis, and excess unused credits may be carried forward by the recipient for three taxable years. In general, for each dollar of credit that can be issued under a mortgage credit certificate, a state must reduce its volume cap for the issuance of qualified mortgage subsidy bonds by five dollars.

C. *Effective Dates*

The extension of the authority to issue qualified mortgage bonds applies with respect to obligations issued after December 31, 1983, and the new reporting, certification, and policy statement requirements apply with respect to obligations issued after December 31, 1984. The new restrictions on qualified veterans' mortgage bonds generally apply to such bonds issued after July 18, 1984.

The election to exchange authority to issue qualified mortgage bonds for authority to issue mortgage credit certificates applies to elections made for calendar years after 1983. However, the credit is available only for interest paid or accrued after December 31, 1984, on indebtedness accrued after December 31, 1984.

D. *Detailed Analysis*

1. *Qualified Mortgage Bond Extension*

The TRA of 1984 [9] extends the authority to issue qualified mortgage bonds, set forth in §103A(c)(1)(B), to December 31, 1987. The reason for this extension is Congress's recognition that first-time home buyers continue to have problems purchasing a home because of high interest rates, and that mortgage subsidy bonds can make an important contribution to making housing more affordable to low and middle-income individuals.[10] The rationale for extending the program for only four years is to permit Congress to reevaluate the qualified mortgage bond program as conditions change.[11]

2. *New Reporting and Certification Requirements*

In order to obtain information which Congress will use to evaluate the mortgage subsidy bond program in the future, the TRA 1984 [12] institutes new reporting, certification, and policy statement requirements with respect to mortgage bonds. Act §611(b)(1) amended §103A(j) by adding new paragraphs (3) to (5). Section 103A(j)(3) sets forth the new information reporting requirements that must be met for all mortgage subsidy bonds—qualified veterans' mortgage bonds as well as qualified mortgage bonds.[13] Under §103A(j)(3)(A), an issuer must submit to the Treasury Secretary a statement containing:

(i) The name and the address of the issuer;

(ii) The issue date, the amount of lendable proceeds, and the stated interest rate, term, and face amount of each obligation that is part of the issue;

(iii) Such information as may be required in order to determine whether the issue meets the requirements of §103A and the extent to which the issue proceeds have been made available to low-income individuals; and

(iv) Such other information as may be required.

The statement must be supplied to the Secretary no later than the 15th day of the second calendar month after the close of the calendar quarter in which the bonds are issued. For example, if a municipality issues mortgage subsidy bonds in February of 1985, the report on the issue is due no later than May 15, 1985. Under §103A(j)(3)(B), the Secretary may grant an extension of time for filing the information statement for reasonable cause.

Section 103A(j)(4) requires, in the case of qualified mortgage bonds, that a designated state official (or the governor if no state official is designated by law) to certify that the requirements of §103A(g) (relating to the annual cap on the aggregate amount of qualified mortgage bonds) have been met by a particular issue before the issuance of that issue.[14] This certification must be submitted to the Secretary at the same time that the information report with respect to the issue is submitted.

In addition to the information and certification requirements described above, new §103A(j)(5) requires the publication of an annual policy statement by issuers of qualified mortgage bonds. This statement must set forth:

(i) The housing, development, and income distribution policies that the issuer will follow in issuing mortgage subsidy bonds and the new mortgage credit certificates (discussed below), and

(ii) An assessment of the issuer's compliance during the one-year period preceding the date of the statement with the prior year's policy statement (if one was published) and with Congress's intent that such bonds and credits be made available, to the greatest extent feasible, to lower-income families.

The annual policy statement must be published only after a public hearing has been held for which reasonable public notice has been given and must be issued by the end of the calendar year, with a copy furnished to the Treasury. An elected official must sign the report. According to the Conference Report,[15] in the case of multiple jurisdiction issuers, the annual report requirement will be met if the issuer files a single report with the Treasury that is signed by either an elected official of each governmental unit on whose behalf bonds have been issued or the state governor.

Note: The reporting, certification, and annual policy statement requirements are effective with respect to obligations issued after December 31, 1984. However, under §103A(j)(5), a mortgage subsidy bond will not be qualified unless the policy statement has been published in the year preceding the year the bonds are issued. Thus, an issuer desiring to issue qualified mortgage bonds in 1985 must publish a policy statement no later than December 31, 1984.

3. *New Requirement for Qualified Veterans' Mortgage Bonds*

The TRA 1984 [16] institutes several new limitations on the issuance of qualified veterans' mortgage bonds, effective generally for obligations issued after July 18, 1984. In order to qualify, a veterans bond must now meet the requirement of §103A(d), which requires that a residence financed through the proceeds of a mortgage bond be a

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single family residence [17] that can reasonably be expected to become the veteran's principal residence.

Three additional new requirements are set forth in §103A(o). First, a veterans' bond will qualify only if each veteran to whom financing is provided under the issue is a "qualified veteran." A "qualified veteran" is defined as a veteran who (i) served on active duty at some time before January 1, 1977, and (ii) applies for a mortgage before the later of the date 30 years after the last date on which such veteran left active service or January 1, 1985.[18] Second, a state may not issue qualified veterans' mortgage bonds unless the state issued such bonds before June 22, 1984.[19] Lastly, §103A(o)(3) places a volume cap on the issuance of qualified veterans' mortgage bonds. This cap is equal to the average annual aggregate amount of qualified veterans' bonds issued by the state during the period from January 1, 1979, through June 22, 1984. However, in calculating this average, the lowest amount of any qualified veterans' bonds issued by a state for one of those calendar years (or portion thereof) during this 1979 through 1984 period is excluded.

Observation: If a state has issued veterans' bonds for only one year during this period, the state's volume cap is zero because that year is technically excluded from the average since it is the year in which the lowest amount of qualified veterans' bonds was issued. This result is presumably not intended because the rule excluding the lowest year in the average would appear to be designed to bolster that average. Here, the exclusion of the only year obviously does not produce such a result.

The volume cap applies to obligations issued after June 22, 1984, and in applying the volume cap after such date, obligations issued on or before that date are not to be taken into account.[20] Also, the volume cap will not apply to any qualified veterans' mortgage funds whose issuance was authorized by state referendum before November 18, 1983, or whose issuance is authorized pursuant to a state referendum before December 1, 1983, where such referendum was authorized by the state legislature before October 18, 1983.[21] It should also be noted that, in the case of any short-term obligation having a term of one year or less and issued to provide financing for property taxes, the amount taken into account in computing the volume cap with respect to such obligations shall be 1/15th of its principal amount.[22]

4. Miscellaneous Changes to Qualified Mortgage Bonds

The TRA 1984 [23] provides certain state governors with the interim authority to continue allocating the state volume cap set by §103A(g) in accordance with the state allocation formula even though the state law authorizing the allocation formula expired as of the close of calendar year 1983. The TRA 1984 [24] also deletes most of the special exceptions to the requirements of §103A that were set out in the Mortgage Subsidy Bond Tax Act of 1980, Act §1104.

5. Mortgage Credit Certificates

a. General

Apart from the extension of qualified mortgage bonds, the most significant TRA 1984 change affecting qualified mortgage bonds is the enactment of the mortgage credit certificate program.[25] In order to institute a mortgage credit certificate program, a state or local issuer must agree to relinquish all or a portion of the annual amount of qualified mortgage bonds that it is entitled to issue under its §103A(g) volume ceiling. In general, for each dollar of credit issued under a mortgage credit certificate, an issuer must reduce its §103A(g) volume cap by five dollars.[26]

The rationale for the institution of mortgage credit certificates stems from Congress's recognition of the relative inefficiency of qualified mortgage bonds as a means of providing a subsidy to first-time home buyers. Under a qualified mortgage bond, the subsidy is split between the first-time home buyer, on the one hand, and tax-exempt investors and middlemen, on the other. Further, Congress noted the difficulty of targeting the subsidy provided by mortgage bonds to those most in need of housing assistance. Accordingly, Congress reasoned that a mortgage certificate credit program would permit all of the subsidy in the form of credits to flow directly to first-time home buyers, thereby providing the same or a larger subsidy at a lower revenue cost. In addition, Congress believed that issuers could achieve greater flexibility in targeting the subsidy to eligible individuals due to the ability to vary the amount of individual credits.[27]

Although Congress in §103A(j)(5) expressed an intent that mortgage credit certificates, as well as qualified mortgage bonds, be targeted first to lower income individuals, there is no binding requirement that such targeting occur. This represents a change from the Senate bill under which an annual income limitation would have been imposed on the utilization of the credit. In addition, the Senate bill would have limited the purchase price of residences eligible for mortgage credit certificates to 90 percent of the average area purchase price. The bill as finally adopted contains no income limitation for recipients of mortgage credit certificates, although the Conference Committee, in limiting the maximum credit a taxpayer may receive to the greater of (i) 20 percent of a qualifying indebtedness on the taxpayer's principal residence, or (ii) $2,000, stated that this limitation is intended to encourage issuers to issue higher percentage credits to individuals who purchase lower-priced residences and who can therefore benefit from a higher percentage credit despite the $2,000 limitation.[28] Also, the final bill eliminated the 90 percent of average purchase price requirement, adopting the general 110 percent of average area purchase price limitation applicable to qualified mortgage bonds.

b. Definition of Mortgage Credit Certificate

Section 25(c)(1) provides that a "mortgage credit certificate" is any certificate that is:

> (i) Issued under a qualified mortgage credit certificate program by a state or local issuer having the authority to issue a qualified mortgage bond, and
>
> (ii) Issued to the taxpayer in connection with the acquisition, qualified rehabilitation, or qualified home improvement of the taxpayer's principle residence.[29]

In addition, a mortgage credit certificate must be in the form that the Secretary prescribes and must specify: (i) the credit certificate rate, which is a percentage ranging from

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no less than 10 percent to no more than 50 percent,[30] and (ii) the certified indebtedness amount.[31]

Under §25(e)(3), a mortgage credit certificate is treated as in effect with respect to interest attributable to the period beginning on the date the certificate is issued, and ending on the earlier of the date on which (i) the certificate is revoked by the issuer or (ii) the residence to which such certificate relates ceases to be the principal residence of the individual to whom the certificate relates. If an issuer revokes a certificate, it must notify the Secretary of the revocation at such time and in such manner as prescribed in regulations.

Under §25(e)(3)(B), a mortgage credit certificate becomes invalid unless the indebtedness to which the certificate relates is incurred no later than the close of the second calendar year following the calendar year for which the issuer elects to reduce its volume cap on qualified mortgage bonds. For example, if an issuer elects to forego a portion of the qualified mortgage bonds it is otherwise entitled to issue for 1984 in exchange for the right to issue mortgage credit certificates, those mortgage credit certificates and the indebtedness to which they relate must be in effect no later than the end of 1986.

Under §25(e)(4), regulations may be prescribed allowing an administrator of a mortgage credit certificate program to reissue a mortgage credit certificate to replace a mortgage credit certificate previously issued to a taxpayer. Any certificate reissued pursuant to such regulations cannot provide a credit that would be greater than the credit allowable with respect to the original certificate for any taxable year ending after the reissuance of the certificate.

A mortgage credit certificate cannot be issued unless the issuer provides reasonable public notice of the eligibility requirements for such certificate, the methods by which such certificates are to be issued, and such other information as may be required.[32] Such public notice must be provided at least 90 days before issuance of the certificate.

c. Qualified Mortgage Credit Certificate Program

A qualified mortgage credit certificate program is any program established by a state or locality for any calendar year for which it is authorized to issue qualified mortgage bonds.[33] Under this program, the issuer must elect to forego issuance of an amount of qualified mortgage bonds that it is otherwise entitled to issue during the calendar year under §103A. Moreover, under the program, indebtedness certified by mortgage credit certificates must meet certain of the requirements applied to mortgage subsidy bonds under §103A, and the mortgage certificate credit program must meet certain additional requirements specified in §25(c)(2)(A).

(1) Election To Surrender Qualified Mortgage Bond Amounts

In order for a mortgage credit certificate program to be qualified, the issuer must elect not to issue an amount of qualified mortgage bonds that it is otherwise entitled to issue during the calendar year for which the program is to be in effect.[34] Although there is no restriction on the amount of qualified mortgage bonds an issuer can elect to surrender—the issuer can elect to forego issuance of all or a portion of the amount it is otherwise entitled to issue pursuant to the volume cap set forth in §103A(g)—this election will effectively set a limit on the amount of credits the issuer can offer under a qualified mortgage credit certificate program. Under §25(d)(2), the general mortgage credit limit is equal to 20 percent of the non-issued bond amount; *i.e.*, the amount of qualified mortgage bonds the issuer elects not to issue. For example, if the total volume of qualified mortgage bonds allocated to an issuer under §103A(g) is $100,000,000, and the issuer elects to forego issuance of this entire amount, the issuer can issue mortgage credit certificates providing total credits in the amount of $20,000,000. This credit amount can be allocated among the certificates issued by the issuer in any manner the issuer selects, so long as the certificate credit rates specified in any mortgage credit certificate is not less than 10 percent or more than 50 percent.

Example: Assume that an issuer elects to forego issuance of $100,000,000 in qualified mortgage bonds so that the total credits that can be offered through mortgage credit certificates is $20,000,000. The issuer may elect to issue mortgage credit certificates covering a total of $100,000,000 in indebtedness and specifying a credit rate of 20 percent. Alternatively, the issuer may issue mortgage credit certificates in the amount of $50,000,000 specifying a 10 percent rate, mortgage credit certificates covering $50,000,000 of mortgage indebtedness specifying a 20 percent rate, and mortgage credit certificates in the amount of $10,000,000 specifying a 50 percent rate.[35] Under either of these alternatives, the total credits offered equal $20,000,000. Of course, other combinations of mortgage credit certificates can be offered under the set of assumptions in this example so long as the total credits provided do not exceed $20,000,000.

Note: If a taxpayer is issued a mortgage credit certificate specifying a credit rate in excess of 20 percent, that taxpayer is limited under §25(a)(2)(A) to a maximum credit of $2,000 for any taxable year. This $2,000 limitation should be kept in mind by an issuer in issuing mortgage credit certificates in excess of 20 percent.

Section 25(d)(3) imposes an additional limit on the credit rate provided by certain issuers who have not fully utilized their qualified mortgage bond ceilings under §103A(g)(4) in prior years. Issuers subject to this additional limit may not issue any mortgage credit certificates with a certificate credit rate in excess of 20 percent unless the issuer submits a plan to the Secretary that insures the weighted average of the certificate credit rates in such mortgage credit certificate program does not exceed 20 percent and the Secretary approves this plan. An issuer is subject to this 20 percent credit rate limit if:

(i) The §103A(g)(4) volume cap for the year the election is made exceeds 20 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding three calendar years for single family owner-occupied residences located within that state, or

(ii) The qualified mortgage bonds issued within the state for calendar year 1983 was less then $150,000,000.

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If the total credits offered under mortgage credit certificates exceeds the 20 percent of the non-issued bond amount limit set forth in §25(d)(2), none of the mortgage credit certificates issued that year are disqualified. However, the §103A(g)(4) volume cap for the calendar year following the calendar year in which the Secretary determines the "correction amount" with respect to such excess shall be reduced by 1.25 times that correction amount.[36] The "correction amount" is simply the amount of credits in excess of the amount permitted under §25(d)(2) multiplied by five. Thus, if an issuer within a state issued $5,000,000 of excess credits under its mortgage credit certificate program, the correction amount is equal to $25,000,000 which is applied to reduce the state's ceiling for the calendar year following the calendar year in which that correction amount was determined.

Query: Presumably, the correction amount cannot be determined until the year subsequent to the year for which the excess credits were issued. If the excess credits arise in 1986, and the correction amount is determined in year 1987, the state's ceiling is reduced for 1988. However, as discussed above, the qualified mortgage bond program will terminate at the end of 1987 unless Congress approves another extension. What compensating adjustment or penalty, if any, would be imposed in such circumstances if qualified mortgage bonds were not extended is open to question.

Although the reduction in the qualified mortgage bond amount is generally allocated to the overall state ceiling, §25(f)(3) provides a special rule for states having constitutional home rule cities. If a state has one or more "constitutional home rule cities" within the meaning of §103A(g)(5)(C), the reduction in the state ceiling must be entirely allocated to the constitutional home rule city if it is the cause of the reduction; the reduction should be entirely allocated to the rest of the state if the state, and not the city, was at fault.

Section 25(f)(4) provides an exception to the reduction requirement if there is a certification program in effect designed to ensure that the requirements of §25 are satisfied and the program meets such other requirements as may be prescribed in regulations. Also, the Secretary may waive the reduction if it is determined that the issuance of the excess credits is due to reasonable cause.[37]

(2) Section 103A Requirements

Under a qualified mortgage credit certificate program, the indebtedness certified by mortgage credit certificates must meet the following requirements in §103A:

(i) The principal residence requirements of §103A(d);

(ii) The §103A(e) requirement that a recipient of a certificate not have had a present ownership interest in a principal residence at any time during the preceding three years;

(iii) The 110 percent (120 percent in targeted areas) purchase price limitation of §103A(f);

(iv) The §103A(h) requirement providing that at least 20 percent of the loans issued under the program be made available for at least one year to targeted areas; and

(v) The §103A(j)(1) requirement that mortgages provided under the program generally be new mortgages.

In applying the three-year requirement of §103A(e) to mortgage credit certificates, each qualified mortgage certificate program is treated as a separate issue and the proceeds of the issue are determined by multiplying the certified indebtedness amount of each mortgage credit certificate by the credit certificate rate specified in the certificate. Further, 100 percent of the proceeds of the issue, as determined under the preceding sentence, must be used to provide financing to individuals who have not owned a principal residence within the preceding three years, unless the issuer submits a plan to the Secretary for administering the customary 90 percent requirement of §103A(e)(1) that satisfies the Secretary that the 90 percent requirement will in fact be met.[38]

In applying the requirement of §103A(h), relating to the 20 percent portion of loans that must be placed in targeted areas for at least a year, each qualified mortgage certificate credit program is treated as a separate issue and the proceeds of each issue is determined by multiplying the certified indebtedness amount of each mortgage credit certificate by the credit certificate rate.[39]

(3) Additional Requirements

Four additional requirements apply to a qualified mortgage credit certificate program under §25(c)(2). First, the program must provide that no mortgage credit certificate may be issued with respect to any residence financed with the proceeds of a qualified mortgage bond or a qualified veteran's mortgage bond. Second, except to the extent provided in regulations, the program may not limit mortgage credit certificates to indebtedness incurred from particular lenders. Third, the program must provide that mortgage credit certificates are not transferable except to the extent permitted in regulations. Finally, if an issuer allocates a block of mortgage credit certificates to be used in connection with a particular development, the developer must be required to furnish the issuer and the home buyer with a certificate that the residence's price is no higher than the price would be without the use of a mortgage credit certificate.

Comment: The Conference Report [40] states that mortgage credit certificates are not assumable and provides no guidance or illustrations as to circumstances in which regulations may permit the transfer of such certificates. Presumably the regulations will authorize transfer, if at all, only in limited situations. Perhaps the regulations will permit transfer in connection with the transfer of a residence upon divorce or separation; another possibility is to permit transfer when one joint owner of a residence acquires the interest of another joint owner. Presumably the regulations will not allow any transfer upon a sale of the residence to a third party.

(4) Denial of Certification Where Certain Requirements Are Not Met

The credit is not available under a mortgage credit certificate if any of the following requirements are not met

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with respect to the indebtedness certified under the certificate:

(i) The §103A(d)(1) principal residence requirement;

(ii) The §103A(e) three-year requirement;

(iii) The 110 percent (120 percent in targeted areas) purchase price requirement of §103A(f);

(iv) The new mortgage requirement of §103A(j) as well as the other requirements set forth in that subsection;

(v) The requirement that a mortgage credit certificate not be issued for any residence that is also financed through a qualified mortgage bond or qualified veteran's mortgage bond;

(vi) The requirement that a mortgage credit certificate not be limited to indebtedness incurred from particular lenders; and

(vii) The requirement that a developer allocated a block of mortgage credit certificates furnish a certificate with respect to purchase price.

However, except to the extent provided in regulations, the foregoing requirements will be treated as met if there is a certification, under penalty of perjury, that such requirements are met.[41]

d. Computation and Carryover of Credit

The taxpayer, who receives a mortgage credit certificate, is allowed a credit in the amount of the certificate credit rate multiplied by the interest paid or incurred by the taxpayer during the taxable year on the remaining principal of the indebtedness certified under the mortgage credit certificate. Thus, for example, if the credit rate is 20 percent and the remaining certified principal balance is equal to $50,000, the taxpayer's credit for the year is equal to $10,000.[42] However, if the certificate credit rate exceeds 20 percent, the credit allowed to a taxpayer may not exceed $2,000 for any taxable year.[43] If two or more persons hold interests in any residence, the $2,000 limit will be allocated among such persons in proportion with their respective interests in the residence.[44]

The mortgage credit under §25 is a nonrefundable credit that is grouped with the other nonrefundable personal credits under the new credit ordering rules enacted by the TRA 1984.[45] However, if a mortgage credit under §25 exceeds the "applicable tax limit," the excess is available for carryover to each of the three succeeding taxable years.[46] The "applicable tax limit" is defined by §25(e)(1)(C) as the tax liability limitation imposed by §26(a) for the taxable year reduced by all other nonrefundable personal credits set forth in Subpart A. Thus, the §25 credit is taken into account against tax liability only after the following Subpart A credits: the household and dependent care credit, the credit for elderly and permanently disabled individuals, the political contribution credit, and the residential energy credit. The excess of any §25 mortgage credit over tax liability as reduced by these other nonrefundable personal credits is, as previously mentioned, available as a carryover for three years. Any unused credit that is carried over is added to any credit allowable for the succeeding year under §25(a) and is subject to the tax liability limit for such succeeding taxable year.

Section 25(e)(1)(B) effectively provides that if mortgage credits are carried over from two or more unused credit years, the credits from the earlier years are taken into account first under the tax liability limit. It is not clear, however, whether a credit attributable to the current year is taken into account before or after any credits that have been carried forward from prior unused credit years.[47]

Under new §163(g),[48] a taxpayer's mortgage interest deduction must be reduced by the full amount of any credit allowable under §25. A full reduction must take place even though all or a portion of the credit cannot be used because of the tax liability limit of §26.

Comment: One consideration that issuers should keep in mind when structuring a mortgage credit certificate program is that mortgage credit certificates may provide a subsidy that cannot be fully utilized, particularly by lower-income taxpayers. For example, assume that the median income for a family of four within the particular jurisdiction is $32,000 and "lower-income" is defined as 80 percent of this median amount [49] or $25,600. If such a family is issued a mortgage credit certificate on a $90,000 mortgage at a time when mortgage interest rates are at 14 percent, that family's first-year interest payment will be approximately $12,600 and provide a mortgage credit of approximately $2,520 (assuming a 20 percent certificate rate). Reducing the family's mortgage interest deduction by the amount of the credit will leave the family with an approximate $10,000 mortgage interest deduction. Assuming the family claims four personal exemptions, providing an additional $4,000 in deductions, and has approximately $1,000 in additional itemized deductions, the family's taxable income will be approximately $14,000 ($25,600 − $4,000 personal exemptions − $7,600 excess itemized deductions). The tax on $14,000 of taxable income, using the joint return schedule for 1984, is $1,421. The $2,500 of credits provided under the mortgage credit certificate far exceeds this sum. Assuming this family's income does not rise dramatically in the next few years, it is entirely likely that the credit carryover amount of almost $1,600 will never be utilized since significant credits should be generated in the succeeding three taxable years.

Observation: If a flat tax or modified flat tax is ever enacted which significantly reduces the top marginal rates, the relative value of the mortgage credit compared to the mortgage interest deduction will increase materially due to the diminished worth of the deduction. Of course, the enactment of a flat tax may lead to the repeal of the mortgage credit in order to make up revenues lost because of the marginal rate reduction.

e. Reporting and Administration Requirements

Section 25(g) requires any lender making a loan with respect to a certified indebtedness amount under a mortgage credit certificate to file a report containing the name, address, and social security number of the certificate recipient, the issuer of the certificate, the date of issue, certified indebtedness amount, and certificate credit rate; and any other information as may be required in the regulations. In addition, §25(g) requires any issuer of a mortgage credit

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certificate to file a report showing such information as may be required in regulations. Any report required under §25(g) shall be filed at such time and in such manner as the regulations may require.

Section 25(i) provides that the Secretary shall issue such regulations as may be necessary to carry out the purposes of §25. These regulations may require recipients of certificates to pay a reasonable processing fee to defray the administration expenses of the mortgage certificate credit program. Section 25(i)(2) further authorizes the Secretary to enter into contracts with any person to provide services in connection with the administration of the mortgage credit certificate program.

New §6708 [50] provides for the imposition of civil penalties for providing false statements where a verified written statement must be made under penalty of perjury with respect to the issuance of the mortgage credit certificate. If such a false statement is due to negligence, the penalty is $1,000 for each mortgage credit certificate with respect to which such a false statement was made. If the false statement is due to fraud, the civil penalty is $10,000 for each mortgage credit certificate in addition to any criminal penalty that may be imposed. The failure of a lender or an issuer to provide the report required by §25(g) will result in a $200 penalty unless it is shown that such failure is due to reasonable cause and not to willful neglect.

Note: The Conference Report [51] states that if a recipient of mortgage credit certificate provides fraudulent information to a lender, it is intended that the recipient's tax return will be treated as a false return and the mortgage credit certificate revoked. However, the government will have the burden of proving the fraud.

f. Termination and Effective Dates

The §25 credit is available with respect to interest paid or accrued after December 31, 1984, on indebtedness incurred after December 31, 1984. However, an election to relinquish authority to issue qualified mortgage bonds in order to issue mortgage credit certificates may be made for calendar years after 1983.

Under §25(h), the election to issue mortgage credit certificates in lieu of qualified mortgage bonds terminates for calendar years after 1987. This is when the qualified mortgage bond program is due to expire.

II. New Limitations on Private Activity Bonds and Federally Guaranteed Bonds

A. Introduction

1. In General

Under §103(a), interest on an obligation of a state, local government, U.S. possession, or the District of Columbia, or interest on qualified scholarship funding bonds,[52] is exempt from Federal income tax. Student or local governmental bonds do not qualify for a tax-exemption, however, if they are either (i) industrial development bonds, or (ii) arbitrage bonds. State and local governmental bonds are tax exempt even though a direct or indirect Federal guarantee may exist with respect to the bonds.[53]

No ceiling generally exists on the issuance of bonds by state or local governments. However, as previously described in I, *supra,* an annual volume cap is placed on the issuance of qualified mortgage bonds.

Under existing law, tax-exempt bonds may be issued to finance loans for non-business purposes, such as student loans, and will not be subject to the restrictions on industrial development bonds because of the non-business nature of the loans. The arbitrage rules will apply to such bonds, however.

2. Industrial Development Bonds (IDBs)

a. Definition

Section 103(b)(2) defines an IDB as any obligation meeting the following two criteria:

> (i) the obligation is part of an issue all or a major portion of the proceeds of which will be used directly or indirectly in any trade or business carried on by any person other than an exempt person, that is, a governmental unit or a tax-exempt organization described in §501(c)(3);[54]

(ii) the payment of principal or interest on the obligation is secured by an interest in, or will be derived from payments with respect to, property or borrowed money used or to be used in a trade or business.

b. Exceptions

Even though an obligation is an IDB, interest on the IDB will be tax exempt if it meets any of the exceptions provided in §103(b)(4), (5), or (6).

Section 103(b)(4) lists ten categories of bonds that are tax exempt as follows:

> (i) projects for low-income residential rental property;
>
> (ii) sports facilities;
>
> (iii) convention or trade show facilities;
>
> (iv) airports, docks, wharves, mass commuting facilities, and parking facilities;
>
> (v) sewage and solid waste disposal facilities, and facilities for local furnishing of electricity or gas;
>
> (vi) air or water pollution control facilities;
>
> (vii) certain facilities for the furnishing of water;
>
> (viii) qualified hydroelectric generator facilities;
>
> (ix) qualified mass commuting vehicles, or
>
> (x) local district heating or cooling facilities.

Section 103(b)(5) provides an exemption for IDBs that are part of an issue substantially all of the proceeds of which are to be used for the acquisition or development of land as a site for an industrial park. For purposes of this provision, land development includes the furnishing of water, sewage, drainage, or similar facilities, or the furnishing of transportation, power, or communication facilities incidental to the use of the site as an industrial park. Land development does not include, except with respect to incidental facilities, the furnishing of structures or buildings.

Section 103(b)(6) is referred to as the "small issue exemption" (or "exception"). It applies to an obligation issued as part of an issue the aggregate face amount of

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which is $1,000,000 or less and substantially all of the proceeds of which will be used (i) for the acquisition, construction, reconstruction, or improvement of land or depreciable property, or (ii) to redeem part or all of a prior small issue. Certain prior issues must be taken into account in determining the "aggregate authorized face amount."[55] Under §103(b)(6)(D), the $1,000,000 maximum permissible amount is raised to $10,000,000, at the election of the issuer. If this election is made, however, the aggregate face amount includes certain related capital expenditures incurred by the principal user of the facility to be financed with the proceeds of the exempt small issue incurred by the principal user during the six-year period beginning three years before the date of issue and ending three years after the date of issue.

The $10,000,000 amount in §103(b)(6)(D) may be increased by up to $10,000,000 of additional capital expenditures if substantially all of the proceeds of the issue are to be used to provide facilities with respect to which an urban development action grant (UDAG) has been made under section 119 of the Housing and Community Development Act of 1974.[56]

Neither the Code nor the regulations define what is meant by a "principal user" for purposes of the §103(b)(6)(D) small issue exemption. However, for letter ruling purposes, the Service has adopted the position that a more than 10-percent user of the facility is a principal user.[57] However, the Service has also ruled that if state law recognizes separate property interests in the same building or same project, such as a condominium or shopping center, the $1,000,000 (or $10,000,000) small issue exemption may be applied with respect to each separate interest.[58] Also, under present law there is no overall limitation on the total amount of small issue obligations that may be used to finance facilities for the benefit of a particular nonexempt person.

A small issue is not exempt if (i) more than 25 percent of the proceeds of the issue are used to provide a facility whose primary purpose is retail food and beverage services, automobile sales or service, or the provision of recreation or entertainment, or (ii) any portion of the proceeds of the issue is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub facility, suntan facility, or race track.[59]

As a result of amendments made by the Tax Equity Fiscal Responsibility Act of 1982 (TEFRA), the small issue exemption will terminate after December 31, 1986.[60]

Although advance refunding obligations generally are not eligible for tax-exemption, §103(b)(7) provides that advance refundings of IDBs to finance convention or trade show facilities, or airports, docks, wharves, mass commuting facilities, or parking facilities qualify for tax-exemption if the facilities financed are generally available to the general public.[61]

c. Substantial Users

An IDB described in §103(b)(4), (5), (6), or (7) will not be exempt for any period during which it is held by a substantial user of the facilities financed with the proceeds of the obligation or by a person related to the substantial user.[62] Related person status is determined under the rules of §267 or §707(b), or §1563(a), although "more than 50 percent" is substituted for "at least 80 percent" each place it appears within §1563(a).[63]

3. Arbitrage Bonds

Section 103(c), as implemented by Regs. §§1.103-13, 14, and 15, treats as taxable the interest on any state or local obligation or qualified scholarship funding bond if the obligation constitutes an arbitrage bond. An arbitrage bond is any obligation issued as part of an issue all or a major portion of the proceeds of which are reasonablly expected to be used directly or indirectly to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations, or to replace funds that were used directly or indirectly to acquire taxable obligations producing a materially higher yield.[64] Under the regulations, the maximum income permitted to be earned generally cannot exceed the interest rate paid on the obligations by more than 0.125 percentage point. However, investments for a temporary period until the bond proceeds are needed for the purposes for which they were issued are not subject to this restriction. Nor are investments on funds constituting reasonably required reserves.[65] If the issuer elects not to have unlimited earnings during the temporary period, the yield limit is raised from 0.125 percentage point to 0.5 percent point over the interest rate paid on the bonds.

In general, in determining whether an obligation is an arbitrage bond, reasonable administrative costs, such as issuance costs and the underwriter's discount, are excluded.

Additional arbitrage rules are applied to qualified mortgage bonds.[66] Under these rules, only 1.125 percentage points of arbitrage may be earned on the mortgages acquired with bond proceeds. This 1.125 percentage point arbitrage profit must, however, include administrative costs and underwriter's discount. In addition, subject to temporary period exceptions, all qualified mortgage bond proceeds other than proceeds invested in debt service reserves not exceeding 150 percent of the bonds' debt service must be invested in mortgages. Any arbitrage profit earned on nonmortgage investments must be paid either to the mortgagers or the Federal government.

4. Tax-Exemptions Outside the Internal Revenue Code

In addition to the exemption provided by §103 and §103A, certain other provisions of Federal law allow for the issuance of specified types of tax-exempt obligations. The chief of these is perhaps the special tax-exemption provided for obligations issued by state or local housing agencies in connection with low-income housing projects, authorized by section 11(b) of the Housing Act of 1937.[67] Special exemptions are also provided for certain District of Columbia bonds and possessions bonds (Puerto Rico, Virgin Islands, and Guam).[68] In general, these special categories of tax-exempt bonds are not subject to the restrictions set forth in §§103 or 103A.[69]

B. Outline of New Restrictions

In TEFRA,[70] Congress enacted various new restrictions on private activity bonds, including new information reporting requirements, public notice and approval requirements,

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cutbacks on ACRS benefits for IDB-financed property, limitations on the maturity of IDBs, and limitations affecting the small issue exemption, all designed to eliminate abuse of the tax-exempt bond provisions and to cut revenue losses.[71] However, despite the TEFRA limitations, Congress continued to be "extremely concerned" by the increasing volume of private activity tax-exempt bonds, observing that the volume of such bonds had increased from $6.2 billion in 1976 to $34.0 billion in 1982.[72] The continued revenue loss, projected at $8.5 billion for 1985, and the upward pressure generated by private activity bonds on tax-exempt rates which would make it more costly to finance traditional public works, such as schools, roads, and public projects, were matters of concern.[73] In addition, the availability of tax-exempt financing for certain types of facilities was believed to affect investment decisions independent of the economic value of the facilities.[74] Finally, Congress was concerned about the existence of Federal guarantees for tax-exempt financing which was viewed as effectively providing a double subsidy for certain activities since the federal guarantees made such bonds more attractive.[75]

Accordingly, in the TRA, Congress has enacted various new restrictions in response to these perceived problems. First, provisions have been enacted to deny a tax-exemption for interest on bonds that are Federally guaranteed, but with exceptions provided for certain housing agency and small business association guarantees. A bond is considered to be Federally guaranteed if (i) payment of principal or interest is guaranteed directly or indirectly by the U.S. or instrumentality or agency thereof, (ii) a significant portion of the bond proceeds is to be used to make Federally guaranteed loans, or (iii) a significant portion of the proceeds is to be invested in Federally insured deposits.

Second, an annual statewide volume cap is enacted limiting private activity bonds (including IDBs and student loan bonds) issued by state and local issuers to the greater of (i) $150 per capita, or (ii) $200,000,000. This cap is to be allocated 50 percent to the state and 50 percent to local jurisdictions unless the state provides a different allocation. The annual cap is phased in over two years for states that issued private activity bonds in excess of the $150 per capita in 1983. Unused portions of the cap may be carried over for up to three years for specified projects. The principal category of bonds excepted from the volume cap are housing bonds issued under §103(b)(4)(A) and under section 11(b) of the 1937 Housing Act.

Third, the TRA imposes a special arbitrage limitation on IDBs comparable to the limitation presently existing for qualified mortgage bonds under §103A(i).

Fourth, the use of IDBs to acquire land or existing facilities is sharply curtailed. IDBs may not be used to finance the acquisition of farmland (and facilities located on such land) except for acquisitions by first-time farmers in an amount not exceeding $250,000. No more than 25 percent of the proceeds of an IDB issue may be used to acquire any nonagricultural land. Existing facilities may no longer be financed with IDB proceeds unless an amount equal to at least 50 percent of the cost of the building and building equipment will be spent for rehabilitating the building and the equipment. In addition, IDBs may no longer be used to finance acquisition of any airplane, skybox, gambling facility, liquor store, or health facility.

Fifth, the TRA repeals the §103(b)(7) exception for the issuance of IDBs for the advance refunding of qualified public facilities.

Sixth, the determination of whether a person is related to a substantial user of a facility financed by IDBs is broadened to include all partners of a partnership and shareholders of Subchapter S corporation and all spouses and dependent children of such partners and shareholders.

Seventh, the TRA makes three changes in the small-issue exception, as follows:

(i) the small issue exception is extended through 1988 for manufacturing facilities;

(ii) an aggregate $40 million limitation per beneficiary for a small issue IDBs is imposed. If the face amount of the small issue IDB allocated to the beneficiary (when increased by the outstanding exempt IDBs of such beneficiary) exceeds the $40 million limitation, the interest on the small issue IDB will not be exempt; and

(iii) separate small issues will be aggregated with respect to a single project, which is defined as a single building, an enclosed shopping mall, or a strip of offices, stores, etc.

Eighth, a tax exemption is denied for all consumer loan bonds, which are obligations a significant portion of the proceeds of which will be used to make or finance loans to persons who are not exempt persons. Qualified student loan bonds, IDBs, and qualified mortgage bond or qualified veterans' mortgage bonds are excluded from the definition of a consumer bond.

Ninth, the TRA clarifies that an IDB exempt under the §103(b)(4)(A) exception for low and moderate-income residential rental property will not be disqualified if part of the building is used for nonresidential purposes.

Finally, the TRA extends most of the §103 requirements to exempt bonds issued by the District of Columbia, by U.S. possessions, and under section 11(b) of the 1937 Housing Act.

Note: The TRA also eliminates most of the exceptions to the rule enacted by TEFRA in §168(f)(12) requiring straight-line cost recovery on property financed by the proceeds of tax-exempt bonds. For a discussion of this amendment, *see* Chapter 6, VII. It should also be noted that various special interest provisions and exceptions are contained within the tax-exempt bond portion of the TRA, such as allowing Pennsylvania State University to be treated as a governmental unit for purposes of issuing tax-exempt bonds.[76] These special rules will not be analyzed here.

C. *Effective Dates*

In general, the TRA provisions affecting IDBs and private activity bonds apply to obligations issued after December 31, 1983.[77]

However, the denial of a tax exemption for obligations invested in federally insured deposits applies to obligations issued after April 14, 1983, unless the obligation was issued pursuant to a binding contract in effect on March 4, 1983.[78] Also, none of the TRA amendments apply to obligations with respect to facilities the original use of which com-

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mences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.[79]

The annual volume cap on private activity bonds does not apply to any issue of obligations if there was an inducement resolution (or other comparable preliminary approval) for the issue before June 19, 1984, if the issue is issued before January 1, 1985.[80] The repeal of the advanced refunding exception for qualified public facilities applies to obligations issued after July 18, 1984, except that if substantially all of the proceeds of the refunded issue were used to provide airports or docks, the repeal applies only to refunding obligations issued after 1984.[81]

The new special arbitrage limit for IDBs applies with respect to bonds issued after December 31, 1984.[82]

The denial of the tax exemption for consumer loan bonds applies to obligations after July 18, 1984, subject to specified exceptions for state programs.[83]

Various other effective date exceptions applicable to certain issuers, certain issues, or certain facilities are also provided.[84]

D. *Detailed Analysis*

1. Federal Guarantees

a. General

Section 103(h), as amended by the TRA,[85] provides that a state or local obligation shall not be treated as tax exempt if it is federally guaranteed. The denial of an exemption is not limited just to IDBs; all state and local obligations are encompassed by §103(h) except as provided in §103(h)(3), discussed below.

An obligation is treated as federally guaranteed if one of the following three criteria is met:

> (i) the payment of principal or interest with respect to such obligation is guaranteed, in whole or in part, directly or indirectly, by the U.S., or by any agency or instrumentality thereof;
>
> (ii) the obligation is issued as part of an issue and a "significant portion" of the issue proceeds will be used in making loans the payment of principal or interest with respect to which will be guaranteed in whole or in part by the U.S., or an agency or instrumentality thereof; or
>
> (iii) such obligation is issued as part of an issue a significant portion of the proceeds of which will be invested, directly or indirectly, in federally insured deposits or accounts.

Observation: Neither the statute nor the legislative history of the TRA describes what is meant by "significant portion." Nor is the term defined in any existing Code sections. However, the term "significant portion" is also used in §103(n), which denies a tax exemption for consumer loan bonds. Although the Senate Finance Committee Report does not specifically mention this term in describing §103(n), and the term is not defined in §103(n), the Report does state that consumer loan bonds are defined as obligations "five-percent or more of which" will be used for loans to nonexempt persons.[86] Moreover, "significant portion" also appears in §103A in connection with the denial of an exemption for mortgage subsidy bonds that are not qualified. The temporary regulations under §103A define "significant portion" as 5 percent of the proceeds.[87] Presumably, 5-percent will also be the criterion for purposes of §103(h)(2).

Section 103(h)(4) provides that to the extent provided in regulations to be prescribed, any entity with statutory authority to borrow from the U.S. will be treated as an instrumentality of the U.S. for purposes of the foregoing provisions. However, except in the case of an IDB or student loan bond, the District of Columbia or any U.S. possession will not be treated as a U.S. instrumentality by reason of having statutory authority to borrow from the U.S.

A "federally insured deposit or account" for purposes of the foregoing provisions is defined as any deposit or account in a financial institution to the extent the deposit or account is insured by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Administration, or any similar federally chartered corporation.[88]

b. Exceptions

Under §103(h)(3), the following guarantees are not to be treated as federal guarantees for purposes of denying the tax exemption:

> (i) any guarantee by the Federal Housing Administration, the Veterans Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association;
>
> (ii) any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans,
>
> (iii) any Small Business Administration guarantee with respect to a qualified contract for pollution control facilities if a fee is charged for the making of such guarantee in an amount at least equal to 1 percent of the amount guaranteed, or
>
> (iv) any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. §839d).[89]

In addition, exceptions are provided for the investment of bond proceeds for a temporary period, for investments of a bona fide debt service fund or reasonably required reserve, for investments in U.S. Treasury obligations, or for investments permitted under regulations.[90]

Exceptions are also provided for obligations to finance low or moderate-income rental properties as described in §103(b)(4)(A) or housing program obligations issued under section 11(b) of the 1937 Housing Act, qualified mortgage bonds, and qualified veteran's mortgage bonds.[91] However, this exception does not apply if the bond proceeds are invested in federally insured deposits or accounts.[92]

Lastly, an exception is provided for bond proceeds loaned to federally insured financial institutions under a

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loans-to-lenders program, unless the proceeds are invested in federally insured deposits or accounts.[93]

c. Energy Subsidy Programs

Section 103(h)(5) continues the rule of pre-TRA law that an obligation will not be exempt if the payment of principal or interest will be made (in whole or in part) under a U.S., state, or local program for encouraging the production or conservation of energy, if the obligation has been used to finance qualified hydroelectric generating facilities or to finance qualified steam-generating or alcohol-producing facilities.

2. Private Activity Bond Volume Cap

a. General

New §103(n), added by the TRA,[94] provides that an issue of private activity bonds will not be tax exempt if the aggregate amount of private activity bonds issued pursuant to such issue, when added to the aggregate amount of private activity bonds previously issued by the issuing authority during the calendar year, exceeds such authority's private activity bond limit for the calendar year. Under this rule, it should be noted that the entire issue is disqualified if even one bond in the issue of private activity bonds exceeds the limit. Also, it is clear that only the issuing authority's separate volume cap is considered in determining whether an issue is disqualified.

b. Definition of Private Activity Bond

Under §103(n)(7), a private activity bond is defined as any tax-exempt obligation that is an IDB or a student loan bond. A student loan bond, in turn, is an obligation which is issued as part of an issue all or a major portion of the proceeds of which will be used directly or indirectly to finance educational loans for individuals.[95]

Excluded from the definition of a private activity bond is a §103(b)(4)(A) obligation to finance low or moderate income multi-family rental projects and housing program obligations issued under §11(b) of the Housing Act of 1937. Also excluded are IDBs used to finance convention, trade show facilities, airports, docks, wharves, mass commuting facilities, parking, storage, or training facilities directly related to any of the foregoing facilities. However, such facilities must be owned by or on behalf of a governmental unit for the exception to apply. In addition, the exception does not apply if the facilities are leased under a lease having significant front-end loading of rental accruals or payments, under regulations to be prescribed. Lastly, a private activity bond does not include any refunding obligation to the extent of the amount of the refunding obligation does not exceed the amount of the obligation refinanced with the proceeds of the refunding obligation. The refunding obligation exception applies to a student loan bond only if the maturity date of the refunding obligation is not later than the maturity date of the student loan bond to be refunded, or, if later, the date 17 years after the date upon which the student loan bond was issued (or in the case of a series of refundings, the date on which the original obligation was issued).

c. Amount of Volume Cap

The annual volume cap for a state for a calendar year is the greater of (i) an amount equal to $150 multiplied by the state's population, or (ii) $200,000,000.[96] For this purpose, the state population with respect to any calendar year is made on the basis of the most recent census estimate of the resident population of the state published by the Bureau of the Census before the beginning of that calendar year.[97]

If the aggregate private activity bonds issued in a state during 1983 exceeds the volume cap computed for the state for 1984, then that state's cap for 1984 shall be the 1984 cap plus 50 percent of the excess of the 1983 private activity bond amount over the 1984 ceiling.[98]

In calendar years after 1986, the $150 per capita amount used in computing the annual volume cap must be reduced to $100 per capita in order to reflect the termination of the small issue exception of §103(b)(6).[99]

d. Allocation of Volume Cap

Section 103(n)(2) provides that the private activity bond limit for any state agency authorized to issue private activity bonds for the calendar year is equal to 50 percent of the state cap for the calendar year. If more than one agency of the state is authorized to issue such bonds, all agencies are treated as a single agency.

Under §103(n)(3), the private activity bond limit for any other issuing authority for the calendar year is an amount equal to the 50 percent balance of the state ceiling multiplied by a fraction. The numerator of this fraction is the population of the jurisdiction of such issuing authority, and the denominator is the entire state population. If jurisdictions overlap, the rules of §103A(g)(3)(B) must be applied.

A state may by law provide a different formula for allocating the annual state volume cap among the governmental units in such state and, for a temporary period, a state governor may proclaim a different formula for allocating the state ceiling.[100] However, the allocation of the annual state volume cap to a constitutional home rule city cannot be altered.[101]

Comment: No statutory prohibition exists that would bar a state from reallocating the volume cap during or towards the end of a calendar year from an issuer within the state that has not fully utilized its cap to an issuer that has done so to facilitate maximum use of the cap within the state. This reallocation should be permissible regardless of whether the original allocation was set by §103(h)(2) and (3) or by a prior state statute. However, it is less clear whether a reallocation can be made to qualify an issue retroactively where it was inadvertently issued after an issuer had fully utilized its cap for the year.

e. Elective Carryforward of Unused Cap

If an issuing authority's private activity bond limit for any calendar year after 1983 exceeds the total amount of private activity bonds issued by the authority during such year, the authority may elect to treat all (or any portion) of the excess as a carryforward for one or more carryforward projects or as a carryforward for the purpose of issuing student loan bonds.[102] A carryforward project is any project described in §103(b)(4) or (5). The election is irrevocable, must be made at such time and in such manner as prescribed by regulations, must specify the project or projects for which the carryforward is elected, and must specify the

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portion of the carryforward amount to be used for each such carryforward project.[103] The carryforward period extends for three calendar years, except that in the case of an air or water pollution control facility, the carryforward period is six calendar years. If more than one carryforward is elected from different taxable years with respect to a particular project, the carryforwards shall be applied in the order of the calendar years in which they arose.[104]

f. Certification of Allocation

If a public official is responsible for an allocation of any portion of the annual volume cap to any private activity bond, the official must certify under penalty of perjury that the allocation was not made in return for a bribe, gift, gratuity, or direct or indirect campaign contribution. Failure to make the certification will result in disqualification of the bond from exemption. Moreover, if any person willfully makes an allocation of the volume cap to a private activity bond in return for a bribe, gift, gratuity, or direct or indirect campaign contribution, that person shall be subject to criminal penalty to the same extent as if the allocation were a willful attempt to evade tax.[105]

3. New Arbitrage Limit for IDBs

a. General

New §103(c)(6) [106] prescribes new arbitrage rules for IDBs comparable to those now provided for qualified mortgage bonds under §103A(i). Under §103(b)(6)(C), the tax exemption for an issue of IDBs will be lost unless (i) at no time during any bond year the amount invested in nonpurpose obligations with a yield higher than the yield on the issue exceeds 150 percent of the debt service on that issue for the bond year, and (ii) the amount permitted to be invested with respect to debt service is promptly and appropriately reduced as the amount of outstanding obligations of the issue is reduced.

A nonpurpose obligation for purposes of this rule is a taxable obligation or security that is acquired with the gross proceeds of an issue and that is not acquired in order to carry out the issue's governmental purpose.[107] Gross proceeds include amounts received (including principal repayments) as a result of investing the original proceeds of the issue, and the amounts used to pay debt service on the issue.[108] The debt service on an issue for any bond year is the scheduled amount of interest and principal amortization payable for such year with respect to such year.[109]

b. Exceptions

An issue will not be disqualified from exemption under this arbitrage restriction for investments in nonpurpose obligations during an initial temporary period until the proceeds are needed for the issue's governmental purpose, nor will the issue be disqualified by reason of temporary investment periods related to debt service.[110] Also, an investment need not be sold or disposed of if the sale or disposition would result in a loss that would exceed the arbitrage profit that must be paid to the U.S., as described below.

The new arbitrage limit on IDBs does not apply to obligations used to finance low or moderate-income multifamily rental property as described in §103(b)(4)(A) or to any housing program obligation under section 11(b) of the Housing Act of 1937.[111]

c. Arbitrage Profit Rebate

In addition to the restriction on investments in nonpurpose obligations in excess of 150 percent of debt service, §103(c)(6)(D) requires the payment of arbitrage profits earned on all nonpurpose obligations to the U.S. This arbitrage profit consists of (i) the excess of total earnings on all nonpurpose obligations (other than investments attributable to an excess described in clause (i)) over the amount that would have been earned if all nonpurpose obligations were invested at the issue's yield rate, and (ii) the earnings on the excess described in the preceding clause (i).

Note: Yield on the issue, for purposes of both this rebate requirement and the §103(c)(6)(C) limitation on investments in nonpurpose obligations, is determined without regard to issuance costs and underwriter's discount.[112]

However, the arbitrage profit earned during the first six months after issue need not be paid over provided the gross proceeds of the issue are expended for the governmental purpose within that six-month period. For purposes of the temporary investment rule, gross proceeds held in a bona fide debt service fund are not taken into account.[113]

In determining the arbitrage profit on nonpurpose obligations in order to determine the amount that must be rebated to the U.S., any gain or loss on the disposition of a nonpurpose obligation is taken into account, and unless the issuer otherwise elects, gross earnings of less than $100,000 on a bona fide debt service fund on the bond year can be disregarded.[114]

Arbitrage profits must be paid by the issuer to the U.S. in installments that are made at least once every five years. Each installment must be in an amount that ensures that 90 percent of the amount of the arbitrage profit due the U.S. with respect to the issue at the time payment of the installment is required will have been paid to the U.S. The last installment must be made no later than 30 days after the day on which the last obligation of the issue is redeemed and must be an amount sufficient to pay the remaining balance of the arbitrage profit due the U.S.[115]

Note: In addition to the §103(c)(6) arbitrage limit for IDBs, the Treasury is authorized to prescribe regulations specifying the circumstances under which qualified and nonqualified student loan bonds are to be treated as arbitrage bonds for purposes of §103.[116]

4. New Restrictions on Acquisitions of Land or Existing Facilities

a. Nonfarm Land

Under §103(b)(16), added by the TRA,[117] the exemption for IDBs described in §103(b)(4), (5), and (6), will not apply with respect to any obligation issued as part of an issue if more than 25 percent of the proceeds of the issue will be used (directly or indirectly) for the acquisition of land that is not farmland. In the case of an issue described in §103(b)(5), relating to the acquisition or development of land as a site for an industrial park, the 25 percent limit is raised to 50 percent. Except as described below under the first-time farmer exception, none of the proceeds of an IDB may be used to acquire farmland.

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The Ways and Means Committee Report [118] states that the terms of the bond indenture generally will govern in determining the amount of proceeds allocable to the purchase of land. If no allocation is made in the indenture, the proceeds will be deemed to have been used for the purchase of land and for other facilities in accordance with their relative fair market values. The Report further states the intention that, in applying this restriction, expenditures nominally related to land but eligible for ACRS deductions, such as irrigation ditches, are to be treated as made for property other than land.

Section 103(b)(16)(C) provides an exception for land acquired by a public agency in connection with an airport, mass transit, or port development project if the land is acquired for noise abatement, wetland preservation, future use, or other public purpose, and there is no other significant use of the land.

b. Existing Facilities and Rehabilitation Expenditures

Section §103(b)(17) [119] provides that the IDB exemptions described in §103(b)(4), (5), and (6) [120] will not be available for any obligation issued as part of an issue if any of the proceeds of the issue will be used for the acquisition of existing property (or an interest therein); that is, property whose first use will not be pursuant to the IDB-financed acquisition. This provision will not apply, however, to the acquisition of an existing building and equipment related to the building if rehabilitation expenditures with respect to the building are at least equal to 15 percent of the cost of the building and related equipment. For any facility other than a building, the restriction will not apply only if rehabilitation expenditures equal to 100 percent of the cost of the facility are incurred.[121]

Note: The Ways and Means Committee Report [122] states that the rehabilitation expenditures need not be financed by the proceeds of the tax-exempt bond. The Report further states that expenditures for building fixtures (such as stoves, refrigerators, carpeting) are treated as expenditures for the rehabilitation of the building. Note that the property listed as fixtures in the Report generally constitutes personal property for income tax purposes, treated as 5-year property under the ACRS; an investment credit may also be available.

Section 103(b)(17)(C) defines a rehabilitation expenditure as any capital expenditure which is incurred "by the person acquiring the building" for property, or additions and improvements to property, in connection with a building rehabilitation. In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures include the rehabilitation of the existing equipment in the building or the replacement of such equipment with equipment having substantially the same function. Any expenditure incurred by a successor to the person acquiring the building or by the seller under a sales contract with the person acquiring the building will be treated as incurred by the person acquiring the building for purposes of determining whether the 15 percent test has been met.

Observation: Neither the statute nor the legislative history defines who will constitute a "successor" to the original purchaser of the building. Presumably a transferee by reason of the death of the original purchaser will qualify as a successor. Also, it is likely that a corporation that is a transferee of another corporation's assets in a tax-free reorganization will be included under the term. However, it is unclear whether a successor will include a partnership that is a transferee of an individual's interest in the building or a corporation that is a transferee of such interest. Unless the General Explanation of the TRA provides clarification, caution should be exercised in relying on the "successor" provision to aggregate rehabilitation expenditures.

Rehabilitation expenditures do not include expenditures described in §48(g)(2)(B), which deals with rehabilitation expenditures that do not qualify for the rehabilitation tax credit for investment credit purposes. Under §48(g)(2)(B), rehabilitation expenditures do not include expenditures for the enlargement of the building, expenditures to rehabilitate a certified historic structure unless the rehabilitation is certified, expenditures by a lessee of the building if the remaining term of the lease is less than 18 years (15 years in the case of low-income housing) at the date rehabilitation is completed, and any expenditures in connection with the rehabilitation of a building allocable to the portion of the building that is (or may reasonably be expected to be) tax-exempt use property under the new tax-exempt entity leasing rules added by the TRA in §168(j)(3).[123]

Comment: In contrast to the requirement that rehabilitation expenditures be depreciated using the straight-line cost recovery method in order to qualify for the rehabilitation credit, no requirement exists that the straight-line method be used in depreciating rehabilitation expenditures incurred to meet the 15-percent IDB rule. However, §168(f)(12), as amended by the TRA, requires the use of the straight-line cost recovery method for all facilities financed with the proceeds of a tax-exempt bond with an exception for low or moderate-income multi-family rental projects described in §103(b)(4)(A). It should also be observed that, although the rehabilitation credit provisions permit a lessee of a building to claim the rehabilitation credit for expenditures incurred by the lessee, it does not appear that this rule will apply for purposes of the 15-percent IDB test. Section 103(b)(17)(C)(i) clearly requires that the rehabilitation expenditures be incurred by the "person acquiring the building," by the successor of such person, or by the seller to such person under a sales contract with such person. Unless a lessee can be treated as a "successor" to the person acquiring the building, a result that is nowhere indicated in the legislative history, rehabilitation expenditures incurred by a lessee in all likelihood cannot be counted in determining whether the 15-percent test is met. Lastly, it should be noted that, although rehabilitation expenditures allocable to the portion of the building that will be "tax-exempt use property" do not qualify for the rehabilitation credit, such rehabilitation expenditures may still be taken into account for purposes of determining whether the rehabilitation credit requirement that a building be "substantially rehabilitated" is satisfied. Whether a comparable rule will apply for purposes of the 15-percent IDB test is unclear; however, no apparent reason exists why it should not apply since the 15-percent IDB

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test is comparable in theory to the "substantially rehabilitated" test.

The 15-percent test will not be satisfied unless the rehabilitation expenditures are incurred no later than two years after the date on which the building was acquired, or, if later, the date on which the obligation was issued. The Ways and Means Committee Report [124] provides the following example:

Example: If an existing building costs $500,000, and existing equipment in the building costs $250,000, at least $112,500 must be expended for rehabilitation of the building and equipment within the two-year period in order for IDB financing to be available.

Section 103(b)(17)(D) provides that the determination of whether the 15-percent test is met is made on a project basis in the case of a project involving two or more buildings acquired with the proceeds of an IDB.

c. Farmland and the First-Time Farmer Exception

Section 103(b)(16)(A)(i) provides that an IDB will not be tax-exempt if any portion of the proceeds of the issue will be used (directly or indirectly) for the acquisition of land (or interest therein) to be used for farming purposes. However, §103(b)(16)(B) provides an exception for first-time farmers to this restriction and to the restriction that IDBs cannot be used to finance the acquisition of an existing facility as provided by §103(b)(17). The maximum amount that can be financed under the first-time farmer exception is $250,000.

For the exception to apply, the land and facilities located thereon must be used in farming within one year of acquisition.[125] The land must be acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who will "materially and substantially participate *on the farm*" in the farming operation of which the property is to be a part. The Ways and Means Committee Report [126] states that the "on the farm" requirement is intended to restrict the availability of the exception to individuals who will generally perform substantial physical work in the farming operation.

A first-time farmer is any individual who has not at any time had any direct or indirect ownership interest in "substantial farmland" in the operation of which such individual (or the individual's spouse or minor children) materially participated. According to the Ways and Means Committee Report,[127] this definition permits individuals to qualify as first-time farmers who previously owned farm equipment and such real property improvements as equipment sheds and used those facilities as part of a farming operation involving only leased land.

The term "substantial farmland" is any parcel of land whose size equals or exceeds 15 percent of the median size of a farm in the county in which the parcel is located, or whose fair market value has at any time while held by the individual equaled or exceeded $125,000.[128]

Note: In IR-84-92, the Service explains how median farm size should be determined until the Census Bureau develops exact numbers for median farm size by county.

The Ways and Means Committee Report [129] states that the first-time farmer exception applies to facilities other than land only to the extent that the other facilities constitute existing real property improvements located on the land. Moreover, when applying the $250,000 limit, expenditures made by an individual's spouse and minor children will be treated as the individual's expenditures.[130]

d. Prohibition on Acquiring Skyboxes, Airplanes, Gambling Establishments, Etc.

Section 103(b)(18) [131] provides that an IDB will not be exempt under §103(b)(4), (5), or (6), if it is part of an issue any portion of the proceeds of which will be used to provide any airplane, skybox, or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is to sell alcoholic beverages for off-premises consumption. No exception to the foregoing provision is provided by statute; however, a transitional rule excepts certain race tracks with respect to which an inducement resolution was approved before June 1, 1984, by any issuing authority, if the issue is issued before January 1, 1985.[132]

5. New Small-Issue Provisions

a. Aggregate Small-Issue Limit

Section 103(b)(15) [133] provides for the denial of tax-exempt status to any small-issue that would otherwise be exempt under §103(b)(6) if the aggregate authorized face amount of the small issue allocated to a beneficiary of the issue, together with all tax-exempt IDBs allocated to that beneficiary, exceeds $40,000,000. The outstanding tax-exempt IDBs of such beneficiary, referred to as a "test-period beneficiary" for purposes of the limitation is the aggregate face amount of all exempt (not just exempt small issues) IDBs (1) allocated to such beneficiary and (2) outstanding at the time of the later small-issue being tested. This does not include as outstanding any obligation that is to be redeemed from the proceeds of the later small issue.

A "test-period beneficiary" is, except as provided in regulations, any person who is an owner or principal user of facilities being financed by an IDB at any time during the three-year period beginning on the later of (i) the date such facilities are placed in service, or (ii) the date of the issue.[134] A test-period beneficiary includes all persons who are related within the meaning of §103(b)(6)(C) to each other.[135]

Comment: Under the House and Senate versions of this overall $40,000,000 limit, IDBs would have been allocated to any user of the facility except a person using less than 5 percent of the facilities. Also, no three-year testing period was provided in either version of the bill. The exclusion of beneficiaries who are not "principal users" of the facilities being financed by the small issue is obviously a more beneficial rule than the House and Senate version that would have excluded only 5-percent users. However, still left unanswered after the many years since the original enactment of the increased small-issue exemption, which now is $10,000,000 but was originally $5,000,000,[136] is the meaning of the term "principal user." Neither the statute nor the regulations have yet to define this term, but as previously mentioned, for letter ruling purposes the Service takes the position that a principal user is any user of more than 10-percent of the facilities being financed with the proceeds of an exempt small issue. However, unless a

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10-percent use test is ever adopted by statute, one might question whether the use of as little as 10.01 percent of a facility constitutes a "principal use." [137]

Observation: The $40,000,000 limitation will probably rule out the use of the small-issue exemption by a locality to attract subsidiaries or divisions of large public corporations that have financed facilities with IDBs in the past. Counsel for issuers or bondholders should also now exercise greater caution in permitting the lease or sublease of facilities financed with small-issues during the three-year testing period. Broad related party rules apply for purposes of the $40,000,000 limit; the lease or sublease to a person who has never utilized IDB-financing could still result in disqualification of a small-issue by reason of related party use of IDBs.

Allocations to a test-period beneficiary are made as follows. If the test-period beneficiary is the owner of any facilities being financed by IDBs, the issue is allocated on the basis of ownership. If the test-period beneficiary is a principal user of the facility, the issue is allocated on the basis of use. For example, if a principal user leases 60 percent of the facilities that have been financed with a $1,000,000 small issue, $600,000 of the issue is allocated to the principal user.

Observation: It is the "aggregate face amount" of IDBs that are the subject of this allocation process. It should be noted that under §103(b)(6)(D)(ii), the aggregate face amount for purposes of the $10,000,000 exempt small issue includes the aggregate amount of capital expenditures with respect to certain facilities having the same principal user that are paid or incurred during the six-year period beginning three years before the date of issuance of the small issue and ending three years after such date. The Service thus could take the position that all capital expenditures that must be counted in determining the aggregate face amount of a $10,000,000 issue must also be taken into account for purposes of the allocation under §103(b)(15). It should be noted, however, that the legislative history does not address this issue. The $10,000,000 of capital expenditures permitted by §103(b)(6)(I) for facilities the subject of a UDAG need not be considered since §103(b)(6)(I) excludes such expenditures from the aggregate face amount computation.

b. Single Projects

Section 103(b)(6)(P) requires that two or more issues part or all of which will be used for a single building, an enclosed shopping mall, or strip of offices, stores, or warehouses using substantial common facilities be considered as a single issue. Moreover, any person who is principal user with respect to any such issue shall be treated as a principal user with respect to the aggregated issue. The purpose of the rule is to prevent an avoidance of the small issue limits through division of ownership of a project.[138] The Senate Finance Committee Report[139] states that under the rules if a project's ownership is divided among several unrelated users, qualification under the small issue exception is to be determined by measuring the capital expenditures and outstanding obligations of all the principal users of that project.

Observation: However, for the previous rule to apply, at least two issues must be issued for the same project. For example, if the penthouse suite of a condominium office building is financed by the proceeds of an exempt small issue, but the rest of the building is financed through conventional sources and is owned by parties unrelated to the owner of the penthouse suite, the only person who would be a principal user (assuming none of the building is leased) for purposes of the small issue would be the owner of the penthouse suite being financed with the small issue proceeds.

The Senate Finance Committee Report [140] provides as illustrations of common facilities: (i) common heating, cooling, and other facilities, or (ii) common entrances, plazas, malls, lobbies, parking, elevators, and stairways for use by employees or patrons of the facilities. The Report further states that, for there to be common facilities, the two facilities used by the different users must generally be contiguous, such as, all units in a strip shopping center using a common parking lot. On the other hand, two or more stores located in a downtown redevelopment project which are not contiguous to each other generally would not be treated as a single project, but structures separated by inconsequential barriers, such as rights of way, would be treated as contiguous.[141] Finally, the Finance Committee Report [142] states that it is expected regulations will be issued defining circumstances where, because use of common facilities is *de minimis,* otherwise separate facilities will not be treated as a single project, such as ordinarily separate department stores that each lease less than 25 percent of an independently owned parking garage adjoining the two stores. Similarly, the use of utilities, such as the same local district heating and cooling system, by otherwise separate businesses may not suffice to treat the buildings used by the businesses as a single project.

c. Extension of Small Issue Exception for Manufacturing Facilities

The TRA [143] amends §103(b)(6)(N) to provide that the December 31, 1986, termination date of the small issue exemption is extended to December 31, 1988, in the case of a small issue substantially all of the proceeds of which will be used to provide a manufacturing facility. A manufacturing facility is a facility that is used in the manufacturing of tangible personal property, including the processing resulting in a change in the condition of such property.

6. Extension of Substantial User Related Party Rules

The TRA [144] amends the substantial user limitation in §103(b)(13) to provide that all partners of a partnership (including both general and limited partners) [145] and spouses and dependent children of partners are treated as related persons to the partnership. Moreover, all shareholders of a Subchapter S corporation and spouses and dependent children of shareholders are treated as related persons to the corporation. Consequently, interest on any IDB held by any partner of a partnership or shareholder of a Subchapter S corporation that is a substantial user of the facilities financed by the IDBs would be taxable.

7. Mixed Use Structure Clarification

The TRA [146] amends §103(b)(4), relating to the exemption for IDBs used to finance low or moderate-income multi-family residential rental property to clarify that prop-

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erty can qualify for IDB financing under this provision even though the building that contains qualifying residential units is also used for nonresidential purposes. However, tax-exempt financing is limited to the portion of the building used for qualifying purposes.[147]

8. Consumer Loan Bonds

Section 103(o) [148] provides that any consumer loan bond may not be treated as exempt under §103(a). A consumer loan bond is defined as any obligation issued as part of an issue all or a significant portion [149] of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans [150] to persons who are neither governmental units nor §501(c)(3) organizations. However, a consumer loan bond does not include (i) qualified student loan bonds, (ii) industrial development bonds, or (iii) qualified mortgage bonds or qualified veteran's mortgage bonds.[151]

9. Repeal of Advance Refunding Exception

The TRA [152] repeals the §103(b)(7) exception permitting tax-exempt treatment of an issue used for the advance refunding of certain IDBs issued to finance convention and trade show facilities, airports, docks, wharves, and mass commuting facilities.

10. Extension of §103 Restrictions to Other Exempt Obligations

The TRA [153] amends §103(m)(1) to provide that in the case of an obligation issued after December 31, 1983, which is exempt by reason of provisions outside the Internal Revenue Code, the obligation will not be treated as exempt unless the "appropriate requirements" of §103(b), (c), (h), (k), (l), and (n) and §103A are met with respect to the obligation. For purposes of these requirements, a possession is generally treated as a state.

11. Clarification of Public Approval for Certain Airports

For purposes of the public approval requirements added in §103(k) by TEFRA, if an airport is located in more than one jurisdiction but owned and operated only by the jurisdiction issuing the tax-exempt bonds, only the issuing jurisdiction is required to satisfy the §103(k) public approval requirements.

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[1] P.L. 96-499, Act §§1101-1104.
[2] §103A(d); however, certain multiple-unit residences may qualify as a single-family residence under §103A(l)(9).)
[3] §103A(e). However, the lendable proceeds of a bond can also be used to finance certain home improvements and certain rehabilitations of existing housing.
[4] §103A(f).
[5] §103A(h).
[6] §103A(i).
[7] §103A(j), although some exceptions are provided for construction period loans, bridge loans, and certain other temporary types of loans.
[8] P.L. 97-248, at §215(b)(1), adding Code §103(l).
[9] Act §611(a).
[10] H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. (1984) p. 1667; S. Rep. No. 169, 98th Cong., 2d Sess. (1984) p. 677.
[11] *Id.*
[12] Act §611(b).
[13] See §103A(c)(3)(C), as amended by Act §611(c)(1).
[14] In the case of a "constitutional home rule city" as defined in §103A(g)(5)(C), the chief executive officer of the city must make this certification.
[15] Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), p. 1188.
[16] Act §611(c).
[17] However, under §103A(l)(9) and (10), certain multiple family residences and certain cooperative units can qualify as "single-family residences."
[18] §103A(o)(4).
[19] §103A(o)(2).
[20] Act §611(d)(3)(B).
[21] Act §611(d)(3)(C).
[22] §103A(o)(6).
[23] Act §611(d)(4).
[24] Act §614.
[25] §25, added by Act §612.
[26] See §§25(d)(2) and 103A(g)(8).
[27] H.R. Rep. No. 432, *supra* note 10, at 1667-1668; S. Rep No. 169, *supra* note 10, at 678.
[28] Conference Report, *supra* note 15, at 1195.
[29] Under §103A(l)(7)(E), a qualified rehabilitation is defined as the rehabilitation of a building that is at least 20 years old when rehabilitation begins, in which at least 75 percent of the building's external walls are retained, and the rehabilitation cost of the building exceeds 25 percent or more of the mortgager's adjusted basis in the residence. A qualified home improvement is, under §103A(l)(6), an alteration, repair, or improvement on or in connection with an existing residence by the residence's owner which substantially protects or improves the basic livability or energy efficiency of the property. Note that §103A(l)(6) limits the financing of such improvements for purposes of qualified mortgage bonds to $15,000, but it is unclear whether this $15,000 limitation applies to mortgage credit certificates. See §25(e)(8), which refers to §§103A(l)(7)(B) and 103A(l)(6) for the definitions of "qualified rehabilitation" and "qualified home improvement," respectively.
[30] §§25(c)(1) and 25(d)(1).
[31] §25(c)(1).
[32] §25(e)(5).
[33] §25(c)(2)(A)(i).
[34] §§25(c)(2)(A)(ii) and 103A(g)(8).
[35] *See* §25(d)(2)(A).
[36] §25(f)(1).
[37] §25(f)(5).
[38] §25(c)(2)(B).
[39] *Id.*
[40] H.R. Rep. No. 861, *supra* note 15, at 1195.
[41] §25(e)(2).
[42] §25(a)(1).
[43] §25(a)(2)(A).
[44] §25(a)(2)(B).
[45] For a complete description of the new ordering rules, see Chapter 14.
[46] §25(e)(1)(A).
[47] *Cf.* §38(a), which clearly provides that unused general business credit carryforwards are applied before current year general business credits.
[48] As added by Act §612(c).
[49] Cf. §103(b)(12)(C).
[50] Act §612(d).
[51] H.R. Rep. No. 861, *supra* note 15, at 1197.
[52] §103(e) defines "qualified scholarship funding bonds" as obligations issued by a non-profit corporation, organized pursuant to state or local government direction, in order to acquire student loan notes incurred under the Higher Education Act of 1965.
[53] In fact, §103(f) recognizes that certain New York City bonds are exempt even though a Federal guarantee may have been provided with respect to such bonds.
[54] §103(b)(3), which defines an exempt person, provides that a §501(c)(3) organization is treated as an exempt person only with respect to a trade or business carried on by the organization that is not an unrelated trade or business under §513(a).
[55] §103(b)(6)(B).
[56] §103(b)(6)(H).
[57] *See, e.g.*, PLR 8034157, PLR 8124136, and PLR 8130105.
[58] *See, e.g.*, PLR 8246062 and PLR 8149042.
[59] §103(b)(6)(O).
[60] P.L. 97-248, §214(c), adding §103(b)(6)(N).
[61] H. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1679; advance

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refunding obligations include obligations issued to refund an IDB where the refunding issue is issued more than 180 days before the prior issue is redeemed.

[62] §103(b)(13).
[63] §103(b)(6)(C).
[64] §103(c)(2).
[65] *See* §103(c)(4)(B). Generally, a reasonably required reserve cannot exceed 15 percent of the proceeds of the issue.
[66] §103A(g).
[67] 42 U.S.C. §1437i(b).
[68] *See also* §103(n).
[69] *See* §103(m); however, District of Columbia bonds are subject to an arbitrage limitation.
[70] P.L. 97-248.
[71] *See* S. Rep. No. 494, 97th Cong., 2d Sess. 167 (1982).
[72] H. Rep. No. 98-432, *supra*, at 1683.
[73] *Id.*
[74] *Id.*
[75] *Id.*, at 1684-1685.
[76] Act §643.
[77] Act §§631(a) and (c).
[78] Act §631(c)(2).
[79] Act §631(c)(3); however, the annual private activity volume cap does apply to such obligation.
[80] Act §631(a)(2).
[81] Act §631(c)(4).
[82] Act §624(c)(1).
[83] Act §626(b).
[84] *See, e.g.*, Act §§631(d) and (f) and §632.
[85] Act §622.
[86] S. Rep. No. 169, 98th Cong., 2d Sess. 707.
[87] Temp. Regs. §61.103A-1(b)(1)(ii).
[88] §103(h)(4)(D).
[89] §103(h)(3)(A).
[90] §103(h)(3)(B).
[91] §103(h)(3)(C).
[92] *Id.*
[93] §103(h)(3)(D).
[94] Act §621.
[95] §103(n)(8).
[96] §103(n)(4)(A).
[97] §103(n)(9).
[98] §103(n)(4)(B); the aggregate 1983 bond amount for purposes of these rules is determined by annualizing the aggregate amount of private activity bonds issued in the state during the first 9 months of calendar year 1983.
[99] §103(n)(4)(C).
[100] §103(n)(6).
[101] *Id.*
[102] §103(n)(10).
[103] *Id.*
[104] *Id.*
[105] §103(n)(12).
[106] Added by Act §624(a).
[107] §103(c)(6)(H).
[108] *Id.*
[109] §103(c)(6)(C)(iii); amounts relating to bonds retired before the beginning of the bond year may not be taken into account.
[110] §103(c)(6)(C)(ii).
[111] §103(c)(6)(B).
[112] *See* §103(c)(6)(H)(iii), referring to issue price within the meaning of §1273 or 1274; *see also* S. Rep. No. 98-169, supra, at 699.
[113] §103(b)(6)(F).
[114] *Id.*
[115] §103(c)(6)(E).
[116] *See* Act §625(a) and (b).
[117] Act §627(a).
[118] H. Rep. No. 98-432, *supra*, at 1691.
[119] Added by the Act §627(b).
[120] §103(b)(17)(A) also lists the exception in §103(b)(7) for the refunding of qualified projects. However, a subsequent portion of the TRA, Act §628(g), repeals this advance refunding exception.
[121] §103(b)(17)(B).
[122] H. Rep. No. 98-432, *supra*, at 1692.
[123] *See* Act §31; the tax-exempt entity leasing rules are described in detail in Chapter 18.
[124] *Id.*
[125] §103(b)(16)(B).
[126] *Id.*, at 1692-1693.
[127] *Id.* at 1693.
[128] §103(b)(16)(D)(v).
[129] *Id.*, at 1692.
[130] *Id.*; the House Report also refers to expenditures by the individual's parents, but nothing in the statute indicates that a parent's expenditures should be taken into account.
[131] Added by Act §627(c).
[132] Act §631(f).
[133] Added by Act §623.
[134] §103(b)(15)(D).
[135] §103(b)(15)(E).
[136] Enacted by P.L. 90-364, effective as to obligations issued after October 24, 1968. The concept of "principal user" is applied for purposes of this increased exemption amount.
[137] *Cf. Malat v. Riddell*, 383 U.S. 569 (1966).
[138] S. Rep. No. 98-169, *supra*, at 701.
[139] *Id.*
[140] *Id.*
[141] *Id.*
[142] *Id.*
[143] Act §630.
[144] Act §628(d).
[145] S. Rep. No. 98-169, *supra* at 702.
[146] Act §628(e).
[147] Conference Report, H. Rep. No. 98-861, *supra* at 1211.
[148] Act §626(a).
[149] A "significant portion" will be 5 percent; *see* S. Rep. No. 98-169, *supra*, at 707, and the Observation in II, D, 1, a, *supra*.
[150] Under §103(o)(2)(C), a loan will not cause an obligation to be a consumer loan bond if the loan enables the borrower to finance any governmental tax or assessment of general application for an essential governmental function, or is used to acquire or carry nonpurpose obligations.
[151] §103(o)(2)(B); a qualified student loan is defined in §103(o)(3).
[152] Act §628(g).
[153] Act §628(a).

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Chapter 21

TIME VALUE OF MONEY (I): ORIGINAL ISSUE AND MARKET DISCOUNT; SECTION 483

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I. Introduction

A. Background

In any transaction in which a person undertakes to make payment of money at some date in the future in exchange for present consideration, whether such consideration consists of money, property, the use of property, or services, where the parties to the transaction are dealing at arm's length, the question of interest will arise. This is especially true in an era with double digit interest rates prevailing in the marketplace. Not only will the parties consider the rate of interest, but they will also consider the manner in which the interest is computed and treated for tax purposes. For many years, even after interest rates had moved to double digit rates, the Code failed to reflect the realities of the marketplace in its provisions relating to the computation of interest. There also existed disparities in the rules relating to the timing of its deduction by the obligor and its inclusion in the income of the obligee. These lapses were especially significant in the provisions relating to original issue discount (OID) and to contracts for the sale of property. Prior to the enactment of P.L. 97-248 (TEFRA), the corporate issuer of a bond at discount was entitled to deduct the amount of such discount ratably, that is, on a straight-line basis, over the term of the bond. Thus, where a bond, typically carrying a below-market rate of interest, redeemable at maturity in 10 years for, say, $1 million was issued for a price of $800,000, the $200,000 discount was divided by the number of months until maturity, and the issuer was allowed to deduct as interest each year the ratable monthly portion (200,000/120) times the number of complete months the instrument was outstanding.[1] The result was an overstatement of interest expense during the early years of the bond's life and an understatement during the later years, a net gain for the issuer because of the time value of the taxes deferred. This particular type of income distortion was explained and analyzed in the committee reports relating to the amendments to the Code effected by TEFRA.[2] These amendments to §1232 and the addition of §§1232A and 1232B (relating to stripped bonds) provided only a partial remedy to the Code's failure to adequately take into account what one recent article has termed "the miracle of compound interest."[3] Requiring both the issuer and the holder of an OID instrument to compute the interest resulting from discount by applying to the issue price the instrument's annual yield to maturity compounded annually (although semiannual compounding is applied to most marketed debt instruments) were long overdue reforms. However, TEFRA left open numerous areas in which significant tax advantages could be obtained.

B. Areas Requiring Further Reform and Revision

1. Debt Instruments Issued for Property

Prior to 1969, there was some question as to whether OID could arise from a transaction in which a bond or other debt instrument was issued for property. To put an end to this source of uncertainty, §1232 was amended to provide that unless (1) the debt instrument itself was actively traded on an exchange, or (2) the property consisted of exchange traded stock or securities, the issue price of any instrument issued for property was its stated redemption price at maturity and, hence, there was no OID.[4] But, generally, bonds (also meaning debentures, notes, certificates or other evidences of indebtedness) issued for property, for the use of property, or for services were not covered by the OID rules. Where a bond was issued for property, the transaction was covered, if at all, by §483 under which all payments denominated by the instrument as interest were tested against a 9 percent simple annual interest rate to determine whether there was included in the nominal purchase price any amount of "unstated interest." While the test rate was periodically changed to reflect market rates, generally the changes lagged far behind such rates. Also, the use of a simple, rather than a compound, rate yielded a generous computation of present values (from the standpoint of the fisc). As is stated in the committee reports,[5] a 9 percent simple rate applied to a payment due in 30 years (*e.g.*, a single payment to be made in 30 years of $3,700 for the use of $1,000 during the term of the loan) yields an effective compound rate of 4½ percent. These §483 rules, which apply only to payments made more than 6 months from the date of sale and only if some or all payments are due more than 1 year after the sale, allocate unstated interest to each payment according to the payment's percentage of the total purchase price, left open numerous avenues for income distortion.[6] Section 483, with its complex regulations containing present value tables, rules relating to late payments, treatment of accrual basis taxpayers, and dispositions of the debt instrument before maturity was not effective in compensating for the Code's deficiencies in the rational and economically sound treatment of interest.[7]

The legislation required to make the Code reflect economic reality included: (1) The extension of the OID rules,

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to debt instruments issued for property in transactions involving significant amounts, and amended to provide semiannual compounding, and (2) To retain §483 for sales transactions involving lesser amounts with rules consistent with the OID rules regarding the computation of interest. The OID rules had not been applied to instruments issued for untraded property due, at least in part, to the difficulty of valuing the property. However, this difficulty had been overcome in §483 by applying to the debt obligation a conservative test rate of interest to determine whether the purported purchase price reflected a charge for interest. This same technique, using a test rate of 110 percent of the average yield of marketed U.S. government obligations ("applicable federal rate" (AFR)), could be adopted in determining the issue price of debt instruments. Where the instrument failed to meet this test, interest would be imputed at a higher rate (120 percent of the AFR). Exceptions and exemptions for transactions involving relatively small amounts and certain routine, non-tax motivated transactions could be provided. Finally, there was no reason to continue to exempt from the OID rules holders in whose hands instruments were not capital assets, or debt instruments issued by natural persons.[8]

2. Market Discount

The acquisition of a bond after its issue will often involve either acquisition discount (where the market interest rate has risen) or the payment of acquisition premium (where the interest rate has fallen). Where a bond has been issued at par and, because of rising interest rates, is sold by its holder at a discount, the new holder is in essentially the same position economically as is a holder of an OID instrument.[9] Assuming no fluctuations in the interest rate, the instrument increases in value as the maturity date approaches. Under the tax laws in effect after the TEFRA amendments (which made no changes in this regard), any gain realized by the holder of an instrument purchased at discount was capital gain, despite the fact that such gain, aside from that portion (if any) attributable to a decrease in interest rates, constituted a return on investment indistinguishable from interest. This called for remedial legislation providing for recognition of the true nature of the gain in question as interest income. Because of the complexities involved in computing discount on a constant interest basis, which might unduly interfere with the operation of the bond market, a rule calling for the treatment as ordinary interest income of any gain realized on disposition of a market discount bond, to the extent of such discount accrued while held by the taxpayer, was deemed adequate to remedy this defect. Holders could, however, elect to accrue discount on a constant interest basis. There was also a need to address income distortion caused by the leveraged purchase of market discount instruments, a device availed of by numerous tax shelters. Since market discount is not included in income currently, but is taken into account only upon the disposition of the bond, through deductions taken against ordinary unrelated income for interest paid or accrued on loans taken out to purchase or carry these bonds in years prior to the year of disposition, taxpayers were able to convert ordinary income into capital gain. Even if gain attributable to market discount is taxed as interest income, and the conversion of ordinary income to capital gain is no longer possible, leveraged purchases could provide a means for tax deferral. What was called for, then, was a deferral of any net interest deduction to the extent it does not exceed the market discount accrued while the bond is held. The denied deductions could then be allowed at the time of disposition of the bond, when the discount, to the extent of any gain realized, was taken into income as interest. Special rules were required to deal with situations where a market discount bond was exchanged for another bond or other property in a nonrecognition transaction. Recognition of accrued market discount when an appreciated bond was disposed of in transactions other than sales or exchanges was necessary. To avoid interest deduction deferral, a holder could elect to include market discount in income currently.

3. Short-Term Instruments

The TEFRA changes did not apply the OID rules to short-term (maturity not more than 1 year from the date of issue) instruments. Short-term zero coupon government obligations (Treasury bills were by far the most common of these) were subject to special rules calling for a ratable inclusion of the acquisition discount upon sale, exchange, or redemption.[10] Regulations exempted from the OID rules nongovernment short-term discount obligations (*e.g.*, certificates of deposit), since interest payable at maturity was not considered OID.[11] It was decided that accrual basis taxpayers (dealers and banks), and certain other cash basis taxpayers would include in income currently acquisition discount (excess of amount payable at maturity over cost) on short-term government obligations and certain other short-term obligations (either OID or acquisition discount as may be elected). Current accrual was also required for certain partnerships and S corporations.

As in the case of market discount bonds, leveraged purchases of short-term instruments could lead to unjustified deferral of tax, where the instruments are held by persons not required to accrue discount interest currently. To prevent income distortion, deductions for interest on funds used to purchase or carry short-term instruments would be allowed only to the extent it exceeds the discount attributable to the instruments during the year and, as in the case of market discount, allowed in the year the instruments are disposed. To avoid this deferral of interest deduction, a holder could elect to accrue the discount as if such accrual were mandatory.

As in the case of market discount obligations, the holder should be allowed to elect to accrue interest on a constant basis. However, compounding must be daily in view of the short-term of the instrument.

4. Tax Exempt Obligations

A tax-exempt obligation, for purposes of the OID rules, is any obligation the interest on which is exempt under the provisions of §103 or which is exempt from tax (without regard to the identity of the holder) under any other provision of law.[12]

Such instruments when issued at discount are exempt from the OID rules. Under the law, as interpreted by the IRS, while OID was not accruable by the holder, the basis of such instruments must be increased while they are outstanding to reflect their increase in value attributable to approaching maturity. Since the rule requiring economic accrual of interest did not apply to such instruments, the

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basis increase was computed by accruing interest on a straight-line basis which, as has been stated, overstates the true amount of interest in the early years of the instrument. Holders of tax-exempt OID instruments (typically, zero coupon bonds) were thus entitled to adjust their basis upward substantially in excess of the bonds' appreciation attributable solely to the OID [13] and, as a result, could realize capital losses in excess of any true economic loss sustained. Curbing this source of income distortion is relatively simple. It requires only that the basis adjustment conform to the OID rules, based on the economic or constant accrual of interest compounded semi-annually (daily for short-term instruments).

5. Section 483

With the expansion of the scope of the OID rules to instruments issued for property, the operation of §483 is to be relegated to those transactions to which the OID rules do not apply, that is, sales involving total payments below the OID threshold ($250,000).

To bring the §483 rules into harmony with the OID rules relating to instruments issued for property, it was necessary only to use the same testing technique to ascertain whether in fact the purported purchase price included unstated interest. Present valuing all payments at a rate equal to the current market interest rate for good credit risks (110 percent of the applicable federal rate) would immediately display the true purchase price, and any unstated interest could be accrued on a constant basis over the life of the obligation. But, since the OID rules were not to apply, the timing of interest deductions and the inclusion of interest in income would depend on the method of accounting used by the taxpayer.[14] As under old §483, transactions under $3,000 and sales of patents, where the sales price was based on the exploitation of the patent rights, are exempted from the OID rules. The old §483 interest rates also apply to sales of principal residences for $250,000 or less and certain sales of farmland. A special low testing rate for inter-family sales of land was also retained from the former provisions.

6. Section 461(h)

All of the above reforms are, essentially, accounting reforms reflecting financial accounting principles. The OID, market discount, short-term obligations, and tax-exempt obligations provisions are contained, however, in part V of subchapter P, a section of the Code dealing primarily with capital gains and losses. This is due to the fact that the predecessor statute, as originally enacted, set forth the rule that the retirement of a bond was to be treated as a sale or exchange. Rules dealing with the treatment of OID were added later. As treatment of OID evolved, more sophisticated rules were added to the basic statute. Section 483, on the other hand, is located in subchapter E, Accounting Periods and Methods of Accounting. Subpart C of part II of the same subchapter deals with the taxable year for which deductions are taken, the general rules for which are contained in §461. Section 91 of the 1984 TRA adds new subsections (h) and (i) to §461. While these accounting changes are discussed in other sections of this portfolio, a very significant provision relating to the time value of money appears in §461(h) providing that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as having been met any earlier than when economic performance with respect to such item occurs. In regard to interest, "economic performance" occurs with the passage of time. This means that no interest is deductible, irrespective of the payor's method of accounting, prior to the close of the period to which it is allocable. Ths rule (and the related comment of the conference committee) will be discussed in the detailed analysis below. It is noted here that the rule must be kept in mind when considering the impact of §483 or transactions which neither §§1272 nor 483 apply.

As interpreted by the conference committee, the accrual of interest, for all purposes of the Code (unless specfically provided otherwise) will be based on economic or constant rate accrual. In effect, it outlaws the use of the Rule of 78's, linear, or other methods of computing interest deductions, whether or not interest is imputed under the provisions discussed above. As will be explained below, the effective date of this rule, appearing in Act §44(b)(3), along with effective dates relating to §483, is "after June 8, 1984."

II. Overview-Structural Outline of Statutory Provisions

This chapter discusses the provisions enacted by §§41-44 of the Act. The Act repeals §§1232, 1232A and 1232B. In their place are substituted a thoroughly revised set of rules dealing with most transactions involving deferred payments.

Subtitle C of the Act contains Act §§41 through 44. It is entitled "Treatment of Bonds and Other Debt Instruments."

A. Act Section 41(a)

Act §41(a) enacts part V of subchapter P (§§1232, 1232A and 1232B are repealed by Act §42(a)(1)). Part V contains 4 subparts as follows:

(i) Original Issue Discount (§§1271-1275)

(ii) Market Discount (§§1276-1278)

(iii) Discount on Short-Term Obligations (§§1281-1283)

(iv) Miscellaneous Provisions (§§1286-1288)

1. Subpart A

§1271 provides rules for the treatment of amounts received on the retirement, sale, or exchange of debt instruments, and the tax treatment of gain realized from short-term governmental obligations (identical to §1232(a)(3)).

§1272 provides rules relating to the amount of OID includible currently in the income of the holder of an OID instrument. This section becomes operative only after the total OID amount is determined under §§1273 or 1274.

§1273 provides the definition of OID and "stated redemption price at maturity" and the rules for determining the amount of OID on debt instruments issued for money and for (1) publicly traded instruments issued for property and (2) instruments issued for publicly traded property.

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§1274 provides the rules for determining the amount of OID with respect to instruments issued for untraded property (to which §1273 does not apply).

§1275 provides definitions and special rules pertaining to the application of §§1271-1274.

2. Subpart B

§1276 provides the rules treating as ordinary income any gain attributable to accrued market discount at the time of disposition of a market discount bond and tax-free exchanges involving such bonds.

§1277 provides rules for the deferral of deductions for interest on debt incurred or continued to purchase or carry market discount bonds.

§1278 provides definitions and special rules pertaining to §§1276 and 1277.

3. Subpart C

§1281 provides for the current inclusion in income of discount on short-term instruments held by certain taxpayers.

§1282 provides rules for the deferral of deductions for interest on debt incurred or continued to purchase or carry short-term obligations (other than those to which §1281 applies).

§1283 provides definitions and special rules pertaining to §§1281-1282.

4. Subpart D

§1286 provides rules relating to stripped bonds (substantially identical to those of former §1232B).

§1287 provides rules denying capital gain treatment to un-registered obligations (substantially identical to former §1232(c)).

§1288 provides rules requiring the adjusted basis of short-term tax-exempt OID obligations be computed on a constant interest basis.

B. Act Section 41(b)

Act §41(b) amends §483 which provides rules consistent with the treatment of OID to contracts for the sale or exchange of property that are not within the OID rules.

C. Act Section 41(c)

Section 41(c) of the Act enacts a penalty provision, §6706, imposing a penalty for each failure to comply with the information reporting requirement of §1275, providing that when a debt instrument is publicly issued, the issuer is to provide the IRS with: (i) the amount of OID, (ii) the issue date, and (iii) such other information as may be required by regulation.

D. Act Section 42

Section 42 of the Act provides technical and conforming amendments relating to the OID provisions. As stated above, it repeals §§1232, 1232A and 1232B, and amends the various sections of the Code referring to the repealed sections and replaces them with references to the new provisions.

E. Act Section 43

Section 43 of the Act contains technical and conforming amendments to the Code provisions dealing with market discount and discount on short-term instruments. It adds paragraphs (42) through (45) to §7701(a), defining substituted basis property, transferred basis property, exchanged basis property, and nonrecognition transaction. The last sentence of §1016(b) is deleted. Subsection (d) (manner of making elections prescribed by the Commissioner) is added to §7805.

F. Act Section 44

The last section of subtitle C of the Act, §44, provides the effective dates for all of the foregoing enactments. It clarifies that prior effective date rules are not to be affected by any of the changes made by the 1984 TRA.

III. Detailed Analysis

Part V of subchapter P is subdivided into 4 subparts, as follows:

A. Original Issue Discount (§§1271-1275)

B. Market Discount (§1276-1278)

C. Discount on Short-Term Obligations (§1281-1283)

D. Miscellaneous Provisions (§1286-1288)

A. Original Issue Discount (OID)

1. General

This subpart contains §§1271 through 1275. Much of it simply recodifies prior law. The most significant change from prior law is the extension of the OID rules, requiring current inclusion in the income of the holder of a debt instrument and, (by operation of §163(e), which incorporates the OID rules to provide a matching interest deduction) the deduction by the issuer of the instrument of OID on a constant interest basis over the life of the instrument. Application of these rules is irrespective of accounting methods, type of debt instruments issued, and whether or not the debt instrument or the property is actively traded.

2. The Retirement of Debt Instruments (§1271)

Post-TRA §1271(a) now contains the basic rule that any amounts received by the holder on retirement of any "debt instrument" are considered amounts received in exchange for such instrument.[15]

The rule was formerly stated in terms of "bonds or other evidences of indebtedness" but, the term "debt instrument," having the same denotation, has been substituted as more appropriate. "Debt instrument," as used throughout the OID rule provisions, means any bond, debenture, note, certificate or other evidence of indebtedness.[16] It does not include, however, any annuity contract to which §72 applies and depends in substantial part on the life expectancy of 1 or more individuals, or annuity contract issued by an insurance company (within the meaning of subchapter L): (i) in cash only (or annuity contract exchange) transactions, (ii) under the election of a beneficiary upon the death of the insured, or (iii) in any transaction involving a qualified pension or employee benefit plan.[17]

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The requirement that the debt instrument be a capital asset in the hands of the holder as prerequisite for application of the OID rules is repealed.[18]

Section 1271(a)(2) restates the rule that where there is an intention to call the debt instrument before maturity, any gain realized from the sale or exchange of such instrument, to the extent of any unamortized OID, is ordinary income. Unamortized OID is the amount of OID, determined under §§1273 or 1274, reduced by the amount of such OID previously includible under §1272 in the income of the holder.

As under prior law, the rule relating to retirement does not apply to a tax-exempt obligation or to any holder who has purchased the debt instrument at a premium [19] (*i.e.*, an amount in excess of the redemption price payable at maturity). The term "tax-exempt" means any obligation, the interest on which is exempt from tax under §103 or is exempt from tax (without regard to the identity of the holder) under any other provision of law.[20] It does not mean a debt instrument held by a tax-exempt entity, the interest on which is exempt solely because of the holder's tax-exempt status.

Section 1271(a)(3) reenacts almost verbatim the provisions of §1232(a)(3) which provides for the ordinary income treatment of any gain from the sale or exchange of any "short-term Government obligation," the definition of which restricts its application to Treasury bills and other instruments issued by the U.S. or state governments having similar terms (maturing in one year or less, paying no interest, and issued at a discount), to the extent such gain does not exceed the holder's ratable share of acquisition discount.[21]

Section 1271 does not apply to instruments issued by natural persons [22] (§1272 applies to these instruments) [23] or to instruments issued before July 2, 1982 (the effective date of TEFRA) by an issuer which is not a corporation and is not a government or political subdivision thereof.[24]

Transition rules, identical to those provided under prior law, apply to instruments issued prior to the effective dates of the various amendments to §1232 after its enactment in the 1954 Code.[25]

Finally, §1271(d) provides that §1271, §1272 (relating to the inclusion in income of OID), and §1286 (relating to the treatment of stripped bonds) shall not require the inclusion of any amount previously includible in gross income. This same provision formerly appeared in §1232(a)(2)(D).

3. *The OID Rules (§§1271-1275)*

Section 1272 provides rules for the computation of the amount of such OID to be *included currently* in the income of the holder. Section 1273 defines OID as the excess of the "stated redemption price at maturity" (hereinafter "SRPM") and the instrument's "issue price." This section provides the rules for determining the *issue price* for debt instruments issued for money or for property where either the instrument or the property is actively traded. Section 1274 provides the rules for determining the *issue price* for instruments issued for untraded property. Section 1275 provides definitions and special rules relating to §§1271-1274. These rules replace former §§1232 and 1232A.

a. Instruments Issued for Money or Traded Property (§1273)

(1) Definitions of OID and Stated Redemption Price at Maturity

OID is the excess of the "stated redemption price payable at maturity" of any debt instrument over the "issue price." [26]

The "stated redemption price payable at maturity" is defined (codifying principles contained in Regs. §1.1232-3(b)(1)(iii)) as the amount fixed by the latest modification of the purchase agreement and includes interest and other amounts payable at that time (however characterized) other than interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument.[27]

The purpose of this definition is to prevent the mismatching of deductions for interest and the inclusion of interest in income. Under this definition, any payment made during the term of a debt instrument which exceeds interest payable at a fixed rate annually is SRPM, requiring computation of OID. This is true whether or not the payment is applied in whole or in part to reduce the principal balance due.

> *Example:* Assume a debt instrument issued for $1,000, maturing in three years, and calling for payments of: (1) $25 at the end of each of the first three six-month periods, (2) payment of $95 at the end of the fourth six-month period, and $25 at the end of each of the last two six-month periods, making the final payment $1,025. The redemption price at maturity is $1,000. The $25 payment reflects interest payable at a fixed rate (five percent) and is excluded from the redemption price. The same would be true if the instrument provided for payment of $50 at the end of the first year, $120 at the end of the second year, and a final payment of $1,050. If the rule under discussion were not applicable, mismatching could occur as follows: If $1,000 is considered the redemption price at maturity, there is no OID and, hence, the issuer and holder treat the interest in accordance with their respective methods of accounting. It can be seen that the annual yield to maturity of this instrument is approximately 7.3 percent. An accrual basis issuer could accrue interest at this rate over the life of the instrument. If the holder is a cash basis taxpayer, he need report only the amount of interest actually received. This mismatching is avoided by treating the instrument as two serial obligations, the first maturing at the end of the second year and having a SRPM of $70, and the second maturing at the end of the third year and having a SRPM of $1,000. There is, therefore, a total of $70 in OID (excess of SRPM ($1,070) over the $1,000 issue price).

The regulations call for the allocation of this OID to each of the series. This technique involves the determination of the issue price for each series. The method for making this determination is set forth in Regs. §1.1232-3(b)(2)(iv)(f), to determine the issue price, the SRPM, and the OID for each series.[28] If the debt instru-

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ment is issued for property, OID (if any) for the entire issue would first be computed under §1274 (as will be explained below), and this amount allocated to each series using the method set forth in the regulations. The definition also requires the serial obligation technique to be applied to debt instruments calling for payments reducing principal, a common example of which is the self-amortizing installment obligation as is commonly issued to purchase a house and consumer items. Under this method, providing for level payments over the life of the obligation, each payment is apportioned between principal and interest. Where the OID rules apply to such an obligation, it is broken down into a series of one month OID debt instruments each having an annual yield equal to the yield of the entire series.[29]

(2) Issue Price of Instruments Issued for Money

As to debt instruments not issued for property, (*i.e.*, for money) the issue price is defined in terms similar to those of §1232.[30] The §1232(b)(2) definition relating to instruments offered to the public was prefaced by the phrase "registered with the Securities and Exchange Commission," such registration is no longer a condition to the determination of the issue price, initial offering price, of publicly offered instruments issued for money.[31]

Where the debt instrument is issued for property (which includes the use of property and services, but excludes money) the issue price of the instrument for purposes of §1273 is its stated redemption price at maturity and hence, there is no OID.[32] This general rule is subject, however, to the special rule for instruments issued for traded property. This rule does not apply for purposes of §1274 providing specifically for the determination of the issue price of debt instruments issued for property (but "property" for §1274 purposes is not defined and thus *excludes* the *use* of property and services).

Observation: "Money" apparently refers only to U.S. dollars.[33] These rules thus do not apply to debt instruments issued by foreign entities denominated in foreign currencies.[34]

The "issue price" of instruments not issued for property and not offered to the public is, as under previous law, the price paid by the first buyer.[35]

(3) Issue Price Where Issued For Traded Property

Section 1273(b)(3) sets forth the rule formerly contained in §1232(b) that the issue price of a debt instrument is publicly traded and is issued for property, or issued for stock or securities traded on an established exchange, is the fair market value of either the debt instrument, or the traded stock or securities. Exchange quotations will usually determine fair market value.[36]

In all other cases, debt instruments issued for property, except those to which §1274 applies, have an issue price equal to their stated redemption price at maturity.[37] Section 483 may be applicable to transactions exempted by §§1271-1275.[38]

(4) Investment Units

Section 1273(c)(2) contains provisions similar to those of §1232(b)(2), relating to investment units (the issuance of debt instruments, usually privately placed debentures or notes, together with other securities, usually stock warrants as a package at a price which is usually not allocated by the parties to the elements of the unit). As under prior law, where an investment unit is issued, the issue price of the unit is to be determined under the principles set forth above, and such issue price is to be allocated to each element of the unit on the basis of the relationship of the fair market value of such element to the fair market value of all elements in the unit.[39]

b. Debt Instruments Issued for Untraded Property (§1274)

(1) General

Section 1274 sets forth provisions determining the issue price of any debt instrument issued for property where neither the instrument nor the property is publicly traded.[40] Such issue price is then compared with the redemption price payable at maturity, to determine whether or not there is OID. If there is OID, the rules of §1272 determine how much must be currently included in the income of the holder of the instrument (and, by operation of §163(e), how much may be deducted by the issuer).

(2) Computing the Amount of OID

Where a debt instrument is issued for property, the issue price is the "stated principal amount," *i.e.*, the stated sales price, *if* there is "adequate stated interest."[41] To determine whether there is adequate stated interest, the stated principal amount is compared with the "testing amount."[42] The "testing amount" is the sum of the present values of all payments to be made under the instrument determined by applying a discount rate of 110 percent of the "applicable federal rate" (AFR) compounded semiannually.[43] If the stated principal amount is *less than or equal to* the testing amount, there is adequate stated interest and, consequently, the stated principal amount is the instrument's issue price.[44] If the stated principal amount is *greater than* the testing amount, there must be computed the "imputed principal amount" by determining the sum of the present values of all payments to be made under the instrument, discounting at 120 percent of the AFR compounded semiannually.[45] This imputed principal amount is the instrument's issue price.[46]

The AFR is a rate to be determined by the Secretary within 15 days after the close of the six-month period ending on September 30 or the six-month period ending on March 31 of each year[47] (*cf.*, the determination of the rates applicable to interest on under and overpayments of tax under §6621(b)). There are to be three such rates; short-term (not more than three years), mid-term (not over nine years), and long-term (over nine years) applicable to debt instrument within such terms.[48] The AFR, based on the average market yield of marketed U.S. obligations, for the six-month period ending September 30 is to apply for the six-month period beginning on the succeeding January 1; such rate, based on the yield for the six-month period ending March 31, goes into effect the succeeding July 1.[49]

In the case of any sale or exchange, the determination of the AFR is made as of the first day on which there is a *binding contract in writing* for the sale or exchange.[50] Also, in determining the term of a debt instrument, there is to be taken into account any options to renew or extend.[51]

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The committee reports contain a number of guidelines to be taken into account by the Secretary in determining the AFR and points out that AFR manipulation may not be effected by renegotiating written contracts.[52]

Example: The ABC partnership issues a debt instrument for the purchase of a tract of land for development purposes. The stated principal amount is $1,500,000. The note provides for the payment semiannually of interest of 12.5 percent and matures in 20 years. The AFR (long-term) is 12 percent, as of the date there was a binding written contract for the sale of the land. Since 110 percent of the AFR is 13.2 percent, the instrument has OID. The sum of the present values of all payments due under the instrument, discounted at 13.2 percent compounded semiannually, will obviously be less than $1.5 million. To determine the *amount* of OID, all payments due under the instrument must be discounted at 120 percent of the AFR, *i.e.*, 14.4 percent. The sum of the present values of these payments so discounted is the imputed principal amount and issue price.

The Conference Committee modified the statute as proposed in the House and Senate bills to make it clear that so long as the sum of the present values of all payments to be made under a debt instrument at 110 percent of the AFR equal or exceed the stated principal amount, the latter amount is the issue price irrespective of whether the instrument calls for annual payments of interest. Thus, for example, in the case of an instrument calling for a balloon payment at maturity, and otherwise meeting the testing amount, an imputed principal amount will not be imposed based on 120 percent of the AFR. In the example discussed in footnote [27] *supra*, if 7.3 percent was equal to 110 percent of the AFR, the testing amount would be $1,000. Conf. Rep at 888.

It is possible for a debt instrument having a stated principal amount equal to the amount payable at maturity (but not the "stated amount payable at maturity" as defined by §1273(a)(2)) and bearing interest at 110 percent of the AFR to be an OID instrument.

Example: Assume a debt instrument issued in payment of a sales price of $1000x bearing interest at 110 percent of AFR (which will be assumed, for the sake of simplicity, to be 10 percent) payable at maturity in two years in the amount of $1000x. Applying the testing amount, the instrument does not appear to have OID. But, assume further that no interest was payable until the close of the 18th month after issue and at maturity in the amount of $105x each payment. The instrument bears 10 percent interest since the sum of the present values of all payments equals $1000x. The instrument has OID, however. It is a serial obligation composed of two series.

The first has a term of 18 months and has a SRPM of $105x. The second series has a term of 24 months and has a SRPM of $1105x. Applying the rules of Regs. §1.1232-3(b)(2)(iv)(f), the first series has an issue price of $91.04 and the second an issue price of $908.88.

Each of these series has a yield to maturity of ten percent. Therefore, while there is no adjustment to the stated principal amount, there is includible in the income of the holder during the first year $102.50.

Note: The imputed principal amount is the purchaser's *basis in the property* for all tax purposes, and is the amount received by the seller as the sales price for purposes of determining gain or loss.[53]

There are two clusters of special rules which must now be outlined. The first pertains to "potentially abusive situations," and the second relates to those transactions to which §1274 does not apply.

(3) Potentially Abusive Situations

Section 1274(a) lays down the general rule that the issue price of any debt instrument issued for property is (1) where there is adquate stated interest (*i.e.*, where the testing amount is satisfied), the stated principal amount, and (2) in all other cases, the imputed principal amount. There are two imputed principal amounts. The first, already discussed, is, where an instrument does not provide for adequate interest, the sum of the present values of all payments discounted at 120 percent of the AFR. The second imputed principal amount is determined under §1274(b)(3)(A) which provides that "[i]n the case of any potentially abusive situation, the imputed principal amount of any debt instrument received in exchange for property shall be the fair market value of such property, adjusted to take into account other considerations involved in the transaction." Subparagraph (B) defines "potentially abusive situation" as: (i) a tax shelter (as defined in §6661(b)(2)(C)(ii) and (ii) any other situation which, by reason of — (I) recent sales transactions, (II) nonrecourse financing, (III) financing with a term in excess of the economic life of the property, or (IV) other circumstances, is of a type which the Secretary specifies by regulations as having a potential for tax avoidance.

A typical abusive situation will involve the sale of depreciable property for a price in excess of its fair market value in order to provide the purchaser an inflated investment credit and cost recovery allowances. Such a transaction may involve a debt instrument providing for an adequate rate of interest, but is nonrecourse. In some circumstances, the instrument may provide for full recourse but will in practical effect be nonrecourse, because of the holder's inability to make collection (a note issued by a thinly capitalized corporation, for example). Also, where there is full recourse against a solvent issuer, the note may disguise interest as purported payments of principal — but this situation seems adequately taken care of by the interest imputation rules discussed above.

The committee report's commentary on the potentially abusive situation effects are confusing. In fact, the statute is unclear in this regard.

Example: Assume property worth $600,000. The purchaser wants as high a basis as possible. The seller wants to maximize long-term capital gain and minimize interest income. The parties agree on a ten-year note for $900,000 principal amount bearing interest at a rate which is below the AFR. Assume that applying 120 percent of the AFR, the imputed principal amount of the note is $700,000 (it will not be uncommon that 120 percent of the AFR is below the rate of interest

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which a commercial lender would demand on a privately issued note of this kind). However, an appraisal of the property results in an imputed principal amount of $600,000. There is, therefore, $300,000 of OID. Is this to be taken into account by both buyer and seller currently under §1272? It would seem that this is the result. Assume that after $150,000 of the OID has been so taken into account, the property's value has increased to $800,000. Is the OID to be recomputed at this time? Assume further that there is no interim appraisal and that the note is paid in full. What is the result?

The Committee report states:

"In case where the principal amount of an obligation is limited pursuant to the fair market value rule described above [referring to §1274(b)(3)(A)], the committee expects that *principal amounts in excess of the fair market value* of the property generally will be treated as contingent purchase price amounts with respect to the property, and will give rise to additional tax basis to the purchaser at the time such amounts actually are paid to the seller." (emphasis added). S. Rep. at 256.

The Committee Report, further, notes that if a nonrecourse obligation is given in exchange for property having a value less than the principal amount of the purported debt obligation, "the obligation will be disregarded in whole or in part under general principles of tax law. Moreover, the original issue discount which is nonrecourse will be subject to a periodic deduction only to the extent that, at the time such periodic deduction would otherwise be taken into account by the issuer, the value of the property exceeds the principal balance of the obligation plus any previously amortized original issue discount." [54] This, also, presents problems.

In the example given above, assume that the full amount of the purchase price has been paid. However, based on the $600,000 appraisal, $300,000 of the payments have been characterized as interest. How, in these circumstances, could there by payment of principal amounts in excess of the fair market value? Perhaps the committee had in mind nonrecourse indebtedness. But even here, the picture is unclear.

Example: Assume the same note as in the foregoing example, except that the note is nonrecourse. There is no need to determine an imputed principal amount since the $300,000 principal amount in excess of the appraised value is disregarded, *i.e.*, not taken into consideration as indebtedness for any purpose. Not only is the purchaser's basis in the property determined to be only $600,000, but interest payments attributable to the $300,000 excess are not allowed as deductions. There is no OID since the principal amount or issue price is equal to the stated redemption price at maturity (disregarding the $300,000 as aforesaid).

The only context in which these committee report comments might appear to make sense is where the note calls for periodic payments to be applied to principal. In the situation set forth in the examples above, assume that the note called for 10 semiannual payments of $95,024. At the end of the first year, $119,410 would have been applied to principal and the balance of the payments to interest. If the imputed principal amount is reduced to $600,000 creating $300,000 of OID, additional interest income is included in gross income of the seller and allowed as interest expense to the purchaser. Assume that at the end of the fifth year, more than $600,000 of principal has been paid under the terms of the note. Is OID then to be adjusted?

Note: The Conference Committee Report states that the conferees agreed that where the fair market value of the property exceeds the stated principal amount, a ***higher*** principal amount may be imputed.

Example: Assume property with a fair market value of $500,000 is purchased by a person in whose hands it is not depreciable. The seller would agree to exchange the property for a debt instrument having a present value of $500,000. This could take the form of a note having a stated principal amount of $400,000, bearing interest at 110 percent of the AFR, and having a stated redemption price at maturity sufficiently high to bring its present value up to the true sales price. In such a case, imputing a principal amount of $500,000 will result in reducing the purchaser's interest deductions.[55]

Undoubtedly regulations will be issued clarifying the problems described above.

(4) Exceptions

Section 1274 does not apply to any debt instrument unless some or all of the payments under the instrument are to be made more than 6 months after the date of the sale or exchange.[56]

(i) Sales for less than $1,000,000 of a farm (as defined by §6420(c)(2)) by an individual, estate or testamentary trust, or by a small business corporation (as defined by §1244(c)(3)) or by a partnership which meets the requirements of §1244(c)(3) — whether the corporation or partnership so qualifies is determined as of the date of the sale.[57] In applying the $1 million limitation, it must be determined at the time of sale that the sales price cannot exceed that amount.[58] Thus, additional contingent payments or provisions calling for a revision or adjustment of the sales price will be taken into consideration to this extent. Also, the limitation cannot be avoided by breaking what is essentially one sales transaction into a number of smaller sales and the like; all sales or exchanges which are part of the same transaction (or a series of related transactions) are treated as one sale or exchange,[59]

(ii) The sale by an individual of his principal residence (within the meaning of §1034),[60]

(iii) Any debt instrument providing for total payments (whether principal or interest) aggregating no more than $250,000, taking into account any consideration other than the debt instrument.[61] Consideration (other than debt instruments) is to be valued at fair market value.[62] An anti-fragmentation rule like that applied to the $1 million farm sale price is provided to prevent avoidance.[63]

Note: A note with $100,000 principal amount bearing 13 percent interest and payable in 240 equal monthly installments is subject to §1274.

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(iv) Transactions to which §1273(b)(3) applies (instruments which are publicly traded or are issued for publicly traded property),[64]

(v) In the case of the sale of a patent coming within §1235(a), any amounts contingent on the productivity, use or disposition of the patent,[65]

(vi) The issuer (obligor) of a debt instrument issued for what is termed "personal use property," and defined as any property substantially all of the use of which is not in connection with a trade or business or the production or collection of income (determined as of the date the instrument is issued).[66] This exception applies *only to the issuer, not to the holder/seller* whose capital gain (if any) is converted into interest income to the extent of any OID (or unstated interest under §483).

Where a debt instrument is issued in *connection with* the acquisition or carrying of personal use property (as distinguished from in consideration for the sale or exchange of such property, *e.g.*, where the instrument is issued for money which is then used to purchase personal use property) and has OID, if the issuer is a cash basis taxpayer, then notwithstanding §163(e) he may deduct OID only when paid.[67]

Example: Cash basis taxpayer A desires to purchase a small airplane for $30,000 for his personal use. The seller cannot finance the purchase. A has $5,000 to apply to the purchase price. His business associate L is willing to lend A $25,000 in exchange for A's note (secured by a lien on the aircraft) maturing in two years and providing for payment of 8 percent simple interest annually and a final payment at maturity of $30,000. The $5,000 of OID must be included by L in income currently under the provisions of §§1273 and 1272. A, however, may not claim any deductions for interest other than the currently payable eight percent until the note matures, at which time he is entitled to deduct the $5,000 of OID.

Note: It is assumed that the interest rate provided (taking the OID into account) is not a below-market rate. If the owner of the airplane were willing to finance the sale on these same terms, while §1274 would not apply (because the amount is under $250,000) §483 might apply to the seller. If the sales price financed were $300,000, then the personal use property exception to §1274 would apply. If the debt instrument issued by A had OID as determined under §1274, the OID rules would apply only to the seller, not to A.

(5) Debt for Debt Exchanges

Where traded debt instruments are exchanged for untraded property or where untraded instruments are exchanged for traded property, or where both are traded, the fair market value of the property will determine the issue price for purposes of determining OID. After TEFRA, but before the Technical Corrections Act of 1982 (P.L. 97-448) (TCA 1982), these provisions did not apply to instruments issued pursuant to a reorganization. Certain potentially abusive transactions were thereby rendered feasible. The TCA 1982 eliminated the exception relating to reorganizations, and added §1232(b)(4). These amendments were intended to put a stop to the potentially abusive transactions. However, under the provisions of §1274, there appeared a possibility that similar abusive transactions could arise involving the exchange, pursuant to a reorganization of a closely held corporation. The special rule relating to debt instruments issued pursuant to a reorganization, formerly §1232(b)(4), appears in the provisions as §1275(a)(4) rephrased to deal not only with the problem confronted in the TCA 1982, but also to similar transactions coming within the provisions of §1274.

Under pre-TCA 1982 law, a corporate taxpayer could issue an OID instrument and then, after deducting a portion of the OID under §1232 or §1232A, in a recapitalization, qualifying under §368(a)(1) as a reorganization, issue a new instrument (new bond) in exchange for the old bond. In such a transaction, the issue price of the new bond was its stated redemption price at maturity. One transaction which came to the attention of the IRS [68] involved the following exchange.

Example: Corporation retires a $1,000 bond having a fair market value of $650 in exchange for 21 bonds maturing in 30 years with a stated principal amount of $270 each and bearing nine percent simple interest payable at maturity. Each of these bonds is redeemable for $1,000 ($270 in principal plus $730 in accumulated interest). The holder of the old $1,000 bond thus receives bonds with a total stated principal amount of $5,670 on which interest computed on a straight line basis (nine percent per year) will accrue at the rate of $510 per year. At maturity, the new bonds will pay $21,000. Under pre-TCA of 1982 law, there was no OID. The issue price of each new bond was equal to its $1,000 redemption price. Section 483 did not apply since the nine percent simple interest test was met. The issuer in this case could claim (as an accrual basis taxpayer) interest on the set of 21 new bonds of $510 per year throughout the 30 year period. While there are grounds for disputing this claim, the tax consequences prior to the 1982 TCA were, at best, unclear. After the TCA of 1982 amendments, where the old bond was traded property, the issue price of the new bond would be the fair market value of the old bond. Further, under §1232(b)(4), the fair market value of the old bond is considered to be the greater of its adjusted issue price (*i.e.*, issue price plus any OID includible in the income of any holder) or its fair market value. If in the case described, the old $1,000 bond's adjusted issue price was $800 (the original issue price plus all OID includible in the income of the holder) the issue price of the new bond would be that amount rather than the actual $650 fair market value of the old bond. Thus, for the set of 21 new bonds, there would be for each new bond OID of only $100 deductible on a constant interest basis by the issuer over the life of the new bond.

Under the 1984 Act, the above transaction could give rise to OID even if neither side is traded property (provided it does not fall within any of the exceptions to §1274). If it does not fall within §1274, then it would be subject to §483. The special rule of §1232(b)(4) is amended to insure that it covers exchanges of a debt instrument for untraded property in a reorganization such as that described. Under §1275(a)(4), where in a debt instrument for debt instru-

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ment exchange pursuant to a reorganization, the amount which (but for §1275(a)(4)) would be the issue price of the new instrument, is less than the adjusted issue price of the old instrument, then the adjusted issue price of the old instrument is treated as the issue price of the new instrument.

Example: Corporation C, a closely held corporation, has outstanding an untraded bond, whose fair market value is $750,000, issued for $800,000 with a redemption price at maturity of $1,000,000. Of the $200,000 OID, $100,000 has been includible in the income of the holder. The adjusted issue price of the bond is therefore $900,000. The bond is exchanged, pursuant to a recapitalization, for a new bond issued by C with the same $1,000,000 redemption price at maturity. The issue price of the new bond is $900,000.

Note: It makes no difference what interest is paid on the new bond. Its issue price is fixed by the higher of the adjusted issue price or the fair market value of the old bond, and applying the definition of OID, stated redemption price at maturity less issue price, the OID is $100,000.

c. Current Inclusion in Income of OID (§1272)

(1) General — Significant Changes with Effective Dates

Once it has been determined under either §§1273 or 1274 that there is OID and the amount thereof, §1272 provides the rules for its inclusion in income. The rules relating to the current inclusion of OID in income are basically the same as those of repealed §1232A. There are, however, several significant changes summarized below:

(i) OID is currently includible in the income of the holder of an instrument issued by a natural person. This change is not effective as to instruments issued before March 2, 1984.[69]

(ii) OID is currently includible in the income of the holder of an instrument which is not a capital asset in his hands. This change is not effective as to instruments issued before December 31, 1984.[70]

(iii) The computation of the daily portions of OID currently includible in income is based on an "accrual period" rather than a "bond period."[71] The accrual period is the six month period (or shorter period from the date or original issue) ending with the date in the calendar year which corresponds with the *maturity date* of the instrument or the date 6 months before such date.[72] Computation of currently includible OID, as under the rules of §1232A, based on a bond period is retained for instruments issued after July 1, 1982 and before January 1, 1985.[73] The bond period is the 1-year period (or shorter period to the maturity date of the instrument) which begins on the date in the calendar year corresponding with the *date of original issue.*[74]

(iv) Where an OID instrument is acquired by purchase after original issue, the OID currently includible in the income of the new holder may be subject to reduction under §1272(a)(6). The formula for computing the amount of reduction is different from that applied under the TEFRA rules. This change is not to apply to any instrument purchased on or before July 18, 1984, and the rules of §1232A(a)(6) are to continue to apply to the holder of such instrument.[75]

(v) Current inclusion of OID in income is not applicable to: (i) tax-exempt obligations, (ii) U.S. savings bonds, or, (iii) short-term obligations (maturing not more than one year from the date of issue).[76] Only (iii) has changed from the previous statutory provisions.[77]

(2) Small Personal Loans

Specifically exempted from current OID accrual are also debt instruments (or any obligations) arising from non-business connected loans between individuals, whether or not related, not exceeding $10,000 (total amount of all loans outstanding) unless the IRS determines that such loan had as a principal purpose the avoidance of tax.[78] For purposes of this exception, a husband and wife are treated as one person (unless they lived apart at all times during the taxable year in which the loan was made).[79]

(3) De Minimis Exception

As under prior law, there is a so-called "de minimis" provision relating to the determination of the amount of OID by the holder of a debt instrument. In any case where the amount of OID determined as explained above is less than 1/4 of one percent of the stated redemption price at maturity multiplied by the number of complete years to maturity the OID is treated as zero.[80] This rule applies only to the holder of the instrument; it does not prohibit the deduction of "de minimis" OID by the issuer.[81]

(4) Definitions

The "date of original issue"[82] is defined in §1275(a)(2). Under prior law, where the instrument was registered with the SEC, the date of original issue was the date on which it was first sold to the public at the issue price. As was seen above, an instrument need not be registered with the SEC (as under the prior law) to be considered as publicly offered. For publicly offered OID instruments, the date of original issue is the date on which the issue was first issued to the public.[83]

Note: It is not clear whether this changed definition applies to instruments issued prior to the effective date of the new OID rules. Section 44(a) of the Act provides the general rule that the amendments made by subtitle C of the Act "shall apply to taxable years ending after the date of this Act." From this, it would seem that the "date of original issue" definitions contained in §1275 apply only to instruments issued after enactment of the 1984 TRA.

The date of original issue of privately placed instruments is, as under prior law, the date on which the instrument was first sold by the issuer.[84] This rule applies only to instruments not issued for property. For instruments issued for property, the date of original issue is the date on which the instrument was issued in a sale or exchange.[85]

Note: The "applicable federal rate" to be applied to determine OID in the case of an instrument issued for property is determined not on the date of original issue, but on the date on which there was a binding written contract for the sale or exchange,[86] an event that may well precede the date of original issue.

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(5) Computation of OID Currently Includible

Once it is determined that OID is currently includible in the income of the holder of a debt instrument, it is necessary to compute the amount accruable as interest income to such holder and, by operation of §163(e) (which incorporates the OID rules in determining the amount of interest allowable as a deduction for a taxable period), the issuer's interest deduction. Section 1272 adopts the same principle as did former §1232A, requiring the holder of an OID instrument to compute and include in gross income the "daily portions" of the OID for each day during the taxable year the holder held the instrument.[87]

Under §1232A enacted by TEFRA, the "daily portion" of OID includible in income for a taxable year was determined by allocating to each day in any "bond period" (one-year period (or shorter period to maturity) beginning on the day in the calendar year corresponding to the date of original issue) such day's ratable portion of the increase during such bond period in the adjusted issue price of the bond.[88] The increase in the adjusted issue price is an amount equal to the excess (if any) of:

> "the adjusted issue price at the beginning of the bond period multiplied by the instrument's annual yield to maturity (determined by compounding at the close of each bond period), over the sum of amounts payable over interest during the bond period." [89]

> *Example:* Under TEFRA rules, if the instrument's annual yield to maturity is ten percent and its issue price is $1,000, the increase in the adjusted issue price for the first bond period is $100. If interest of, say, $50 is paid during this period the increase in the adjusted issue price is limited to the excess of $100 over the $50 payable interest, or $50. Compounding the interest (*i.e.*, adding unpaid accrued interest to principal) the adjusted issue price as of the beginning of the next bond period would be $1,050. Allocated to each day in the bond period is $50/365. If the bond were held during the taxable year for 100 days of the bond period, the holder would accrue $13.70 of OID in income.

Effective as to instruments issued after December 31, 1984,[90] the "bond period" is changed to the "accrual period." [91] "Accrual period" is defined as (except as otherwise provided by regulations) a six-month period (or shorter period from the date of original issue) ending on the day in the calendar year corresponding to the maturity date of the instrument or the date six months before such maturity date.[92]

> *Example:* A bond issued on February 1, 1984 and maturing on January 31, 1994 will have two accrual periods: (i) August 1 - January 31, and (ii) February 1 - July 31.

To compute the amount of OID includible in a taxable year, it is first necessary to determine the instrument's accrual periods falling within the year, and then to determine the number of days in each accrual period the instrument was held. Next, determine the adjusted issue price of the instrument at the beginning of each accrual period (if more than one are included). This is the issue price plus any amounts of OID includible in the income of any holder since the date of issue. This adjusted issue price is then multiplied by the yield to maturity computed to take into account the length of the accrual period (*i.e.*, the annual yield times the fraction of one year covered by the accrual period, usually 1/2). The product is then reduced by any interest payable during the accrual period. This is the amount of OID includible in income. This amount is added to the adjusted issue price to determine the adjusted issue price at the beginning of the next accrual period, and so forth.

> *Example (1):* On March 31, A acquires a bond on the date of issue for $80,000. Its redemption price at maturity is $100,000. The yield to maturity is 13 percent. Interest payments are made semiannually in the amount of $5,000. Assume that the first accrual period is three months (a shorter than 6 month first accrual period will be somewhat unusual, but may occur). For the accrual period ending June 30, there is computed $2,600 of OID. Assume that interest of $2,500 is paid for this three month period. This must be deducted from the $2,600. Total OID includible is, therefore, $100. This is added to the $80,000 issue price to obtain the adjusted issue price for the next accrual period. The next accrual period ends on December 31, on which date A still holds the bond. Interest of $5,000 is paid. The yield times the adjusted issue price is $5,206.50. Subtracting the $5,000 interest payment leaves $206.50 to be included for this period. Total OID for the year is $306.50. Assume that A sells the bond to B the following year on February 29. A will compute the OID for the accrual period ending June 30 and include 60/182 of this amount in income (assuming that no interest is paid on the instrument until June 30). The yield times the adjusted issue price as of January 1 (the beginning of the accrual period) is ($80,306.50 x 6.5 percent) or $5,219.92. From this amount must be deducted the $5,000 in interest payable on June 30, the last day of the accrual period. This deduction is required even though A will not receive the interest. B's right to receive this interest is reflected in the price paid for the instrument. There is included in A's income for the year of sale 60/182 x $219.12 or $72.24. This is added to his basis in the instrument for purposes of determining gain or loss on the sale. B, on June 30, will compute the OID using the $80,306.50 adjusted issue price as of January 1 times the period yield of 6.5 percent to obtain the OID for the accrual period ending June 30. This will be reduced by interest paid of $5,000. The result will then be multiplied by 122/182 to obtain the sum of the daily portions of OID attributable to the accrual period ending June 30. Applying these computations, $147.42 is included in B's income for the period. The adjusted issue price is raised to $80,526.15 at the beginning of the accrual period ending December 31, and so forth. Note that if B had paid more than $80,378.74 for the instrument, the OID includible by him in income would be subject to reduction under §1272(a)(6), explained below. This is not taken into account in this example.

> *Example (2):* A debt instrument is issued in 1985 for the issue price of $827,893.65 maturing in three years. Interest of $25,000 is payable semiannually. The redemption price at maturity is $1,000,000. The yield to

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maturity is 12 percent. The $172,106.39 of OID is taken into income of the holder as follows:

Accrual Periods:

1) $24,673.62

2) $26,154.03. . .and so forth.

The rules relating to the current inclusion of OID in income apply generally to obligations issued after *July 1, 1982.*[93] However, as the switch from the bond period to the accrual period would cause considerable problems, for purposes of computing currently includible OID under §1272 with respect to debt instruments issued after July 1, 1982 and before January 1, 1985, the accrual period is a one year period (or shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue (*i.e.*, the same as the bond period provided by §1232A).[94]

Example: An OID instrument was issued on March 1, 1983. The bond period for purposes of determining the daily portions of OID for the holder's calendar year is March 1, 1983 — February 29, 1984. Without the effective date provision set forth above, for 1984, for periods after July 18, 1984, the daily portions of OID would have to be based on accrual periods March 1 - August 31 and September 1 — February 29. But there is no adjusted issue price for March 1, 1984 based on the increase for the preceding 6-month period. With respect to such instrument, computation of OID currently includible in income is exactly the same as under repealed §1232A.

Note: Where the issue price of an instrument is based on the imputed principal amount, the yield to maturity of the instrument is 120 percent of the AFR in effect as of the date there was a binding contract in writing for the sale or exchange.

Where the debt instrument provides for only one payment of interest per year, the method described above to determine the OID allocable to each day in an accrual period applies. The adjusted issue price at the beginning of an accrual period multiplied by the annual yield of the instrument can never be less than the amount of interest payable during that period, *unless* the interest payable during such period exceeds interest payable at a fixed rate during the life of the instrument at least annually, in which case the interest payment is considered a maturity of a serial obligation as explained above.

Example: Assume a debt instrument like that described in the Example (2) above with the difference that a $50,000 interest payment is made on December 31 of each year. The date of issue is January 1. If the market calls for a 12 percent interest rate, the instrument will be worth $824,313.07 (the present values of all payments to be made discounted at 12 percent compounded semiannually). The OID is therefore $175,687 (as compared to OID of $172,106 where interest is paid semiannually). The increase in the adjusted issue price for the first accrual period is $49,458.78, and for the second accrual period is $2,426.31. Total interest includible for the year (including the $50,000 payment on December 31) is $101,885.01 as compared with $100,827.65 on the bond with semiannual payments of interest.

(6) Reduction of Currently Includible OID Where Holder Paid Acquisition Premium

Where after the date of original issue, the holder sells the interest, some adjustment may have to be made in computing the OID included in the buyer's income. If interest rates have risen since the instrument was issued, the sales price will usually be less than the holder's basis, in which case there arises acquisition or "market" discount. If rates have decreased, the holder can usually sell the bond at a gain, in which case the purchaser pays "acquisition premium." In this case, the original issue price and adjusted issue price remain unchanged, as does the stated redemption price at maturity. The new holder must still compute OID in the same manner as the former holder, but the OID is reduced. The daily portion of OID includible in the holder's income is multiplied by a fraction:

$$\frac{\text{(cost)} - \text{(issue price + portion of OID previously includible in gross income of any holder)}}{\text{sum of daily portions for all days from purchase date to stated maturity date}}$$ [95]

Note: (1) The reduction formula is not to be applied in computing the values of either the numerator or denominator. (2) OID not includible in the gross income of any holder is not taken into consideration in determining the value of the numerator. (3) The "stated" maturity date may be different from the maturity date if the instrument is amended by the parties.

Example: P purchases from the holder a bond whose yield to maturity is 14 percent (computed by the holder as outlined above) and whose basis (issue price plus OID included in holder's income) on the date it was sold was $10.7x. P pays $13x for the bond. The total of the daily portions of OID from the date of purchase to maturity of the bond is $5x. The value of the fraction set forth above is thus .46. P computes the sum of the daily portions of OID for each accrual period and multiplies the result by .46 to arrive at the amount includible in income for that period. Note that the initial computation before application of the reduction fraction is to be completed as if the purchaser were the original holder. The adjusted issue price is therefore increased each accrual period on the basis of the OID as originally computed without regard to the reduction fraction. P's basis in the instrument, however, is increased only by the amount of OID includible in income.

In the case of debt instruments issued by corporations after May 27, 1969 and before July 2, 1982 (TEFRA effective date) for which OID is currently includible on a straight-line basis, the reduction formula is the same as that set forth above, except that the denominator is the number of complete months (plus any fractional part of a month) from the purchase date to maturity.

For debt instruments subject to the OID rules of TEFRA instruments issued by an issuer other than a natural person after July 1, 1982), the reduction formula under §1232A(a)(6) is:

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$$\frac{\text{(cost) − (issue price + sum of daily portions of OID for all days before the date of purchase)}}{\text{Number of days from purchase date to maturity}}$$ [96]

Under Act §44(i)(2), the §1232A(a)(6) formula applies to OID instruments purchased on or before July 18, 1984 (date of enactment of the 1984 TRA).

(7) Pre-TEFRA Instruments

Accrual of OID on a straight-line or ratable basis, as under §1232 prior to TEFRA, applies to all corporate debt instruments issued after May 27, 1969 (when current accrual of OID was first required but restricted to corporate debt instruments) and before July 2, 1982 (TEFRA effective date). These OID accrual rules, including the rules applicable to the treatment of acquisition discount with respect to such instruments, remain unchanged. Also, after the enactment of TEFRA, constant rate interest accrual of OID was required for both corporate and governmental obligations (but not instruments issued by individuals). While §1272 applies to instruments issued by natural persons, under §1272(a)(2) this is effective only as to instruments issued on or after March 2, 1984. Holders of instruments issued by natural persons before that date are not required to include OID in income currently.

(8) Special Rules

The OID rules, both before and after the Act, do not apply to any holder who has purchased the instrument at a premium or to any life insurance company holder to which §811(b) applies.[97]

The term "purchase" does not apply to any acquisition of an instrument in circumstances where its basis in the hands of the acquiring person is determined *to any extent* by reference to the adjusted basis in the hands of the person from whom acquired.[98] Under §1232A(c)(2), the term "purchase" excluded acquisitions where the basis of the bond was determined under §1014(a) (relating to property acquired from a decedent). This does not apply to instruments acquired after July 18, 1984.

Finally, §1272(d)(2) provides, as did prior law, that the basis of any debt instrument in the hands of the holder shall be increased by the amount includible in gross income by §1272.[99]

If at the time the instrument was issued, there was an intention to call it before maturity, some portion of what would otherwise be capital gain may be characterized as ordinary income.[100]

Example: Assume a three-year note issued for $8,000 cash with a redemption price of $10,000, with no interest payable during the life of the note (a so-called zero coupon instrument). The annual yield to maturity is approximately 7.56 percent. Assume an issue date of January 1. On June 30, the holder accrues $302.40 of OID, and on the following December 31, he accrues $313.83. At that time, the adjusted issue price is $8,648.63. The instrument is sold for $9,000. The new holder accrues OID for the first accrual period ending June 30 (as reduced under §1272(a)(6)) of $83.04. His basis in the instrument is thus $9,083.04. On July 1, he sells the instrument for $9,200. If at the time the instrument was issued, there was an intention to call it before maturity, the $116.96 gain is ordinary income to the extent of the OID ($2,000) reduced by the amount of such OID includible in the income of any holder without regard to §1272(a)(6),[101] *i.e.*, the OID which would have been includible in the income of the first holder through the third accrual period, or $975.55. Thus any gain on the sale of the instrument, where there was an intention to call it before maturity, $1,024.45 is ordinary income. If there was no such intention, the holder's gain, in this case, would be all capital gain. If the sale takes place at some date other than the day after the end of an accrual period, the daily portion of OID is computed to the day before the date of sale and included as interest income for that year. The holder's basis is adjusted to include this gain, and the gain is all capital gain. Of course, where the instrument is not a capital asset in the hands of the holder, all gain is ordinary income in any event. The rule set forth does not apply to tax-exempt obligations or to any holder who has purchased the debt instrument at a premium.

Where a debt instrument having OID is publicly offered, §1275(c) requires that certain information appear on the debt instrument.

The Secretary is granted very broad regulatory authority to modify the OID rules in the specific areas applicable to instruments having varying rates of interest, situations involving put and call options, indefinite maturities, contingent payments, assumptions of debt instruments, "*or other circumstances" where the statute does not carry out the purposes of subpart A* (the OID rules) of part V of subchapter P. These regulations will therefore be legislative in effect.[102]

(9) Conforming Amendments to §163

In connection with the above OID rules, the Act amends §163(e) (which, as under prior law, makes the interest deduction allowable to the issuer under §163 consistent with the inclusion of OID in the holder's income) to provide that:

In the case of any debt instrument issued after July 1, 1982, the portion of the OID allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the OID during such taxable year.[103] "Debt instrument" has the same meaning as under §1274(a)(1).[104] The daily portion is to be computed under §1272(a), without regard to §§1272(a)(6) and 1273(a)(3).[105]

4. Market Discount

a. General

Where a debt instrument is purchased at a price less than the stated redemption price, the difference is termed "market discount," as defined by §1278.[106]

Prior to TRA 1984, there were no provisions applicable to market discount. When the instrument was sold or exchanged, the holder's gain (where the instrument was held as a capital asset) was capital gain despite the fact that such gain, aside from any amount attributable to a

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decrease of interest rates, had all of the characteristics of interest.[107]

Example: The purchaser of a corporate bond bearing 12 percent interest, having a redemption price at maturity of $10,000, and a ten-year term, half of which has expired; in a market where the interest rate on bonds of similar quality is 15 percent, may pay, say, $8,500 [108] for the instrument. His position is indistinguishable from the purchaser at the time of its original issue of a five-year bond bearing 12 percent interest maturing in five years with a redemption price of $10,000. Carrying through the time value of money reforms commencing with TEFRA, Congress decided to require that taxpayers take into account as ordinary income, gain attributable to market discount at the time of disposition of the debt instrument.

Another problem addressed by Congress in the 1984 TRA is the practice of leveraged purchases of market discount bonds. Even if market discount must be taken into account as ordinary income on the disposition of a market discount bond, where such bond has been purchased with borrowed funds and the interest on such funds is currently deducted, the holder obtains a tax advantage. The interest deductions offset current unrelated income, effectively deferring payment of tax on the market discount gain to be recognized in a later taxable period. Rules providing for the deferral of such interest until the year in which the market discount is included in income are dealt with in subpart B of part V of subchapter P, containing §§1276 through 1278. Section 1276 relates to the treatment of "disposition gain"; §1277 provides rules for the deferral of deductions for interest on money borrowed to purchase or carry market discount bonds; §1278 provides definitions and special rules.

b. Disposition Gain

(1) General

In drafting the market discount provisions, Congress referred throughout to "market discount bonds," using the term "bond" (as under prior law), rather than the term "debt instrument." The heading of subpart B as originally enacted "Market Discount on Bonds" was amended by (H. Con. Res.) 328 (June 29, 1984) to strike out the words "on Bonds." But the provisions of §§1276-1278 use the terms "bond" and "bonds," referring to debt instruments of all descriptions. It is to be understood that *all* debt instruments except those specifically excluded are included in the meaning of this term.

(2) Exceptions

The market discount rules (§§1276-1278) do not apply to: (i) *short-term obligations* (having a fixed maturity date not more than one year from the date of issue),[109] (ii) *tax exempt obligations* (as defined by §1275(a)(3)),[110] (iii) *U.S. savings bonds*,[111] or (iv) *installment obligations* to which §453B applies.[112]

(3) Ordinary Income Treatment of Disposition Gain

As stated above, market discount is defined as the excess of the stated redemption price at maturity of a bond over its basis immediately after its acquisition by the taxpayer. In the case of a bond having OID, the stated redemption price at maturity is treated as equal to its "revised issue price." [113] For this purpose, "revised issue price" is defined as the sum of the issue price of the bond plus the total amount of OID includible in the income of all the holders up to the date of purchase without reduction by acquisition discount under §1272(a)(6) or (b)(4).[114] These terms (stated redemption price at maturity, issue price, original issue discount) have the same meanings as in the OID rules of §§1271-1275.[115]

The general rule of §1276 is that any gain on the disposition of a market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. This gain must be recognized notwithstanding any other provisions of subtitle A of the Code (income taxes).[117]

The term "disposition" is not limited to a sale or exchange. It means any transaction qualifying as a disposition, *i.e.*, transfer of ownership or retirement. The accrued market discount is to be computed using a ratable inclusion of such discount.[118] This ratable accrual is based on the number of days the bond has been held, divided by the number of days after the date of acquisition through the maturity date.[119] This fraction is multiplied by the amount of market discount. Thus, if market discount is $1,000, the bond matures in 1000 days and has been held for 500 days at the time it is disposed of, gain to the extent of $500 is ordinary income.

The amount required to be included as ordinary income is to be treated as interest for all purposes of the Code except; §871(a) and §881 (imposing a tax on U.S. source income of foreign individuals and corporations not connected with a U.S. business), §§1441 and 1442 (requiring withholding on certain periodic income from U.S. sources of foreign individuals and corporations), §6049 (requiring an information return to be filed by the payor of interest to certain persons).[120]

(4) Elections Available

The holder of a market discount bond may elect to accrue such discount on a constant interest rate basis (as if the market discount were OID) for the entire period during which he holds the bond.[121] Such election is irrevocable, but may be made with respect to each bond held.[122] That is, if made with respect to one bond, it does not apply to other market discount bonds held by the electing taxpayer.

If the election is taken:

"the accrued market discount on such bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a) with respect to such bond for all periods during which the bond was held by the taxpayer if such bound had been—

"(i) originally issued on the date on which such bond was acquired by the taxpayer, and

"(ii) for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition." [123]

It is important to note that when the statute refers to the "accrual" of market discount, it does not mean the

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current inclusion of such a discount in income, as is the case with OID. The discount is accrued for purposes of determining the amount of gain to be treated as ordinary income upon disposition of the bond. If market discount is accrued on a constant interest rate basis, and the bond is sold before maturity at a gain, there will be less market discount to be taken into account than under ratable accrual since under a constant rate accrual, less interest accrues during the early years than under a ratable method.

Example: Thus, under the foregoing election, if the bond has a stated redemption price at maturity of $10,000 and is purchased for $8,000, the $2,000 of market discount is accrued as if it were OID on an OID bond issued originally for $8,000 and having a stated redemption price of $10,000; *i.e.*, the $10,000 will be discounted from the maturity date to the date at which accruals are being measured based on the bond's effective rate of interest.

Where a bond having OID is purchased, and the new holder elects to accrue market discount on a constant interest basis, there exists a situation illustrated in the following example:

Example: Assume a zero coupon bond maturing in 5 years and having a redemption price at maturity of $10,000. The issue price of the bond is $5,000. The yield on this bond is 14.36 percent. The original holder holds the bond for two years, including in income $1,598 of OID (four accrual periods). At this time, he sells the bond to purchaser P. Since under §1278(a)(2)(B), for purposes of determining market discount, the stated redemption price at maturity of the bond is treated as equal to its revised issue price (issue price of $5,000 plus $1,598 of OID includible in the income of all holders), if the bond is sold for exactly $6,598, there is no market discount. This same rule applies where the purchaser elects to accrue market discount on a constant interest basis. Assume that P purchases the bond for $6,000. A nonelecting purchaser would continue to include OID in income as did the former holder and would, in addition, accrue the acquisition discount of $598 (excess of $6,598 over P's basis of $6,000) ratably over the three years remaining to maturity.

A holder electing to accrue market discount on a constant interest basis would, instead, compute the yield to maturity of a bond issued for $6,000 and maturing in three years at a price of $6,598. The yield is 3.19 percent, and this, presumably, will be applied to compute the daily portions of accrued market discount.

However, §1276(b)(2)(B)(ii) provides that in a case such as this, "the portion of the original issue discount which would have been includible in the gross income of the taxpayer under §1272(a) shall be made under regulations prescribed by the Secretary."

While the situation discussed in the example involves a zero coupon bond, the computation will be more complex where the bond pays coupon interest. In computing the OID includible in income, interest paid during the accrual period is deducted in determining the increase in the adjusted issue price for the period. Where acquisition discount on the bond is to be accrued in the same manner as OID, what portion of the current interest payments are to be applied, if any? The regulations would appear to have this situation in mind.

The taxpayer may also elect to include market discount currently,[124] that is, to include such market discount in income using *either* a straight-line or constant interest rate method. If such an election is made, it applies to all market discount bonds acquired by the taxpayer on or after the first day of the taxable year to which the election applies.[125] Once made, this election also applies to all future years unless the Commissioner consents to its revocation.[126] If this election is made, then the accrual of market discount under the rules set forth immediately above does not apply, nor do the rules relating to the deferral of interest deductions to be discussed below.[127]

(5) Nonrecognition Transactions

It was stated above, that where a market discount bond is disposed of at a gain, such gain must be recognized for purposes of treating accrued market discount as ordinary income notwithstanding any other provisions of subtitle A of the Code,[128] and that a disposition occurs whenever there is a transfer of ownership, however effected. Further, for purposes of this rule, a person disposing of a market discount bond other than by a sale, exchange or involuntary conversion is treated as realizing the fair market value of the bond.[129] This rule is similar to the rule relating to the disposition of §1245 property (requiring depreciation recapture). The statute provides that rules similar to those of §1245(b), except §1245(b)(1), shall be prescribed by regulations applicable to dispositions of market discount bonds.[130] Section 1245(b)(1) excludes from the provisions of §1245(a) transfers by gift.

Section 1245(b)(3) provides that if the basis of property transferred in certain tax-free transactions is determined by reference to its basis in the hands of the transferor by reason of the application of §§332, 351, 361, 371(a), 374(a), 721 or 731, then the amount of gain taken into account by the transferor under §1245(a)(1) is not to exceed the gain to be recognized by the transferor (without regard to §1245). The regulations to be prescribed under §1276 are to follow §1245(b)(3) and to include in the transactions to which tax-free treatment is accorded exchanges qualifying under §§354(a), 355(a) and 356(a).[131] The latter three sections relate to exchanges either effected pursuant to corporate reorganizations or certain distributions of property by a controlled corporation. Under their provisions, the property received in such an exchange, generally, has a basis equal to the basis of the property given up.

These regulations are also to provide for an adjustment to the basis of property reflecting gain recognized under the general rule of §1276(a).[132] Thus, if a market discount bond is transferred as a gift resulting in recognition of gain by the transferor on its disposition, the transferee's basis will be adjusted (increased) to reflect such gain.

(a) Special Definitions (§43(a) of the Act)

The Code contains what are commonly referred to as "nonrecognition provisions." A "nonrecognition transaction" is defined by §7701(a)(45) (added by §43(a)(1) of

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the Act) as: "any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A." Further, with respect to some of these transactions, it is provided that the basis of the property transferred in the hands of the transferee is to be determined in whole or in part by reference to its basis in the hands of the transferor. Such property is, under §7701(a)(43) termed "transferred basis property." In other nonrecognition transactions, the Code provides that the basis of property received by the transferor in an exchange is to be determined in whole or in part by reference to the property given up in the exchange. Section 7701(a)(44) terms such property "exchanged basis property." Section 7701(a)(42) terms both kinds of property (transferred and exchanged basis property) "substituted basis property." The former definition, contained in the last sentence of §1016, is deleted (Act §43(a)(2)).

Under the general rule of §1276(a) (like that of §1245(a)) gain is recognized from the disposition of appreciated market discount bonds notwithstanding the nonrecognition provisions. But, exeptions similar to those of §1245(b) are made as has been explained above. Section 1276(c) provides the treatment to be accorded market discount bonds disposed of in nonrecognition transactions.

(i) Where the bond is transferred basis property in the hands of the transferee, accrued discount in the hands of the transferee is determined as if the transferee had acquired the bond on the same date as the transferor and for an amount equal to transferor's basis at the time of transfer.[133] Adjustments are to be made reflecting (A) any gain recognized by the transferor, and (B) for any OID or market discount included in the income of the transferor.[134]

Example: Individual taxpayer A transfers a market discount bond to a controlled corporation in a transaction qualifying under §351. As part of the transaction, A receives from the corporation property other than stock or securities and, as a consequence, recognizes gain. This bond was issued at discount and acquired by A from its holder by purchase. At the time of the transfer to the corporation, A's basis in the bond, including OID includible in his income to the date of transfer, was $6,300. Since its purchase, A had accrued to the date of transfer $500 in market discount. In the hands of the corporation, the bond has a basis of: $6,000 (A's cost) + $500 (gain recognized by A on the transfer) + $300 (OID included in A's income during the period he held the bond) = $6,800. If, after accruing another $500 of market discount, the bond is distributed to A in a complete liquidation, the corporation will be treated as having sold the bond for its fair market value. At that time, the accrued market discount of $1,000 is treated as ordinary income to the extent of any gain realized by it on the disposition of the bond.

(ii) Where the bond is exchanged for other property in a nonrecognition transaction and such other property is exchanged basis property in the hands of the taxpayer:

(A) Where such other property is a market discount bond, the accrued market discount on the bond exchanged (to the extent not treated as ordinary income under §1276(a)) is attributed to the bond received,[135]

(B) Where such other property is not a market discount bond, the accrued market discount on the bond exchanged is to be treated as ordinary income on the disposition of such other property (*i.e.*, the property received).[136]

Example: Taxpayer A pursuant to a recapitalization qualifying under §368(a)(1) receives in exchange for a market discount bond (old bond), with respect to which there has accrued $500 in market discount, a corporate bond (new bond). Whether or not the old bond had OID or whether the bond received has OID is irrelevant as is whether any gain was recognized in the transaction. The $500 in market discount is attributed to the new bond, and to the extent of any gain realized upon the disposition of such new bond, the $500 is treated as ordinary income. Of course, any OID included in A's income with respect to the old bond as well as any gain recognized in the transaction are reflected in A's basis in the new bond and, accordingly, in the determination of gain realized upon its disposition.

If the basis of any market discount bond in the hands of a transferee is determined under §334(c) (property received in a §333 liquidation), §732(a) or §732(b) (distributions by a partnership to a partner other than in liquidation and liquidating distributions of a partnership, respectively) it is to be treated as transferred basis property in the hands of such transferee.[137]

Note: The definitions added by Act §43 apply to the entire Code. "Transfered basis property" is also used in the provisions of §467.

(b) Effective Date and De Minimis Rule

The provisions of §1276 outlined above are not to apply to any market discount bond *issued* on or before, July 18, 1984, the date of enactment of the 1984 TRA.[138]

A *de minimis* exception identical to that applicable to §1272 applies to market discount, namely, if the market discount is less than 1/4 of one percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity after acquisition of the bond, market discount is deemed to be zero.

c. Deferral of Deductions for Interest

Section 1277(a) sets forth the general rule that the "net direct interest expense" with respect to any market discount bond, (meaning the excess of (if any) of interest paid or accrued during the taxable year on indebtedness incurred or continued to purchase or carry a market discount bond, over the aggregate amount of interest (including OID) includible in gross income with respect to such bond, is allowable as a deduction only to the extent it exceeds the market discount accrued on the bond while held by the taxpayer during the taxable year.

The general rule is that any interest so deferred, termed "disallowed interest expense,"[139] is treated as interest paid or accrued in the year in which the bond is disposed of. It is then deductible, subject to any other Code limitations (*e.g.*, §163(d)) whether or not gain is recognized from the disposition.[140]

An election is provided by §1277(b)(1) under which disallowed interest may in some cases be treated as paid or

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accrued in a year prior to the year in which the bond is disposed of. If the election is made, and there is "net interest income" from the bond, meaning the excess of any interest (including OID) includible in gross income with respect to the bond over interest paid or accrued during the year on indebtedness incurred to purchase or carry the bond,[141] then to the extent of such net interest income, any disallowed interest with respect to the bond is treated as paid or accrued for that year.[142]

The statute provides that the disallowed interest expense, for purposes of making the election, is determined at the close of the preceding taxable year, and that it shall not take into account any amount as to which an election to treat it as paid under §1277(b)(1) has been made.[143]

Example: A purchases a market discount bond in Year 1 from which he receives during the year $12,000 in coupon interest. The bond also has OID of which A is required to include $10,000 in income for the year. A elects to accrue market discount on a constant interest basis. Such discount accrued for Year 1 is $6,000. A pays during Year 1 $28,000 in interest on funds borrowed to purchase or carry the bond. A's net direct interest expense is $6,000. Since this does not exceed the accrued market discount, it is disallowed interest for Year one. In Year two, coupon interest is still $12,000, but OID income has increased to $12,500. Also, accrued market discount for Year two has increased to $6,800. In this year, A pays interest of only $18,000 on in debtedness incurred to carry the bond (having paid off a portion of the principal). In Year two, there is net interest income of $6,500. To this extent, the interest disallowed for Year one ($6,000) is treated, at the election of the taxpayer, as paid or accrued in Year two and may, therefore, be deducted (subject to any other Code restrictions). As a result of this election, interest expense incurred with respect to the bond is $24,000 (the $6,000 treated as paid in Year two plus the $18,000 paid during the year). There was also, as has been seen, $24,500 of interest on the bond included in A's income. Thus, there was no net direct interest expense for the year, and all of the $18,000 paid is currently treated as paid or incurred in Year two. If the bond is disposed of at the end of Year two, for a gain of $7,500, all of this gain is treated as ordinary interest income (since it does not exceed the $12,800 in accrued market discount).

Where a market discount bond is disposed of in a nonrecognition transaction (as explained above), and there is disallowed interest expense with respect to the bond, such expense is treated as paid or incurred only to the extent gain is recognized from the transaction.[144] Where there is no gain, or the gain is less than the disallowed interest expense, it is carried over to the transferee where the bond is transferred basis property.[145] The disallowed interest expense is then allowed to the transferee upon his disposition of the bond. Where property received in the transaction in exchange for a market discount bond is exchanged basis property, then the disallowed interest is allowed in the year such exchanged basis property is disposed of.[146]

Example: A holds a market discount bond with respect to which there is $500 of disallowed interest. He disposes of the bond by transferring it to a partnership in a transaction qualifying under §721(a). No gain is recognized on the transfer. The partnership, upon its disposition of the bond, is entitled to treat the $500 as interest paid or accrued in the year of disposition. A holds another such bond which is exchanged for other property in a corporate reorganization. The exchange qualifies under §354(a), A taking a basis in the property received determined by reference to his basis in the market discount bond transferred. The $500 in disallowed interest is treated as paid or accrued by A upon his disposition of the property received.

Query: In this latter case, if the property received is an interest bearing debt instrument, may A make an election under §1277(b)(1)?

It is important to understand that the interest deferral provisions explained above apply to all market discount bonds regardless of the date on which they were issued. Market discount accrues on such bonds acquired after July 18, 1984 (date of enactment of 1984 TRA), just as it does in the case of bonds issued after the date of enactment,[147] but there is no requirement that accrued discount on such pre-enactment bonds be treated as ordinary income upon their disposition.[148]

Where interest is disallowed with respect to a pre-enactment bond, and gain is recognized by the holder upon the disposition of the bond (*i.e.*, sale, exchange, retirement, but not gift or other nontaxable transfer) [149] then to the extent of such gain, any disallowed interest expense is treated as ordinary income.[150] In many cases, the disallowed interest expense treated as paid in the year the bond is disposed of and the ordinary income recognized under the preceding rule will exactly offset each other.

Example: Calendar year individual taxpayer A purchases a market discount bond on November 16, 1984. The bond was issued in 1983. If A has paid or accrued any interest on debt to purchase or carry the bond, he must compute and accrue market discount on the bond for the days during 1984 and subsequent years during which he holds the bond. The interest deduction deferral rules of §1277 will apply to restrict the deduction of such interest. When the bond is disposed of, all disallowed interest expense will be treated as paid or accrued in the year of disposition. If the bond is disposed of at a gain, then to the extent of the disallowed interest treated as paid or accrued by reason of §1277(b)(2), such gain is treated as ordinary income.

Assume that the disallowed interest at the time the bond was disposed of in 1986 was $1,800, and that gain was recognized on such disposition (without regard to §1276(a)(1)) in the amount of $2,500, the gain will be treated as ordinary interest income to the extent of $1,800. This will offset by $1,800 the interest deduction allowable.

If a bond is disposed of in a nonrecognition transaction, the same rules apply as those explained above relating to post-enactment bonds. The disallowed interest will be carried over to transferred basis property and will attach to exchanged basis property and will be allowed only when such property is disposed of.

If the bond in the above example is disposed of by way of gift, while no gain is recognized, the disallowed interest

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is allowed in the year of disposition. If it is disposed of by transfer to a controlled corporation in a transaction to which §351 applies, the disallowed interest is not allowed at the time of transfer, but will be allowed to the transferee in the year the bond is disposed of. If the transferee disposes of the bond at a gain, then such gain, to the extent of the disallowed interest allowed is treated as ordinary interest income.[151]

One problem to be anticipated in applying the rules of §1277 is determining whether indebtedness of the holder of a bond was incurred to purchase or carry the bond. This problem is often encountered in applying §265(2), disallowing deductions for interest on indebtedness incurred to purchase or carry a tax-exempt obligation. Presumably, the IRS will look to Rev. Proc. 72-18, 1972 C.B. 740, as clarified by Rev. Proc. 74-8, 1974-1 C.B. 419 for guidance. In the case of banks and other financial institutions, within the meaning of §§585 or 593, §1277(c) provides that principles similar to those of §291(e)(1)(B)(ii) are to be applied. Thus, unless the taxpayer bank establishes otherwise, interest paid on indebtedness incurred to purchase or carry market discount bonds is determined by multiplying total interest paid or accrued during the taxable year by the fraction: average adjusted basis of all market discount bonds over average adjusted basis of all assets.[152]

The amount derived from this computation would be reduced by the amount of all interest included in the taxpayer's income from market discount bonds to obtain the net direct interest expense for the year.

Also, §1277(c) provides that rules similar to those of §265(5) are to apply to characterize short sales expenses as interest for purposes of determining the net direct interest expense with respect to market discount bonds. Section 265(5) was added to the Code by §56(c) of the Act.

Accrued market discount, whether treated as ordinary income upon the disposition of the market discount bond under the rules of §1276 or included in income currently under the election afforded by §1278(b), and whether such discount is computed on a ratable or constant interest basis, is treated as interest for all purposes of the Code except §§871(a) and 881 (relating to the 30 percent tax on nonresident alien individuals and foreign corporations on U.S. source income not connected with a U.S. business) and §§1441 and 1442 (relating to the withholding of such 30 percent tax). Such interest need not be reported under the provisions of §6049 by the payor. Regulations may extend these exceptions.[153]

d. Technical and Conforming Amendments

Carrying through the basic similarity of the recapture rules of §1245 and the provisions of §1276(a), amendments are made to:

(i) Section 341(e) (relating to exceptions to the application of the collapsible corporation rules) to add §1276 to §341(e)(12)'s list of Code sections not to be taken into account in determining whether gain from the sale or exchange of property would give rise to ordinary income.[154]

(ii) Paragraph (2) of §453B(d) (relating to the treatment of installment obligations in §337 liquidations) is also amended to add §1276 to the Code sections there listed. If in a §337 liquidation an installment obligation is distributed and there is accrued market discount with respect to the obligation, then the corporation must recognize such discount to the extent of the gain which would have been realized if the obligation had been sold for its fair market value.[155]

(iii) The definition of "unrealized receivables" set forth in §751(c) is amended to include market discount bonds and short-term obligations as defined in §1283 (discussed in *infra*), to the extent that gain from the sale of the bond would be treated as ordinary income.[156]

5. Short-Term Obligations (§§1281-1283)

a. Background

(1) Governmental Obligations

Under §1232(a)(3), gain from the sale or exchange of a short term government obligation was treated as ordinary income to the extent of the holder's ratable share of acquisition discount. This rule has been carried over and appears in §1271(a)(3). A short term governmental obligation is an obligation issued by the U.S. or any state at discount, without interest, and payable at a fixed maturity date not more than one year from the date of maturity issue,[157] *e.g.*, a Treasury bill. Acquisition discount is defined as the excess of the obligation's redemption price at maturity over the holder's basis.[158] The holder's ratable share of discount was multiplied by the number of days held over the number of days from the date of acquisition to (and including) the date of maturity [159] (*i.e.*, discount was computed on a linear basis). This provision was made necessary by the repeal of §1221(5) which excluded from the definition of "capital asset" short-term governmental obligations.[160] This rule applied to cash and accrual basis taxpayers alike, since, under §454(b) neither had to include discount in income currently with respect to such obligations.[161]

(2) Nongovernmental Obligations

The inclusion of interest in the income of the holder of a nongovernmental short-term obligation was governed, as a general rule, by the holder's method of accounting. Accrual basis taxpayers were required to accrue and include currently in income the interest on such obligation. While the method to be used was somewhat unclear,[162] inclusion of any interest earned during the taxable year was clearly called for. Cash basis taxpayers were not required to include any interest with respect to such obligations in income until received.

Under Regs. §1.1232-3(b)(1)(iii), in determining whether a debt instrument had OID, there was excluded from the stated redemption price at maturity not only interest unconditionally payable at a fixed rate periodically at intervals not exceeding one year (the rule adopted by §1273(a)(2)), but also, in the case of a short-term obligation, interest payable at maturity. Thus, a nongovernmental short-term obligation issued at discount without interest and payable at maturity had no OID with the result that the cash basis holder was not obligated to include the discount in income currently.

Note: The regulations cited above appear to distinguish between: (i) A note given for a $1,000 loan providing for

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payment at maturity of principal plus interest of (assuming a 12 percent simple rate) $1,120, and (ii) an obligation issued for $892 and payable at maturity in the amount of $1,000.[163]

Both of these instruments would appear to satisfy the requirement that interest be payable at a fixed rate at intervals of not more than one year. The note described in (i) would not appear to be considered issued at discount, however, whereas the note in (ii), absent the provisions of the regulations, would be considered to have OID of $108. The distinction is somewhat artificial and difficult to define in general terms. The redemption price of both includes a charge for the use of the money loaned at 12 percent. Presumably, this distinction carries over to the provisions of §§1281-1283.[164]

Under pre-1984 TRA law, a cash basis taxpayer could obtain tax advantages by purchasing a short-term obligation, with principal and interest paid at redemption (a so-called discount obligation) and maturing the following year, using funds borrowed at currently payable interest. Interest deductions taken for the year of purchase were not offset by interest income on the note, resulting in a net deferral of tax. Accrual basis taxpayers could obtain a similar advantage by purchasing Treasury bills maturing the following year, due to §454(b).

The post-TRA 1984 provisions relating to short-term obligations originated in efforts to counteract these tax advantages which Congress deemed unjustifiable.[165] Attention was directed primarily to the deferral of interest deductions related to indebtedness incurred to purchase or acquire short-term obligations, the holders of which were not required currently to include in income any accrued discount. This would include virtually all holders of Treasury bills and all cash basis holders of other short-term instruments issued at discount. The problem of tracing indebtedness to the holding of specific types of securities poses numerous administrative problems. Congress concluded, therefore, that a solution to the problem would be to require current inclusion of discount by most holders, leaving deferral of interest deductions to apply to those cash basis taxpayers whose dealings in securities would not be significant.

b. The Statutory Provisions and Analysis

(1) General Rule Requiring Current Inclusion

Section 1281 requires the current inclusion of acquisition discount relating to short-term obligations in income by all accrual basis taxpayers.[166] This is also required of certain cash basis taxpayers who might be expected to deal in large volumes of such obligations, namely:

(i) persons holding such obligations for sale to customers in their trade or business,

(ii) banks, as defined by §581,

(iii) regulated investment companies (RICs)[167] and common trust funds,

(iv) persons holding such obligations as part of a hedging transaction and who have identified them as such under §1256(e)(2).[168]

Current inclusion in income under §1281 is also required of a pass-thru entity (a partnership or S corporation) formed or availed of to avoid §1281[169] and any obligation acquired by a pass-thru entity (not formed or availed of to avoid §1281) during the "required accrual period,"[170] as defined by §1281(b)(2)(B). A key term in this definition is "ownership test," a test met for a taxable year, if for at least 90 days, 20 percent or more of the value of the interests of the pass-thru entity are held by persons who must accrue acquisition discount (enumerated above) or by other pass-thru entities formed or availed of to avoid §1281.[171] The "required accrual period" is, then, the period which begins with the first taxable year for which the ownership test is met by the entity (or predecessor) and ends with the first taxable year after such taxable year in which the ownership test is not met, *and* with respect to which the Secretary consents to the termination of the ownership period.[172]

Example: Calendar year partnership A: does not meet the ownership test at any time during 1985, meets the test for at least 90-days during 1986, and meets the test for only 20 days of 1987. The year 1986 is a required accrual period. It terminates on January 1, 1987, but only if the Commissioner consents to the termination. Such consent will probably be promptly given unless there is some question as to whether the partnership (or any of the pass-thru entity partners) was formed or availed of to avoid §1281. Consent will probably be withheld pending this determination and, if given, will be retroactive.

Included in income is *acquisition discount* rather than OID,[173] the basis on which the treatment of gain is provided under §1271(a)(3). In a short-term instrument, acquisition and original issue discount overlap.

Example: Assume a note issued for $890 without interest is redeemable at the end of one year for $1,000. The note is sold six months before maturity for $965. If the holder is required to include in income ratably the $110 of OID, and to increase his basis in the note in a like amount,[174] he would report for the year $55 of interest and $20 of capital gain. If the purchaser were subject to the same requirements, applying a reduction of the currently includible OID to take into account the acquisition premium (relative to the first holder's basis) as under §1272(b)(4), $35 would be reported as interest and his basis at maturity would be $1,000.

If the purchaser were to accrue and include in income acquisition discount, there would be the same result.[175] Acquisition discount equals OID as reduced by the acquisition premium paid to the seller of the note (capital gain realized by the seller). It thus should make no difference in the above case to the purchaser of the obligation whether he is to include in income OID or acquisition discount, except that the computation under the latter is less complex.

On the other hand, if interest rates had gone up, and the purchaser paid only $935 for the obligation, the original holder could claim a $10 capital loss and acquisition discount in the hands of the purchaser would be $65. In this situation, it would be distinctly advantageous for the purchaser to include in income only the remaining unamortized OID, $55, over the life of the obligation. Upon redemption at maturity, he would have a basis of $990 and a $10 capital gain. The

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market discount rules do not apply to short-term obligations.

Section 1283, provides definitions and special rules for §§1281-1282. "Short-term obligation" is defined as any debt instrument maturing in one year or less from its issue date, and, as do the OID and market discount rules, excepting from such definition tax-exempt obligations. "Acquisition discount" is defined as the excess of the obligation's stated redemption price at maturity (as defined by §1273) over the taxpayer's basis for the obligation. Section 1281(a) requires current inclusion in income of an amount equal to the daily portions of the acquisition discount for each day during the taxable year on which the obligation was held. Section 1283(b)(1) provides that such daily portion is to be determined on the basis of ratable accrual of the discount.[176] But the holder is allowed to elect to accrue acquisition discount on a constant interest basis, compounding daily. This election may be made with respect to any obligation and is irrevocable.[177]

In the case of nongovernmental obligations, §1283(c)(1) provides that §§1283 and 1284 (relating to the deferral of interest) are to be applied "by taking into account [OID] in lieu of acquisition discount," and that appropriate adjustments are to be made in the application of §1283(b).[178] The latter provision presumably means that the OID may be accrued either ratably or on a constant interest basis as is acquisition discount. It is further provided, however, that the taxpayer may elect not to have §1283(c)(1) apply provided the election is made to all obligations held by the taxpayer during the year to which the election applies and to all future years. This election may not be revoked without the Commissioner's consent.[179]

(2) Deferral of Interest Deductions

Section 1282, applicable to those persons not required to include currently in income discount on short-term obligations, provides rules substantially identical in all respects to those of §1277 regarding the disallowances (deferral) of interest expense allocable to accrued discount. It is provided that a taxpayer not required to include discount in income currently may elect to do so[180] and that such election applies to all short-term obligations acquired on or after the first day of the first taxable year to which it applies and is irrevocable without consent. Taxpayers making this election will not be subject to deferral of interest deductions.[181]

Note: The interest deduction deferral rules relating to market discount are apparently to apply in full, including the various definitions therein. Section 1282(a) provides that the "net direct interest expense" with respect to any short-term obligation shall be allowed as a deduction only to the extent it exceeds the sum of the daily portions of acquisition discount (OID in the case of nongovernmental obligations unless the §1283(c)(2) election is made) for each day during the taxable year for which the taxpayer held such obligation. The rules regarding the method of accrual (or constant interest) apply.[182]

As under §1277, disallowed interest deduction is allowed in the year the obligation is disposed of.

Note: The committee reports state that stripped coupons or stripped bonds payable not more than one year from the date of purchase (irrespective of the date of issue of the bond) are to be considered short-term obligations subject to the rules of §§1281-1283.[183]

Observations: A cash basis holder of a short-term obligation issued at discount, who is not required to include discount in income currently, will, upon the sale or exchange of the obligation, be required under general principles of tax law apportion any gain realized between capital gain and interest income.[184] The statute makes no specific provision for this case. The market discount rules do not apply, nor do the OID rules since both §§1271 and 1272 exclude from their provisions short-term obligations. Yet, some portion of the gain is attributable to the use or forebearance of money. The conflict between the concept of OID and the treatment of short-term obligations is encountered here again. If the obligation provides for the payment of interest at a fixed rate at maturity, and it is held until maturity, there is no question that the interest is to be treated as such by the holder (*e.g.*, a loan of $1,000 repayable in one year with interest at x percent). Where the obligation does not on its face provide for a fixed rate of interest, but is issued at discount (*e.g.*, a certificate of deposit) the same result follows. If the instrument is sold before maturity, how is the gain (if any) to be apportioned? In all probability, the taxpayer will not be required to treat as interest any amount greater than the portion of the OID allocable on a constant interest basis.

Example: A 1 year certificate of deposit paying $10,000 at maturity is issued for $8,870. Three months after the date of issue, it is sold for $9,200. Of the $330 gain, $268 is interest and $62 is capital gain (the instrument bears an interest rate of 12 percent compounded daily). In the hands of the purchaser, there is $800 of acquisition discount and $962 of unamortized OID. If the purchaser is an accrual basis taxpayer, it makes no difference whether the discount currently includible in income is acquisition discount or OID (as reduced by the acquisition premium of $62).

If, the original holder were to compute OID on a linear basis, $282 of the $330 gain would be characterized as interest and only $48 as capital gain. But, it is improbable that the IRS would require the OID to be computed in this manner.

The provisions of subpart C (§§1281-1283) as stated above apply to obligations acquired after July 18, 1984.[185]

(3) Act Section 44(e) Election

An election is provided under Act §44(e) to have §1281 apply to all obligations held during the first taxable year that includes July 18, 1984 (date of enactment). This can be made only by taxpayers as to whom the current inclusion of discount is mandatory under §1281 with respect to such obligations.[186] It would thus appear to be unavailable to a taxpayer electing under §1282(b)(2)(A) to have §1281 apply to all obligations acquired on or after the first day of the year to which the election applies and all subsequent years, but this is not entirely clear.

A taxpayer making the Act §44(e) election is treated as having changed his method of accounting with the Commissioner's consent. Consequently, §481(a) is applicable to require adjustments necessary to prevent the double inclu-

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sion or omission of income or deductions. Section 44(e)(2) of the Act provides a five-year "spread period" for the taking of the net adjustments required by §481 into account. As explained by the conference committee,[187] the net adjustments to which §481 will apply consist of the excess of the amounts of discount included in income under "cash basis accounting" over the amounts includible under "accrual basis accounting." The former is the amount includible if §1281 were not enacted, and the latter is the amount which would be included if §1281 applied to the year of election and previous taxable years.

Thus, in the case of calendar year taxpayer A, who acquired a $1,000 6 month certificate of deposit for $937 on November 1, 1983 and held it to maturity, income for 1984 using cash basis accounting is $63. Under accrual basis accounting, there is included only $43. The net adjustment under §481 is $20. The rules set forth in Act §44(e)(2) for taking the net §481 adjustments into income over a five-year spread period are somewhat complex and designed to insure that there is no omission of any amount from income. The conference committee report states the intent that in determining the net adjustments under §481 to prevent the omission of amounts, the cash basis income is computed as if such income had accrued in the preceding taxable year and, thereby, resulted in an increase in the basis of the related short-term obligations. Absent this treatment, there would be no omission from income to which §481 could apply.[188]

6. Miscellaneous Provisions

Subpart D of new part V of subchapter P contains the following miscellaneous provisions:

Tax Treatment of Stripped Bonds (§1286)

Denial of Capital Gain Treatment for Gains on Certain Obligations Not in Registered Form (§1287)

Treatment of OID on Tax Exempt Obligations (§1288)

a. Stripped Bonds

The provisions of §1286 are substantially identical to those of repealed §1232B.[189] Where the coupons are removed from a bond and either the stripped bond or the coupons are disposed of separately, the transaction is treated in all respects as if the separated elements were OID instruments, issued on the purchase date, at a price equal to the bond's or the coupon's ratable share of the purchase price. One minor change made to these provisions is that the words "by a corporation" are eliminated from the phrase "issued by a corporation on the purchase date." This was made necessary by the change to the OID rules making them applicable to instruments issued by natural persons. A detailed analysis of the stripped bond provisions is not provided here since there is no change from prior law except that noted. A stripped bond or coupon, regardless of when the bond was issued, is to be treated as a short-term obligation for purposes of §§1281-1283 where 1 year or less remains to maturity.

b. Unregistered Securities

Section 310(b)(6) of P.L. 97-248 (TEFRA) reenacted the provisions of §1232(c) as in effect prior to the repeal of §1232 by §42(a)(1) of the 1984 TRA. These provisions were reenacted as §1287 without change. Since the provisions of prior law are unaffected by this enactment, no detailed analysis of these provisions are called for in this chapter.

c. Tax-Exempt Obligations Issued at Discount

Under the law in effect prior to the 1984 TRA, the holder of a tax-exempt obligation issued at discount was entitled to accrue such discount ratably over the life of the obligation and to adjust the basis of the obligation to reflect such accrual. Since the ratable accrual of discount will always exceed accrual based on a constant interest rate (economic accrual), the basis such of a tax-exempt obligation usually exceeded its fair market value.

Example: State authority S issues a zero coupon $10,000 bond maturing in five years for $6,139, reflecting a 10 percent interest rate. At the end of the third year from the date of issue, the basis of the bond in the hands of the original holder would be $8,456 reflecting the ratable accrual of the $3,861 of discount. The fair market value of the bond, assuming that a 10 percent interest rate were applied to discount the amount payable at maturity, would be $8,227. A sale of the bond at this time would result in a capital loss of $228.97, even though there is no true economic loss from the sale. The purchaser, in turn, would continue to increase his basis in the bond by accruing the unamortized OID ratably. At maturity, his basis would be $9,771 generating a capital gain of $228, even though all of this gain is attributable to interest.

Also, where a tax-exempt bond was issued to finance the acquisition of property to be used by a private person, the latter assuming the issuer's obligation to make payments, and where the tax-exempt bond had OID, the person obligated to make the payments and treated, for purposes of interest deductions under §163, as the issuer of the bond, the amount of OID accruable in a given taxable year was based on ratable accrual rather than economic accrual on a constant interest basis. This resulted in substantially higher interest deductions during the early years of the bond's life than would have been allowable under the rules of §1232A (or post-1984 TRA §1272).

To correct this anomalous situation, it is provided in §1288 that for purposes of §163 and for purposes of the adjusted basis of the holder of a tax-exempt bond, OID on any tax-exempt obligations is to be treated as accruing in the manner provided by §1272(a) (on a constant interest basis), without regard to paragraph (6) thereof (providing for a reduction of OID accruals where the bond was acquired at an acquisition premium.

Example: In the case of the bond described in the preceding example, the basis of the original holder at the time of sale would be $8,227 resulting in neither gain or loss. The purchaser would continue to accrue the OID in the same manner and in the same amount as if he were the original holder, resulting in his basis in the bond exactly matching the increase in its fair market value due to the passage of time (assuming no fluctuations in the interest rates). If the purchaser held the bond to maturity, there would be no gain or loss. If interest rates had fallen at the time of the sale of the bond, and its fair market value had been $8.500. the

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amount paid by the purchaser, the purchaser's basis in the bond $10,273 (his basis, $8,500 plus the OID accrued from the date of purchase to maturity without reduction). He would have a capital loss of $273, the amount of the acquisition premium.

Section 1288(b)(3) provides that for short-term tax-exempt obligations, "rules similar to the rules of §1283(b) shall apply." The latter rules permit the accrual of discount on either a ratable (days held divided by days from acquisition through maturity) or constant interest basis (compounding daily).

The provisions of §1288 apply to obligations *issued* after September 3, 1982, and *acquired* after March 1, 1984.[190]

d. Use of Industrial Development Bonds for Property Acquisitions

Many acquisitions of property are financed by tax exempt bonds. In a typical transaction, the seller of the property receives a bond in exchange for the property [191] and the purchaser assumes liability to make payments on the bond as they come due. The seller retains a security interest in the property. Under this arrangement, while the governmental authority is the issuer of the tax-exempt bond (required for tax-exemption under §103), its liability is limited to the purchaser's obligation, assumed in exchange for the property, to make payments in accordance with the terms of the bond. The purchaser's obligation is considered a debt instrument and is subject to the rules of §§1272 and 1274. If, under these circumstances, the debt instrument failed to provide adequate interest, measured by 110 percent of the applicable federal rate (AFR), interest would be imputed under §1274 at 120 percent of the AFR. If the purchaser's debt instrument, because of the arrangement described, is considered a tax-exempt bond, the result would be to distort income. Because of the lower than market interest rates paid on tax-exempt issues, making such financing attractive, most such bonds would not meet the adequate interest test. Imputing interest at 120 percent of the AFR would reduce the purchaser's basis in the property (usually depreciable) and correspondingly reduce the seller's gain (or increase the loss). Also, the purchaser/issuer would be entitled to larger interest deductions over the life of the bond than if the interest rate provided in the bond were honored for tax purposes. These results would largely defeat the purpose of such financing. Recognizing this problem, it is provided in §1288(b)(1) that:

(A) OID in the case of a tax-exempt bond is determined without regard to the *de minimis* exception of §1273(a)(3), and

(B) In determining the AFR to be applied under §1274, the Secretary will provide regulations for adjustments to take into account the fact that the interest is tax-exempt. This means that something resembling an AFR for tax-exempt bonds will be prescribed. If the bond fails to meet this test, then OID will arise (with the effects described above), even though such OID is relatively small (1/4 percent or less of the redemption price at maturity times the number of complete years of the term of the bond). The same adjustments to the AFR are to be used in applying §483 (discussed immediately below).

7. Section 483

a. Background

When property is sold and the parties to the transaction agree to payment of part or all of the purchase price in installments, some or all of which are to be made more than a year from the date of sale, the IRS has been permitted (since 1963) to determine whether and the extent to which purported payments of the purchase price are, in reality, payment for the use of money, which must be treated as such for tax purposes. It makes no difference whether the payments are made under the terms of a contractual obligation or a debt instrument issued by the purchaser.

As under §1274, where the payment terms fail to provide for an adequate charge for interest, the appropriate adjustment is to impute an adequate charge. This has the effect of reducing the seller's gain and the purchaser's basis in the property, and increasing the amount of interest includible in the income of the seller and the amount of deductions allowable to the purchaser for interest expenses. Where both parties are taxable and similarly situated, there will normally be sufficient commercial and tax considerations to guarantee an adequate interest charge. While the seller will want as much of the total payments as possible to be taxed as long-term capital gain, he will also want compensation for the time value of money. The purchaser of the property to be depreciated, will want as high a basis as possible, but will also want to be able to deduct any payments made for the use of money. In many, if not most cases, however, investment credits and ACRS deductions give greater tax benefits than interest deductions. On the other hand, the seller will gain a distinct advantage in having what are in reality charges for the use of money taxed as capital gain. The tax advantages of investment credits and ACRS deductions will usually be greater than the benefits derived from interest deductions over the life of the debt instrument issued for the property.

Where the seller or the buyer is tax exempt, the tax considerations change. The tax exempt seller is unconcerned with the amount of gain realized, but is concerned with charging adequate interest on any deferred payments. Where it is the buyer, investment credits and ACRS deductions are of not importance, but it will want to negotiate low interest charges on its payments.

In all of these situations, there are advantages to be gained by providing for an inflated sales price and low interest charges. In some cases, the party with superior bargaining power may be able to impose such terms even though the other party will be unable to gain tax advantages sufficient to offset non-tax detriments. That tax considerations often dictate terms to which the parties would not have agreed, if only commercial considerations were involved, has long been recognized and underlies the statutory provisions of §483.

Prior to the 1984 TRA, §483 required the testing of the terms of sales having deferred payments. The sum of the present values of all payments (including interest payments, but excluding any payments of principal made

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within six months from the date of sale) was obtained using a "test rate" of interest. If this amount was less than the sum of all payments of the purchase price there was "unstated interest." In such a case, interest was imputed at a higher rate than the test rate. Both the test rate and the rate used for interest imputation were prescribed by regulations and changed from time to time to reflect market rates. These rates, however, generally lagged far behind market rates.

Another feature of pre-Act §483 was that the total amount of imputed interest was allocated to payments in proportion to the percentage such payment was of the total purchase price. For example, if a contract called for the purchase price to be paid in two installments, the first six months and one day after the date of sale and the second ten years after the date of sale, one-half of the total amount of imputed interest was allocated to the first payment. This led to a distortion. If interest were charged at an adequate rate, most of the interest would be allocated to the second payment. Thus, pre-Act §483 failed to satisfy the legislative intent behind its enactment. Congress decided, therefore, to amend §483 to make its application consistent with the provisions of §1274 and §1272, but retained the principle that inclusions in gross income and the allowance of deductions are determined by the affected taxpayer's method of accounting.

b. Operation of Amended Section 483

(1) General

Amended §483 retains the "total unstated interest" test. If the sum of the present values of all payments (other than payments of principal made within six months of the sale) to be made under the contract (or debt instrument) discounted at the test rate is less than the sum of all payments (other than payments made within six months of the date of sale) of the purchase price, interest is imputed at a higher rate. The test rate is 110 percent of the AFR as determined under §1274(d),[191] and the rate used for imputing interest is 120 percent of the AFR.

(2) Structure of Statute

Section 483(a) provides that in the case of any payment under a contract for the sale or exchange of property where §483 applies to such payment, there is treated as interest that portion of unstated interest determined in a manner consistent with §1272(a).

It must first be determined whether §483 applies to a payment.

(a) Exceptions

(i) Payments of principal made within six months of the date of sale or exchange, or any payments under a contract or debt instrument if all of the payments are due within one year from the date of sale. §483(c)(1).

(ii) Any payments made under a contract where at the time of the sale or exchange it can be determined that the sales price cannot exceed $3,000. §483(d)(2).

(iii) Any payments made under the terms of a debt instrument to which §1272 applies. Thus, if total payments to be made under the debt instrument exceed $250,000, §483 will not apply. §483(d)(1).

(iv) Any payments made by a purchaser of property as carrying charges if such amounts are treated by §163(b) as if they included interest. §483(d)(3).

(v) Any payments made under a contract or debt instrument issued for the sale or exchange of a patent where such payments are contingent on the productivity, use or disposition of the property transferred. §483(d)(4).

Special rules apply to sales of principal residences, farmlands, and land. These will be discussed below.

(b) Determining and Allocating Total Unstated Interest

If the payments under a contract of sale or the terms of a debt instrument issued for property are not excepted under the foregoing provisions, it must be determined whether and the extent to which the payments to be made include unstated interest. If so, the total unstated interest attributable to all payments is allocated to the payments in a manner consistent with the method prescribed by §1272(a). Thus, such total unstated interest is treated as if it were OID in the case of an accrual basis taxpayer, and for each accrual period the total of the daily portions of such total unstated interest for the number of days the contractual obligation or instrument was held or outstanding is treated as currently includible/deductible interest for all purposes of the Code. As to a cash basis taxpayer, a similar computation is made, but amounts are not included in income or allowed as deductions until actually or constructively received or paid. If the sum of payments of principal exceeds the sum of the present values of all payments to be made, there is unstated interest. The present values are determined by discounting the payments at an interest rate of 110 percent of the AFR.

To determine the *amount* of total unstated interest, the sum of the present values of all payments (excepting payments of principal within six months from the date of sale) is determined, discounting such payments at an interest rate equal to 120 percent of the AFR. The excess of the sum of all payments of principal to which §483 applies over the sum of present values represents total unstated interest. This is to be allocated to payments made under the contract or debt instrument in a manner consistent with §1272(a). To do this, the yield to maturity of the obligation or instrument is determined. This, by definition, is 120 percent of the AFR (the rate used to determine unstated interest). This yield is then applied as in determining the OID attributable to each six-month accrual period.[192]

An accrual period is the six-month period ending with the date in the calendar year corresponding with the maturity date of the obligation or instrument, or a date six-months earlier. If the last payment due under the contract or the maturity date of the instrument is, say, May 1, the accrual periods are November 2 through May 1 and May 2 through November 1. The portion of total unstated interest allocable to each day in each accrual period is computed by multiplying the yield to maturity by the principal amount outstanding at the beginning of each accrual period, including any unpaid interest (including unstated interest), and dividing the result by the number of days in the period. An accrual basis holder of the obligation then computes interest income includible for the number of days the obligation was held during the taxable year just as if the unstated

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interest were OID. An accrual basis obligor deducts interest on the same basis, *i.e.*, number of days the obligation was outstanding. A cash basis obligee uses the same method for determining the portion of each payment received (or constructively received) constituting interest, and a cash basis obligor uses this method to determine the portion of each payment made which is interest expense.

Example: Assume a $100x sales price, to be paid in two installments, the first, six months after the date of sale and the second two years after the date of sale. No interest is provided for. The first payment is $5x and the second is $95x. The AFR is 12 percent. The first $5x payment is treated, for purposes of §483, as if it had been made on the date of sale.

Discounting $95x at 120 percent of the AFR (= 14.4 percent) yields $71.94x. There is thus total unstated interest of $23.06x and an adjusted purchase price of $76.94x ($71.94 + $5.00). The first period accrues interest of $5.18x. This is added to the $71.94x unpaid principal amount to compute accrued unstated interest for the second accrual period of $5.55x. To the third accrual period is allocated $5.95x of the unstated interest, and to the final $95x payment there is allocated $6.38x. An accrual basis obligee must take into income these amounts of unstated interest, and an accrual basis obligor is entitled to take interest deductions in these amounts for the respective accrual periods. A cash basis obligee includes all of the $23.06x of interest in income at the time the final $95x payment is made, and a cash basis obligor deducts the same amount of interest when the final payment is made.

If, in the example above, the parties had provided for interest to be paid in the amount of $24.80x at the time of the first $5x payment, the payments would then include interest at a rate equal to 120 percent of the AFR. No §483 adjustments would be necessary, since the payments would not be payments to which §483 applies. No deduction of this amount would be allowed the obligor, however, whether a cash or accrual basis taxpayer. Deductions would be allowed to such obligor only in the amount of interest allocable to each taxable year on the basis of a constant interest rate of 14.4 percent (or any higher rate if it had been agreed to by the parties). Thus for the first taxable year, interest would be allowable only to the extent of $14.04x (7.2 percent times $100x plus 7.2 percent times $95x). This results from the application of §461(h) of the Code added by Act §91.

Example: The same rules are applied to the following more complex transaction. Taxpayer A contracts to purchase an item of property from seller B. The agreed on sales price is $50,000. The date of sale is January 1, 1985. The purchase price is to be paid in installments and interest is provided at a rate of 10 percent. The schedule of payments is as follows:

	Payment	Interest	Principal	Balance Due
June 30, 1985	$5,000	$2,500	$2,500	$47,500
December 31, 1985	$15,000	$2,375	$12,625	$34,875
June 30, 1986	$15,000	$1,744	$13,256	$21,619
January 1, 1987	$10,00	$1,080	$8,919	$12,700
June 30, 1987	$13,334	$635	$12,700	0

The AFR (short-term) is 12 percent. The first payment is composed of $2,500 in principal and $2,500 in interest (5 percent of $50,00). For purposes of §483, the $2,500 of principal paid within six months from the date of sale is treated as if it were paid on the date of sale. The total of payments to which §483(a) applies is thus $47,500.

That there is unstated interest is evident since the rate of interest provided in the contract is below 110 percent of the AFR. Some agreements may provide for irregular payments of interest at varying rates. For example, in the agreement described above, the parties could have provided that of the fourth payment, due January 1, 1987, $2,000 is to be treated as interest and the $8,000 balance applied to reduce the principal balance due, and provided for a final payment of $14,000.

Steps to determine unstated interest:

(i) Testing the schedule of payments, the sum of the present values of all payments (except the first $2,500 payment) is $45,359 using 110 percent of the AFR. There is, therefore, unstated interest since this is less than $47,500.

(ii) The amount of total unstated interest is determined to be $2,948 ($47,500 total of deferred payments less $44,552 = sum of present values of all deferred payments and interest discounted at 120 percent of the AFR).

(iii) Total unstated interest is allocated to each payment as follows:

1st Payment - $708

2d Payment - $884

3rd Payment - $669

4th Payment - $427

5th Payment - $261

If the obligor (purchaser) is a cash basis taxpayer, $1,592 of the unstated interest is deductible in 1985, $669 is deductible in 1986, $688 is deductible in 1987. If he is an accrual basis taxpayer, $1,592 is deductible in 1985, $2,824 is deductible in 1986 (the accrual for one day is negligible), and $635 is deductible in 1987.

The purchase price of the property is adjusted to $47,052 for all purposes of the Code.

(3) Special Rules

It was noted in the discussion of §1274 that its provisions do not apply to sales or personal residences or farms by individuals or small businesses for less than $1,000,000. If §483 were to apply to such transactions, little would be gained by exempting them from §1274 (except that cash basis taxpayers would be treated differently. It was decided, therefore, in a concurrent resolution adopted by the House and amended by the Senate (H. Con. Res.) 328) [19] after enactment of the Act and before enrollment, to add subsection (e) to §483 (redesignating former (e) as (f) and down the line through (g) to (h)) which provides that in the case of any *debt instrument* arising from the sale or exchange by an individual of his principal residence (within

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the meaning of §1034) or any sale or exchange by a person of land used by such person as a farm (within the meaning of §6420(C) [should read (c)](2)), §483 is to be applied using the discount rates as in effect prior to its amendment, *i.e.*, a test rate of nine percent simple interest as modified from time to time by regulations, and a rate of ten percent compounded semiannually for purposes of determining total unstated interest. Note that Congress did not make any change to the method of apportioning the unstated interest. Thus, the former method of apportionment in accordance with the proportion each payment was to the total principal amount is *not* retained. All that is effected by this change is to replace the words "110 percent of the applicable Federal rate" and "110 percent of the applicable Federal rate" in §483(b) and (c)(1), respectively, with (as currently provided by regulations) "9 percent simple interest" and "10 percent interest compounded semiannually."

In the case of a sale of a personal residence, §483(e) applies only to the extent the purchase price of the residence does not exceed $250,000. Thus, where a personal residence is sold for $300,000, the nine percent test rate and ten percent imputation rate apply to 83.3 percent of the payments, and the TRA 1984 rates apply to the balance in any adjustment under §483.

Retained as subsection (f) of §483 are the provisions of former subsection (g) providing for a lower (seven percent compounded semiannually) rate to determine the total unstated interest rate in the case of a sale of land between related persons (a "qualified sale"). The provisions are identical under the amended section with the exception that in the phrase "under the regulations under subsection (b)" in §483(g)(1), as in effect prior to the Act, post-TRA 1984 §483(f)(1) omits the words "under the regulations." It would thus appear that the 7 percent rate is permanent (unless changed legislatively).

It should be noted that under pre-1984 TRA §483, §483(f), providing exceptions and limitations, provided that in the case of the seller, §483 was not to apply to any payments received from a sale or exchange if all of the gain from such transaction would be treated as ordinary income. This exception was not retained in the amended provisions.

It is also noted that, like the OID rules, §483 does not apply to any amount which constitutes an annuity to which §72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. The Committee Report states that this exception is not intended to apply if the possibility that the life contingency will determine the amount of the payments is remote; that is, the contingency must be real and significant.[194]

(4) Conference Committee "Clarification of Intent"

Included in the report of the Conference Committee[195] are three significant "clarifications of intent" which apply both to §1274 and §483:

(a) Circumvention by Low Interest Loans

The committee stated that where a seller agrees to lend money to the buyer at a rate equal to 100 percent of the AFR (thus escaping any adjustments under post-TRA 1984 §7872) and the buyer used the loan proceeds to purchase untraded property from the seller, the loan will be treated as a purchase money loan subject to the 110 percent of AFR test and 120 percent of AFR interest imputation under §1274 or 483.

(b) Variable Rate

Where a debt instrument or contract of sale provides for a variable interest rate, no interest will be imputed under §§1274 or 483 where the rate is tied to an index or otherwise allowed to float, so long as it is adjusted no more frequently than at six-month intervals and can never drop below 110 percent of the short-term AFR.

Observation: Assume that the rate provided is 2 percentage points above the rate provided by §6621(b) (rate applicable to overpayments and underpayments of tax). This rate will always be more than the short-term AFR. It is possible, however, that, especially where the obligation is long-term, such rate may drop below the appropriate AFR. Apparently this is acceptable for purposes of determining whether a debt instrument or contractual obligation provides for adequate interest.

(c) Transfers of Debt Obligations or Rights

Current regulations under §483 provide the tax consequences of transfers of debt obligations subject to the rules of §483. These rules apply where (1) the holder of a debt instrument or obligation transfers it to another, or (2) where the obligor transfers his obligation to another person who assumes it. Similar regulations are expected by the conferees to be issued under the post-TRA 1984 OID and §483 provisions. Since §§1274 and 483 apply only to transactions occurring after December 31, 1984, the regulations in question are to deal with transfers of obligations to make or the rights to receive deferred payments effected after that date regardless of when these obligations were issued.

8. Effective Dates

a. General

Act §44(a) states the general rule that, except as otherwise provided in the section, the amendments made by subtitle C shall apply to taxable years ending after July 18, 1984 (date of enactment).

b. Sections 1274 and 483

In Act §44(b)(1) it is provided that §1274 and the amendments made to §483 by Act §41(a) apply to sales or exchanges after December 31, 1984, further, these provisions are not to apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984 and at all times thereafter before the sale or exchange.

c. Amendment of Section 482 Regulations

Act §44(b)(2) directs the Secretary to amend the regulations under §482 (namely, Regs. §1.482-2(a) relating to loans and advances) no later than 180 days after July 18, 1984 to modify the safe harbor interest rates so that such rates are consistent with those applicable under §483 as amended by Act §41(a).

Note: Henceforth, under the amended regulations, loans or advances made by one commonly controlled organization, trade or business not engaged in the business of lending money to another which bear interest at a rate equal to 110 percent of the AFR will be considered having been made at an arm's length rate. If this rate is not

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charged, and the taxpayer cannot establish that the rate charged was at arm's length, then gross income of the lender will be increased to reflect what it would be if a rate of 120 percent of the AFR had been charged. These rules apply only to loans and advances denominated in U.S. dollars.

d. Clarification of Interest Accrual

The pre-Act provisions of §483 as interpreted by the regulations, permitted income distortion by allocating unstated interest to payments of principal made under a contract for the sale of property on the basis of the proportion the payment bore to the total purchase price. The unstated interest so allocated was deductible by the obligor for the taxable year in which the payment was made. This is no longer true of the allocation of unstated interest. However, since the amendments to §483 do not go into effect until after December 31, 1984, Congress decided to put an end to this source of distortion by providing in Act §44(b)(3)(A) that after March 1, 1984 and before January 1, 1985, nothing in §483 shall permit any interest to be deductible before the period to which it is properly allocable.[196]

In addition, there has been considerable controversy concerning the proper method for the accrual of interest in transactions to which §483 may not apply. The IRS ruled in Rev. Rul. 83-84, 1983-1 C.B. 97 that the only proper method for accruing interest is the economic (constant interest) accrual. The ruling applied specifically to the use of the so-called Rule of 78s under which interest deductions are accelerated by reason of what constitutes a prepayment penalty built into the method of computing the rate at which the lender earns interest. Excepted were small ($5,000 or under) consumer loans. The ruling was generally viewed as an expression of the position that irrespective of the method used, no deduction for interest will be allowed for any year in excess of the amount of the economic accrual of interest. Statutory underpinning for this position is provided by §461(h) added by Act §91(a), providing, generally, that in determining whether an amount has been incurred with respect to any item during a taxable year, the all events test is not to be treated as met any earlier than when economic performance with respect to the item occurs. The conference committee report makes it clear that "in the case of interest, economic performance occurs with the passage of time (that is, as the borrower uses and the lender foregoes the use of, the lender's money) rather than as payments are made." [197] Section 44(b)(3)(A)(i)(II), relating to §461(h), provides that after June 8, 1984 and before January 1, 1985, notwithstanding §483 *or any other provision of law*, no interest shall be deductible before the period to which such interest is properly allocable. The conference committee states that no inference is intended as to the propriety of interest accruals prior to June 8, 1984, inconsistent with the provisions of Rev. Rul. 83-84.[198]

e. Fair Market Value Rule

Act §44(b)(3)(A)(ii) provides that in the case of any sale or exchange after March 1, 1984 and before January 1, 1985, §483 shall be treated as including provisions similar to the provisions of §1274(b)(3) which permits the Commissioner to determine an imputed principal amount of a debt instrument based on the fair market value of the property for which it was issued. There is no similar provision included in amended §483. Prior to the Act, §483 was the only Code provision relating to deferred payments for property, and the fair market value rule was deemed necessary to deal with potential tax abuse in such a transaction not subject to §1274 entered into before January 1, 1985.

None of these interest accrual rules apply in the case of contracts that were binding on March 1, 1984 and at all times after that date to the date of sale or exchange.

f. Obligation Providing for Equal Annual Payments

Finally, Congress, Rev. Rul. 83-84 notwithstanding, provided in §44(b)(3)(C) that none of these interest accrual rules (except the fair market value rule) is to apply to any debt instrument with substantially equal annual payments, *i.e.*, self amortizing installment payments of the type used in most mortgages and consumer loans to which the Rule of 78s is often applied.

Rev. Rul. 83-84 thus appears to be overruled to the extent that Congress expressly refused to extend to it the interest accrual principles described above in cases involving such self amortizing loans.

g. Miscellaneous

The reporting requirements relating to issuers of publicly issued OID instruments are to take effect on August 17, 1984.[199]

Section 44(j) provides that nothing in the amendment made by Act §44(a) (part V of subchapter P) is to effect the effective date provision (including any transition rules) for a provision which was a predecessor of any provision contained in such part V.

9. Observation and Implications

a. The "Fair Market Value" Rule

The provisions of §1274(b)(3), Fair Market Value Rule in Potentially Abusive Situations" will be applied in determining total unstated interest under §483 as in effect prior to the effective date of the §483 amendments, *i.e.*, sales after December 31, 1984. This rule appears to inject into the statute provisions totally unrelated to the time value of money and to the purposes of §1274. In effect, it converts payments of the sales price of property into interest payments irrespective of whether the debt instrument issued for the property bears interest at 110 percent of the AFR. The purpose of §1274 (and of §483) is to insure that the purported sales price does not contain disguised interest, and that such price reflects an adequate interest charge.

The fair market value rule allows the imputation of interest above 120 percent of the AFR. Its purpose is not to insure that the purchase price does not contain disguised interest, but rather that the purchaser of the property will not be entitled to excessive investment credit and ACRS deductions. If a full recourse note is issued by a solvent purchaser for a purchase price in excess of the fair market value of property, and bears adequate interest, the purchaser can gain no advantage since the present value of any investment credit and ACRS deductions cannot equal the overpayment.

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These provisions would make sense only where the debt instrument is nonrecourse or is issued by a purchaser with limited liability whose eventual payment of the purchase price is speculative. If the instrument is nonrecourse, the Commissioner already has the authority to disregard the purported indebtedness to the extent it exceeds the fair market value of the property under pre-Act law, as stated in the committee reports.[200] If this is so, then interest deductions, to the extent they are attributable to the disregarded indebtedness are disallowed as are investment credits and ACRS deductions.

Where the purchaser is a corporation whose ability to pay the full amount of the purchase price is speculative, it would appear that the transaction could be treated in the same manner as nonrecourse indebtedness where there is a substantial discrepancy between the value of the property and its purchase price. If the seller is a taxable entity, it is hardly likely that it will agree to pay tax on phantom gain. In any event, the Commissioner has ample authority to deal with sham transactions.

The commentary in the committee reports regarding these provisions is unclear at best. The fair market value rule would seem to be little more than an anti-tax shelter measure thrown into unrelated provisions. It will be interesting to see how the IRS exercises its authority under these provisions which have implications far beyond the scope of §1274 and the OID rules.

b. Exchanges of Stock Pursuant to Reorganizations

Where the parties to a corporate merger agree to an exchange of stock, typically where the shareholders of the merged corporation are to receive shares of the surviving corporation in exchange for their stock, the number of shares to be issued may be made to depend on certain contingencies which will result in the issuance of additional shares more than one year after the merger. Such transactions have been held to be subject to §483.[201] While this application of §483 has been criticized,[202] Congress did not see fit to change the law in this respect. Such exchanges will not, of course, be subject to §1274 since they do not involve the issue of debt instruments.

c. Bond Premium

Somewhat surprisingly, no provisions were enacted regarding the amortization of bond premium, even though this involves the time value of money as much as OID. Under pre-Act law, where a taxpayer purchased a debt instrument for an amount greater than its redemption price at maturity, he was entitled to deduct the premium paid under §171(a)(1) ratably over the period for which the instrument was held by him or under any "reasonable method."[203] The issuer must include premium in income ratably over the life of the debt instrument.[204] There was no requirement that premium be amortized on a constant interest basis. The only provision enacted in the 1984 TRA which might have a bearing on this is §461(h), the very broad language of which may be applicable to prohibit the deduction of bond premium on a ratable or straight line basis on the ground that the holder's expense is not deductible prior to the taxable year in which "economic performance" occurs. The committee report[205] interprets the language of §461 (applicable to debts incurred in transactions occurring after June 8, 1984)[206] to mean that interest incurred by an accrual method taxpayer will be deductible only on a constant interest basis. The same principle could be applied to the deduction of premium.

d. The Rule of 78s

The committee reports make it clear that no inference is to be drawn from the changes effected by §461(h) as to the validity of Rev. Rul. 83-84, 1983-1 C.B. 97.[207] This ruling held that the computation of interest, for purposes of deduction by the borrower/purchaser must be based on the economic accrual of interest. Excepted were certain small consumer loans with terms of five years or less. Specifically targeted by the ruling (although not confined to such transactions) were loans of money or purchase money loans providing for level payments, each of which reflects a payment of interest and a payment of principal. Sections 1274 and 483 will apply to such loans as well as to any other deferred payment transactions involving the sale or exchange of property. But, aside from whatever effect these sections may have on the imputation of interest, §461(h) adopts the position of Rev. Rul. 83-84 without restrictions as to the amount of the loan or sales price or term of the deferred payment agreement. This will affect virtually all consumer loans on which taxpayers have reported interest deductions based on the Rule of 78s computation, usually provided by the lender. This may be softened somewhat by regulations authorized by §461(h)(2)(D).

e. Effects on Section 482

Act §44(b)(2) provides that within 180 days after enactment, the Secretary is to issue regulations modifying the safe harbor interest rates so that such rates are consistent with the rates applicable under §483 as amended. What this means is not entirely clear. Where one commonly controlled entity makes a loan or advance to another such entity, including deferred payments for goods or services[208] and interest is not charged by the creditor entity at a rate equal to an arm's length rate *determined consistently with the rates provided* by §1274(d), the Commissioner is authorized to make adjustments to gross income to reflect an arm's length rate. The regulations provide a safe harbor. Where the rate charged (as of the latest amendments to the regulations effective as to loans or advances made after August, 1980) is at least 11 but not more than 13 percent per annum, simple interest, this will be deemed to be an arm's length charge, unless the taxpayer can establish that some other rate was arm's-length. Where no interest was charged or was less than 11 or more than 13 percent per annum, simple interest, the Commissioner is authorized to adjust gross income to reflect the 12 percent per annum, simple interest.[209]

To make this safe harbor rule consistent with the rates provided under §483, a lower bracket rate of 110 percent of the AFR compounded semiannually would seem appropriate, as would an imputation rate (where the charge was less than the lower bracket amount) of 120 percent of the AFR compounded semiannually. This leaves the upper bracket rate to be set. Perhaps this will be 130 percent of the AFR. These rates apply not only to loans of money, but to "[i]ndebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group.[210]

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Where a U.S. corporation sells goods to a controlled foreign subsidiary on credit and fails to provide for interest at the safe harbor rate, the U.S. entity's income is increased to reflect the imputed rate (under pre-Act regulations, 12 percent). If this adjustment is made, it would then appear that §483 will not apply to make any additional adjustment, since the U.S. taxpayer is treated as if adequate interest had been charged. Likewise, if the rate charged by the foreign controlled entity were greater than the safe harbor rate, interest in excess of 12 percent (under pre-Act regulations) would not be allowable as a deduction. Applying a 110 percent - 130 percent of AFR bracket in lieu of the present 11 - 13 percent simple interest bracket, will expose many more transactions to §482 adjustments.

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[1] §1232A(b) and §1272(b) retain this method termed "ratable inclusion," for debt instruments issued prior to July 2, 1982 (TEFRA effective date). The method is also often referred to as "linear" or "straight-line" accrual of interest.

[2] *See* General Explanation of P.L. 97-248 (TEFRA), Joint Committee on Taxation, December 31, 1982, at pp. 158-160. Table I on p. 160 illustrates the distortion occasioned by ratable inclusion. For a 30 year bond issued in 1982, interest is overstated through the year 2000. From that point to maturity, it is overstated in a like amount.

[3] Canellos and Klienbard, "The Miracle of Compound Interest: Interest Deferral and Discount After 1982," 38 Tax L. Rev. 565 (1983).

[4] *I.e.* since the issue price was equal to the stated redemption price at maturity. *See* definition of OID in §1232(b)(1), restated in §1273(a)(1).

[5] S. Rep. No. 98-169, 98th Cong., 2d Sess. (hereinafter S. Rep.) at 253, fn. 11. S. Rep. may be found in Worksheet 21.

[6] *See* Canellos and Klienbard, op. cit. at 597-598, and S. Rep. at p. 253.

[7] It also, unlike the OID rules, permitted the timing of interest deductions and inclusion of interest income to depend on the taxpayer's accounting period.

[8] The TEFRA rules applied only to instruments issued by persons other than natural persons, *i.e.*, governmental obligations and debt instruments issued by corporations (including S corporations), partnerships, estates, and trusts.

[9] When the acquired debt instrument is an OID instrument, acquisition discount arises when the price paid by the purchaser is less than the issue price of the debt instrument plus amortized OID (*i.e.*, OID includible in the income of any holder). When the price paid exceeds such issue price plus amortized OID, the excess is acquisition premium. The new holder continues to include OID in income as did the previous holder, reduced by an allocable portion of the premium paid. But, acquisition discount is not added to OID.

[10] §1232(a)(3).

[11] Regs. §1.1232-3(b)(1)(iii). Of course, accrual basis holders were required to include OID in income currently.

[12] §1275(a)(3).

[13] *See* Rev. Rul. 73-112, 1973-1 C.B. 47. Under this ruling, ratable accrual was based on total OID, multiplied by the number of days the bond was held, and divided by total number of days from date of issue to maturity.

[14] §467(h) added by TRA 1984 §92(a), discussed in the detailed analysis below, limits the deduction for interest, irrespective of the taxpayer's accounting method, to the amount properly allocable to the taxable year computed on an economic accrual basis. Thus, the purchaser of property is not entitled to any greater interest deduction than if he were the issuer of an OID instrument subject to the OID rules.

[15] This rule, which originated in the Revenue Act of 1934 and carried into §1232(a) of 1954 Code from §117(f) of the 1939 Code, was originally limited to registered or coupon bonds. These requirements were dropped as to bonds issued after December 31, 1954. The purpose of the rule was to overrule holding that the payment of a bond by a corporation was the fulfillment of a contractual obligation to repay money and not a sale or exchange. *Fairbanks v. U.S.*, 306 U.S. 436 (1939). *U.S. v. Midland Ross Corp.*, 381 U.S. 54 (1965), clarified the Service's authority to tax gain from the sale, exchange, or retirement of a bond issued at discount as ordinary income to the extent such gain represents "compensation for the use or forbearance of money." This definition of interest was set forth in *Deputy v. DuPont*, 308 U.S. 488, 498 (1940). Thus, a cash basis holder of a short-term nongovernment obligation issued at discount must apportion any gain realized at disposition between capital and interest elements. Accrual basis taxpayers, under former law, were required to include such discount in income as it accrued, adjusting the basis of the debt instrument accordingly. This is now required by §1281. Statutory rules also apply to short-term government obligations. §1271(a)(3), (carried over from §1232(a)(3)), and §1281(a). The apportionment to be made by a cash basis taxpayer may presumably be made either on the basis of ratable or economic accrual of the discount. *See* §1281, discussed below, permitting either method for those taxpayers required to include in income currently OID on nongovernment short-term obligations.

[16] §1275(a)(1)(A).

[17] §1275(a)(1)(B).

[18] *See* S. Rep. at 253.

[19] §1271(a)(2)(B).

[20] §1275(a)(3).

[21] This provision is explained in 1 below.

[22] §1271(b)(1).

[23] As to instruments issued prior to March 1, 1984, *see* §1272(a)(2)(D).

[24] §1271(b)(2).

[25] §1271(c).

[26] §1273(a)(1).

[27] §1273(a)(2).

[28] Under the regulations cited, which have not been amended to reflect the TEFRA changes, the total OID of an instrument made up of serial obligations is apportioned among each series. Where the total of payments during a year exceeds interest payable at an annual fixed rate, the excess is treated as the SRPM for the series. If the instrument skips a year's interest, making this up the following year, there is a two-year serial obligation. Applying the regulations to the $1,000 note described in the text above, the total OID of $70 is apportioned to the two series (1) the two year series maturing at $95 and (2) the 3 year series maturing at $1,000. To determine the OID allocable to each series, multiply total OID by:

$$\frac{\text{SRPM for the series x years (or months, days) to maturity}}{\text{the sum of the products of the above factors for each series}}$$

$$\text{First Series: } \$70 \times \frac{\$70 \times 2 \text{ (Years)}}{\$3{,}140}$$

$$\text{Second Series: } \$1{,}000 \times \frac{\$1{,}000 \times 3 \text{ (Years)}}{\$3{,}140}$$

Discount for first series = $3.12; for second series = $66.88; issue price for first series = $66.88, issue price for second series = $933.12. It can be seen that each of the series has an approximate yield of 7.3 percent, allocating $1.67 of each of the fixed $25 interest payments to the first series and $23.33 to the second.

[29] Of course, irregular payments could cause some components of the series to have greater yields than others. *See* S. Rep. at 255.

[30] *See* §1232(b)(2); compared with §1273(b).

[31] §1273(b)(1).

[32] §1273(b)(4) and (5). As will be explained below, an untraded debt instrument, issued for the use of property or for services, will not have OID within the meaning of §1273 or §1274. However, under §467, it may be subject to rules similar to the OID rules. *See* Chapter 22, *infra*.

[33] *See* S. Rep. at 253: " 'Property' for [the purpose of applying §1274] includes all tangible and intangible assets of any sort except money (U.S. currency and checks)." This could raise some interesting problems. A controlled Belgian subsidiary issues a debenture denominated in Euromarks or in Belgian francs. Is the applicable federal rate (based on marketed obligations of the U.S.) appropriate in determining whether the instrument has OID? §964 requires that U.S. tax laws be applied in determining the foreign entity's earnings and profits. This will probably be dealt with in regulations.

[34] *Cf.* Regs. §1.482-2(a)(2)(iii)(D).

[35] §1273(b)(2).

[36] The property traded will determine the issue price. If both sides are traded, market forces will usually make the prices coincide.

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[37] §1273(b)(4). Section 1274, as a general rule, will apply to a debt instrument issued for untraded property where total payments under the instrument exceed $250,000, but §1274 nowhere defines "property." Presumably, absent a definition like that provided by §1273(b)(5), *supra*, "property" does not include the use of property or services. "Property" as used in §483 does not, by inference, include the use of property or services, otherwise it would conflict with §467.

[38] That is, if the total payments do not exceed $250,000, as a general rule. See discussion of §§1274 and 483 in this Chapter, *infra*.

[39] The method set forth in Regs. §1.1232-3(b)(2)(ii) to apportion the issue price of an investment unit between the debt instrument and the other property is somewhat unsatisfactory. Where the other property consists of stock warrants, having no "readily ascertainable value" (as is generally the case with untraded stock options), the interest rate which the debt instrument would have to bear to be marketed at face value or par must be determined. The sum of the present values of all payments due under the instrument is determined using this hypothetical rate. The value of the instrument so determined is subtracted from the unit's issue price to determine the amount allocable to the warrants. This amount is the OID. The hypothetical market interest rate varies from expert to expert; a variance of .25 percent can translate into hundreds of thousands of dollars of OID.

Query: Could these difficulties be skirted by adopting rules similar to those of §1274, *i.e.*, valuation of the debt instrument by applying 120 percent of the applicable federal rate? The problem is that, to be marketable, many issues would have to provide for interest greater than this rate. If an instrument bearing interest at 120 percent of the AFR is sold with warrants to induce the lender to purchase it, it would seem that some OID must be involved. Note that a convertible bond sold at par is not considered to have been issued at a discount solely because of the conversion privilege. Regs. §1.1232-3(b)(2)(i). The issue price includes any amount paid in respect of the conversion privilege.

[40] While "property" is not defined, it excludes traded property to which §1273(b)(3) applies.

[41] §1274(a)(1). The "stated principal amount" is usually the sales price set by the parties. If no price is set, and the instrument simply provides for a stream of payments to be made in the future, the principal amount will be the "imputed principal amount" based on 120 percent of the applicable federal rate.

[42] §1274(c)(2).

[43] §1274(c)(3).

[44] §1274(a)(1).

[45] §1274(b)(1) and (2).

[46] §1274(a)(2). Where the instrument provides for varying interest rates, such as a rate to be adjusted annually, but not more often than semiannually, to reflect some objective index, such as the prime rate, the testing amount will be satisfied so long as, under the rate formula, it cannot fall below 110 percent of the AFR, and is payable unconditionally at least annually. *See* H.R. Rep. No. 98-861, 98th Cong., 2d Sess. (hereinafter referred to as the Conference Report or C. Rep.) at p. 889. Acceptable indices will probably be furnished by regulations.

[47] §1274(d)(1)(B).

[48] §1274(d)(1)(A).

[49] §1274(d)(1)(C). According to the Joint Committee on Taxation, preliminary estimates indicate that the short-, mid- and long-term safe harbor rates (*i.e.*, equal to 110 percent of the AFR) for the period July 1 through December 31, would be approximately 11.25 percent, 12.65 percent and 13.25 percent, respectively, if the new provision were currently in effect. *See* J. C. Staff description of the 1984 TRA provisions affecting deferred payment sales of property (for purposes of a hearing held on August 3, 1984) *reprinted* in BNA Daily Tax Report No. 151 (August 6, 1984) at J-1, J-3 footnote 10.

[50] §1274(d)(2).

[51] §1274(d)(3).

[52] In S. Rep. at 254, it is stated that the committee expects that federal obligations with characteristics that result in yields substantially below or above a market rate of interest (*e.g.*, "flower bonds") will be disregarded. Further, once a binding contract in writing fixes the AFR appropriate to the instrument, this cannot be changed by renegotiating the contract.

[53] S. Rep. at 256. Also, it is pointed out by the committee that the "total contract price" for purposes of applying §453 (relating to installment obligations) will include debt of the purchaser only to the extent of the principal amount of the debt instrument as determined under the rules of §1274 (where §1274 is applicable). Presumably, where §483 applies, there is the same result.

[54] S. Rep. at 256.

[55] S. Rep. at 255.

[56] §1274(c)(1)(B).

[57] C. Rep. at 888.

[58] §1274(c)(2)(A)(i). Note that there appears to be a clerical error in numbering the paragraphs under §1274(c). Paragraph (1) provides the general rule regarding debt instruments to which §1274 applies; paragraph (2) defines "adequate stated interest"; paragraph (3) defines the "testing amount." Next is another paragraph (2) listing exceptions. This latter paragraph is the one referred to in this footnote. It obviously should be numbered (4). Hereinafter, this paragraph is referred to as "§1274(c)(2)."

[59] §1274(c)(2)(A)(i)(III).

[60] *Id.*

[61] §1274(c)(2)(B).

[62] §1274(c)(2)(C). All debt instruments issued for property are to be aggregated together with any consideration other than debt instruments.

[63] §1274(c)(2)(C)(i) and (ii).

[64] All sales or exchanges which are part of the same transaction (or a series of related transactions) are to be treated as one sale or exchange. §1274(c)(2)(C)(iii).

[65] §1274(c)(2)(O). As to such instruments, OID is determined under §1273. Note the special rule provided by §1275(a)(4), discussed below, relating to debt for debt exchanges pursuant to reorganizations.

[66] §1275(b)(1). As an example of personal use property, the committee report posits a house, one room of which is used for business purposes. This rule applies both to §1274 and §483.

[67] §1275(b)(2). There is no requirement of current inclusion in income for OID with respect to a loan between natural persons not exceeding $10,000. §1272(a)(2)(E) discussed below.

[68] *See* Canellos and Klienbard, op. cit (fn. 3) at 600-602.

[69] §1272(a)(2)(D).

[70] Act §44(d).

[71] §1272(a)(3).

[72] §1272(a)(5).

[73] Act §44(i)(1).

[74] *Id.*

[75] Act §44(i)(2).

[76] §1272(a)(2)(A) through (C).

[77] Under 1232 and 1232A, there was no provision specifically excepting short-term obligations. However, Regs. 1.1232-3(b)(1)(iii) effectively exempted short-term instruments held by cash basis taxpayers since there was excluded from the redemption price, payable at maturity, any interest payable at maturity. Accrual basis taxpayers have always been required to accrue OID, but under the new provisions of §§1281-1283, they may now elect to accrue OID on nongovernmental short-term obligations on either a ratable or constant interest basis. Certain cash basis taxpayers must also currently include OID on such obligations under these same provisions.

[78] §1272(a)(2)(E)(i) and (ii).

[79] §1272(a)(2)(E)(iii).

[80] §1273(a)(3).

[81] §163(e)(2)(B) as amended by Act §42(A)(3). This is a change from prior law.

[82] This term is used in the definition of "accrual period" in §1272(a)(5). Section 1275(c)(1) (relating to information reporting) refers to "the issue date." This probably has the same meaning.

[83] §1275(a)(2)(A).

[84] §1275(a)(2)(B).

[85] §1274(d)(2).

[86] §1272(a)(1).

[87] The former rule is now contained in Act §44(i)(1) as explained above.

[88] §1272(a)(3)(A), substituting bond period for accrual period.

[89] Act §44(i)(1).

[90] §1272(a)(1).

[91] §1272(a)(5).

[92] §1272(a).

[93] Act §44(i)(1).

[94] §1272(a)(6). Note that under this formula, the value of the fraction can never be greater than 1. A value of 1 would result only if the purchaser paid an amount equal to the redemption price at maturity. Under the former method of 1232A(a)(6), the value of the reduction fraction could exceed 1 resulting in negative reduction, clearly an undesirable result.

[95] As stated above, and also as noted by the Conference Committee, C. Rep. at 804, the revised formula of 1272(a)(6) "is intended to prevent situations in which the amortization of the acquisition premium exceeds accrual of OID and to provide better matching between the two."

[96] §1272(c).

[97] §1272(d)(1).

[98] It should be emphasized that an instrument's adjusted issue price is not necessarily the same as its adjusted basis in the hands of the holder as adjusted for amounts includible in income under §1272.

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[99] §1271(a)(2).
[100] *Id.*
[101] §1275(d).
[102] §163(e)(1), Act §42(a).
[103] §163(e)(2)(A).
[104] §163(e)(2)(B).
[105] §1278(a)(2)(A).
[106] Of course, if the instrument had OID, the purchaser was required to include this in income currently under §§1232 or 1232A.
[107] (as an example only - this does *not* reflect the accurately computed discount).
[108] §1278(a)(1)(B)(i).
[109] §1278(a)(1)(B)(ii).
[110] §1278(a)(1)(B)(iii).
[111] §1278(a)(1)(B)(iv).
[112] §1278(a)(2)(B).
[113] §1278(a)(4).
[114] §1278(a)(5).
[115]

$$(1)\ \frac{9{,}000 - (8{,}000 + 500)}{(2{,}000 - 500)} = \frac{500}{1{,}500} = \frac{1}{3}$$

$$(2)\ 500 \times \frac{1}{3} = 167$$

(3)
$$\begin{array}{r} 500 \\ -167 \\ \hline \$333 \end{array}$$

[116] §1276(a)(1).
[117] §1276(b)(1).
[118] *Id. Note:* The denominator does not include the date on which the bond was acquired, but does include the maturity date.
[119] §1276(a)(3). OID, on the other hand, is considered interest for all purposes of the Code. See S. Rep. at 256.
[120] §1276(b)(2)(A).
[121] §1276(b)(2)(C). It is, of course, always advantageous to accrue market discount on a constant interest basis. For some taxpayers, however, the complexities may outweigh the advantages or, if the bond is to be held to maturity and the interest deduction deferral rules do not apply, it makes no difference what method is used.
[122] §1276(b)(2)(A).
[123] §1276(b)(2).
[124] §1278(b)(1)(3).
[125] *Id.*
[126] §1278(b)(1)(A).
[127] "Gain" in the context of §1276 does not mean gain for any purposes of the Code other than triggering recognition of accrued market discount as ordinary income. §1276 does not require recognition of gain for any other purpose.
[128] §1276(a)(2).
[129] §1276(d)(1); §1276(d)(1)(A).
[130] §1276(d)(1)(B).
[131] §1276(d)(2).
[132] §1276(c)(1)(A).
[133] §1276(c)(1)(B).
[134] §1276(c)(2)(A).
[135] §1276(c)(2)(B).
[136] §1276(c)(3).
[137] §1276(e).
[138] §1277(b)(3).
[139] §1277(b)(2)(A).
[140] §1277(b)(1)(C).
[141] §1277(b)(1)(A).
[142] §1277(b)(1)(B).
[143] §1277(b)(2)(B)(i).
[144] §1277(b)(2)(B)(ii)(I).
[145] §1277(b)(2)(B)(ii)(II).
[146] Act §44(c)(2): "§1277. . . shall apply to obligations acquired after the date of enactment of this Act in taxable years ending after such date."
[147] §1276(e) provides that §1276 is not to apply to any market discount bond *issued* on or before July 18, 1984 (date of enactment).
[148] That is, recognized gain without regard to the provisions of §1276.
[149] §1277(d). In the case of a market discount bond issued on or before enactment, any gain recognized on any disposition is to be recognized as ordinary income to the extent it does not exceed the amount of disallowed interest expense allowed in the year the bond is disposed of. *See* S. Rep. at 159.
[150] *See* S. Rep. at 159. "If such bond [pre-enactment bond] is disposed of in a nonrecognition transaction, a similar interest characterization [disposition gain recognized as interest income to the extent of disallowed interest expense allowed as an ordinary deduction at the time of disposition] rule will apply at the time gain is recognized and the disallowed expense is allowed as a deduction."
[151] *See* S. Rep. at 158.
[152] §1276(a)(3) and §1278(b)(1).
[153] Act §43(c)(1).
[154] Act §43(c)(2).
[155] Act §43(c)(3).
[156] §1271(a)(3)(B).
[157] §1271(a)(3)(C).
[158] §1271(a)(3)(D).
[159] §505(a) of P.L. 97-34 (ERTA) effective as to obligations acquired after June 23, 1981.
[160] Unless subject to the provisions of §1281, *infra.*
[161] The IRS position announced in Rev. Rul. 83-84, 1983-1 C.B. is that such interest must be included on a constant interest basis.
[162] Interest payable on a short-term obligation monthly, semiannually, or at maturity appears to satisfy the rule that it be paid at a fixed rate. Why then a separate provision relating to interest payable at maturity? Perhaps this is not considered paid at "fixed periodic intervals." *See* §1273(a)(2).
[163] But this is not entirely clear as will be explained below.
[164] S. Rep. at 160; C. Rep. at 807.
[165] This includes taxpayers using a hybrid method of accounting. *See* C. Rep. at 809.
[166] RICs are permitted optional accrual with respect to short-term governmental obligations for years after 1978. The option will apply only for such years ending prior to the taxable year that contains July 18, 1984.
[167] §1281(b)(1)(B) through (E).
[168] §1281(b)(2)(A)(i).
[169] §1281(b)(2)(A)(ii).
[170] §1281(b)(2)(C).
[171] §1281(b)(2)(B)(i) and (ii).
[172] §1281(a). Acquisition discount is defined for purposes of subpart C in §1283(a)(2): The excess of the stated redemption price at maturity over the taxpayer's basis in the obligation.
[173] Mandatory inclusion in income requires an adjustment to basis. See §1283(d)(1).
[174] That is, the $35 of acquisition discount would be included in income currently raising his basis in the obligation to $1,000.
[175] Daily portion of acquisition discount = the amount of such discount divided by the number of days from the acquisition date to (and including) the maturity date - identical to §1271(a)(3)(D).
[176] 1283(b)(2)(A)(i) and (ii). This computation is based on the obligation's yield to maturity.
[177] §1283(b)(2)(B).
[178] §1282(c)(2)(A) and (B).
[179] §1282(b)(2)(A).
[180] §1282(b)(2)(B).
[181] *See* §1283(b).
[182] C. Rep. at 808.
[183] *See U.S. v. Midland Ross Corp.*, 381 U.S. 54 (1965).
[184] Act §44(d).
[185] Conf. Rep. at 809.
[186] *Id.*
[187] Conf. Rep. at 810.
[188] Conforming amendments referring to the enacted OID provisions are made. Also, there is added to "Definitions and Special Rules" the term "purchase" which, under §1286(d)(6), uses the meaning given such term by §1272(d)(1). C. Rep. at 805 notes that the provision that creates OID with respect to stripped bonds applies for all purposes of part V of subchapter P.
[189] Act §44(f).
[190] Often a bank advances the purchase price to the seller in exchange for the bond and sells the bond to the public or retains it as an investment. The municipal or county issuer thus, in effect, lends its authority to issue tax exempt bonds to the purchaser to induce the latter to enter into the transaction.
[191] §483(b).
[192] *Id.*
[193] 98th Cong., 2d Sess., Cong. Rec. H7524 (1984).
[194] Conf. Rep. at 887-888.

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[195] Conf. Rep. at 888-889.
[196] Act §44(b)(3)(A)(i)(I).
[197] Conf. Rep. at 875.
[198] *Id.*
[199] Act §44(h).
[200] S. Rep. 255; Supplemental H.R. Rep. 98-432, 98th Cong., 2d Sess., at 1248.
[201] Rev. Rul. 73-298, 1973-2 C.B. 173; Rev. Rul. 72-32, 1972-1 C.B. 48; Rev. Rul. 70-300, 1970-1 C.B. 125. *See Vorbleski v. Comr.*, 589 F.2d 123 (3rd Cir. 1978).
[202] Carlson, "Income Tax Blue Law: Imputation of Interest Under Section 483," 34 Tax L. Rev. 187, (1979).
[203] Regs. §1.171-2(f).
[204] Regs. §1.61-12(c).
[205] Conf. Rep. at 875.
[206] Act §44(b)(3)(A)(i)(II).
[207] Conf. Rep. at 875.
[208] §482 applies where one such entity makes directly or indirectly a loan or advance to or otherwise becomes a creditor of another such entity. Regs. §1.482-2(a)(1).
[209] Regs. §1.482-2(a)(2)(iii).
[210] Regs. §1.482-2(a)(2)(iii)(D).

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Chapter 22

TIME VALUE OF MONEY (II): DEFERRED PAYMENTS FOR THE USE OF PROPERTY AND SERVICES: BELOW-MARKET INTEREST LOANS

Note: See October 1984 legislative change at p. B-414, infra.

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I. Deferred Payments for the Use of Property and Services

A. Background

Section 92 of the 1984 TRA enacts Code §467. Section 467 prescribes rules for certain situations involving deferred payments (and prepayments) for the use of property and services which reflect charges for the use or forbearance of money but which, the IRS generally treats as involving only items of rent or compensation. Congress' principal targets were leases covering terms of more than one year and involving total payments of more than $250,000 under the terms of which: (1) rent allocable to one calendar year is not payable until after the close of the succeeding calendar year; or (2) rent charged for one year or period of use differs from rent charged for some other year or period.[1] This is a difficult legislative task because, while most deferred payments for a present benefit can be viewed as including a charge for the use or forbearance of money, this is not always true with rent payments. A lease may provide for gradually increasing rents for numerous reasons having nothing to do with the usual considerations underlying interest charges. Payment for the use of property in one year at some time after the close of that year should, generally, include some interest element. The mere fact that the rent charged for the first year of a lease is less than that charged for the second or some later year, however, does not necessarily mean that some portion of the first year's rent was deferred. Where an accrual basis lessee enters into a stepped rent agreement [2] with a cash basis lessor, the lessee deducting rent on a level payment basis and the lessor reporting the rent as income only in the year received, however, there is basis for suspecting tax abuse. This is especially so where no discernible reason exists for the arrangement other than to gain tax advantages. At the very least, where any portion of rent is deferred, both parties should be placed on the accrual basis with respect to the rent so that a mismatching of income and deductions does not occur. Where a lease is deliberately structured to minimize taxes by disguising what is, in reality, interest as a charge for the use of property, some adjustments are called for. There are also sound policy reasons to restrict stepped rental arrangements bearing the earmarks of tax avoidance to provide level payments. Section 467, added by TRA §92, provides rules applying time value of money concepts to deferred payments for the use of property. While some of these problems may arise in arrangements involving deferred payments for services, the Code already contains a number of special rules in that area.[3] Regulations to be issued under §467 will apply rules, similar to those applicable to payments for the use of property, to payments for services, only where the latter are not covered by some other specific Code provisions.[4]

B. Overview

1. Transactions to Which the Statute Applies

Section 467 applies only to those payments for the use of property which are made under a "§467 rental agreement." A "§467 rental agreement" is defined as any rental agreement for the use of tangible property under which,

> (i) There is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year following the calendar year in which such use occurs; or
>
> (ii) There are increases in the amount to be paid as rent under the agreement.[5]

If a rental agreement does not fit either of these definitions, §467 does not apply.

The legislation contemplates that a rental agreement will either provide for even rent payable for, and allocable to, each period of use covered by a lease or it will not. If it does not, it is a §467 rental agreement.[6]

Irrespective of whether an agreement is a §467 rental agreement, §467 will not apply to any amount paid for the use of property if the sum of the following amounts does not exceed $250,000:

> (i) the aggregate amount of payments received as consideration for the use of the property; and
>
> (ii) the value of other consideration for such use.[7]

2. Rent "Taken into Account," and Interest

The general rule of §467(a) is that the lessor or lessee under any §467 rental agreement shall *take into account* (*i.e.* include in income or treat as an expense incurred, irrespective of the taxpayer's accounting method), for any taxable year, the sum of:

> (i) the rent *accrued* under §467(b);[8] and
>
> (ii) interest for the year on amounts taken into account in a prior year which are unpaid.[9]

The significance of this language is best understood after considering §467(b). Under §467(b), where the parties to a §467 rental agreement allocate the rents to be paid to the periods covered by the agreement, this allocation will

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be given effect in accruing rental income and expenses for the taxable year. Where rent *allocated to one period*, however, is not payable until *after the close of such period*, such rent is to be taken into account "in an amount determined under regulations which shall be based on present value concepts." [10] Section 467(e)(4) provides that, for purposes of computing present value and interest under §467(a)(2), the rate used is to be 110 percent of the "applicable federal rate" (AFR) as defined by §1274(d).

The operation of these provisions is illustrated by the following example:

Example: A rental agreement entered into on January 1 having a term of three calendar years provides for rent payable at the close of each year in the respective amounts of $50,000, $75,000, and $100,000. This is clearly a §467 rental agreement. The parties to the agreement allocate $75,000 of the total rent paid to each of the three years. This means, in effect, that $25,000 of the rent allocable to Year 1 is not payable until the close of Year 3.

The $25,000 allocated to Year 1 and payable at the close of Year 3 is taken into account for any taxable year in which this one year lease period, or any portion of it, falls to the extent of its present value. Assuming that 110 percent of the AFR is 12 percent, the $25,000 allocable to Year 1 is taken into account to the extent of $19,802.[11] Rent taken into account for Year 1 is, therefore, $69,802 ($50,000 + $19,802). No adjustments are made to Year 2 rent. Interest on the rent taken into account for Year 1, but which remains unpaid, *i.e.*, $19,802, is taken into account by the lessor and lessee for Year 2. Such interest is $2,448. In the third year, the rent taken into account is $75,000. In addition, $2,750 in interest on the deferred rent for Year 1 must also be taken into account.[12]

The following amounts must be reported by the lessor and the lessee in their respective returns for each of the three years covered by the lease:

Year 1:	Rent	$69,802
Year 2:	Rent	$75,000
	Interest	$ 2,448
Year 3:	Rent	$75,000
	Interest	$ 2,750

3. Rent Leveling: Leasebacks and Long-Term Agreements

The rules discussed above apply, generally, to all §467 rental agreements as to which the parties have allocated the rents payable to the periods covered. Where they have not made such an allocation, or where the agreement is a "disqualified leaseback or long-term agreement," another rule applies. Under this rule, there is accrued (and taken into account under the general rule of §467(a)) for each taxable year that portion of the "constant rental amount" allocable to each period.[13] The constant rental amount is determined by "leveling" the rents. To do this, one determines the amount of rent which, if paid in equal amounts at the close of each period, would have an aggregate present value equal to the aggregate present values of the rents called for in the agreement.[14] This constant rental amount is the amount accruable as rental for each period.[15] In addition, interest on unpaid rentals taken into account must also be accrued.[16]

Rent leveling, as stated above, applies to §467 rental agreements where the parties have failed to allocate the rents to the period covered.[17] It also applies to "disqualified leaseback transactions and long-term agreements." [18] A leaseback transaction is a §467 rental agreement which involves a leaseback to any person who had an interest in the property (other than a de minimis ownership interest) [19] at any time within two years before the leaseback to that person (or to a related person).[20] "Related person," for this purpose, has the meaning supplied by §467(d)(4)(D).[21] A long-term agreement is a §467 rental agreement for a term in excess of 75 percent of the property's statutory (ACRS) [22] recovery period.[23] If the property is not recovery property, it is treated as such for purposes of determining whether the lease is long-term.[24] Options to extend the lease exercisable solely by the lessee are not taken into account in determining the lease term.[25] If the agreement is a leaseback transaction or a long-term agreement, it is disqualified only if the Commissioner determines that a principal purpose for providing increasing rents is tax avoidance.[26] For this purpose, the statute mandates the promulgation of regulations providing specific exceptions to disqualification, *i.e.*, circumstances under which an agreement will not be treated as having a principal tax avoidance purpose.[27] Among such safe harbor circumstances will be included:

(i) changes in amounts paid that are determined by reference to price indices;

(ii) rents based on a fixed percentage of lessor receipts or similar amounts; or

(iii) changes in amounts paid to unrelated parties.[28]

4. Recapture

In a §467 rental agreement, where the rents have not been leveled, and the agreement calls for stepped up rents for the later periods of the lease, the property, if sold subject to the unexpired lease, may have a value enhanced by the unpaid rents. That is, if the property is disposed of, a portion of its value will be attributable to future unrealized rental income. To prevent the conversion of such income to capital gain, the statute provides recapture rules, similar to those of §1245.[29]

If property subject to a §467 rental agreement is disposed of, and subject to a leaseback or long-term agreement (as defined above) which was determined not to be disqualified, the "recapture amount" is treated as ordinary income.[30]

The "recapture amount" is the *lesser* of: (1) "prior understated inclusions;" or (2) the excess of the amount realized over the lessor's adjusted basis in the property.[31] If the disposition was other than a sale, exchange, or involuntary conversion, the fair market value of the property is substituted for the amount realized, following the §1245 pattern.[32]

A "prior understated inclusion" is the excess (if any) of the amount which would have been taken into account had

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the rent been leveled over the amount actually taken into account under the general rule of §467(a).[33]

Regulations are to apply exceptions similar to those applicable to §1245 or §1250 (whichever is appropriate, depending on whether the property is §1245 or §1250 property) for recapture purposes.[34]

5. Other Provisions

"Comparable rules" are to apply to §467 rental agreements providing for decreasing rents.[35] Also, as will be provided in regulations, rules comparable to those of §467(a)(2) (relating to the imputation of interest with respect to unpaid amounts taken into account) are to apply to payments for services which meet the requirements of §467(d). (Section 467(d) defines a §467 rental agreement and restricts the application of §467 to contracts calling for total payments in excess of $250,000).[36]

C. Detailed Analysis

1. General

a. Legislative History

In interpreting the statute, it is helpful to consider its development. In the House bill,[37] the OID rules were extended to the interest element of rental (or service) transactions involving deferred payments. The OID rules applied where payment for the use of property in one calendar year was deferred until after the close of the succeeding calendar year. Thus, the lessee was considered, in such a case, to have issued a debt instrument having OID on the last day of the first calendar year. The amount of the OID was determined by computing the present value of the deferred payment using an interest rate of 120 percent of the AFR. If a three-year lease beginning January 1, 1985 provided for one $300,000 payment at the close of the third year (and the parties allocated $100,000 to each year of use) the lessee was considered to have issued, on December 31, 1985, a debt instrument with a stated redemption price at maturity on December 31, 1987 of $100,000 for an issue price (assuming an AFR of 10 percent) of $79,209. (This figure represents the present value of $100,000 payable in two years discounted at 12 percent compounded semiannually).[38] Similarly, the lessee was considered to have issued a debt instrument on December 31, 1986 maturing on December 31, 1987 with a stated redemption price of $100,000 and an issue price of $89,000.[39] The OID would be currently included income by the lessor and deducted by the lessee under the TRA's OID rules.

Note: The OID rules were applied to the deferred rent for 1986 even though the rent for that year was payable at the end of the succeeding calendar year. The House bill contained no rent leveling provisions.

The Senate bill took a somewhat different approach. Under the Senate version of §467,[40] the statute applied to any "deferred rental payment agreement." For this purpose, a deferred rental payment was defined as any agreement under which: (i) there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the succeeding calendar year; or (ii) there is at least one amount allocable to the use of property for any lease period which is not "commercially reasonable." [41]

Note: "Commercially reasonable" was vaguely defined as being dependent on the facts and circumstances. Strict rules limiting the permissible scope of commercial reasonableness were to apply to leasebacks. These rules did not apply where an exchange-traded debt instrument was issued for the use of the property (or services). Stepped rents under a leaseback were allowed to the extent of the applicable federal short-term rate. Rents under any of the above deferred rental agreements were leveled. Interest thereon was imputed at 120 percent of the AFR with respect to the lease period. The interest was imposed on the excess of the constant rental amount over the payments made under the agreement for the period and on any unpaid interest attributable to any previous lease period.[42]

The conferees objected to two features of the Senate version.[43] First, the "commercially reasonable" standard was considered too vague for practical application. Second, the allowance of stepped rentals based on the AFR was considered unjustified. The statute as redrafted by the Conference Committee incorporates features of both the House and Senate versions, but is also quite different in many respects.

b. The $250,000 Limitation

Section 467 has a relatively narrow scope. It applies only to rental agreements under which total rents exceed $250,000, taking into account all forms of consideration paid for the use of the property leased but excluding any amounts paid as consideration other than for the use of the property.[44]

Query: Will expenses incurred by the lessee under an agreement to make improvements to the property or, as is common, to maintain the property in the condition it was in when leased, be deemed consideration "received by the lessor for the use of the property?" Probably not. The statute, in setting the $250,000 limit, refers to the "aggregate amount of payments *received* as consideration for the use of the property, and the aggregate *value* of other consideration to be *received* for such use. This, arguably, includes payments of property taxes and insurance by the lessee. The $250,000 probably includes only amounts payable under the agreement which will be required to be reported by the lessor as income.

2. Qualification as a Section 467 Rental Agreement: Tax Consequences

To qualify as a §467 rental agreement, the agreement must provide either:

(1) That an amount of rent allocable to use of the property in one calendar year is not payable until after the close of the year following such calendar year; or

(2) For "increase in the amount to be paid as rent."

a. When is Deferred Rent Subject to Present Value Accrual?

If an agreement for a three-year rental period provides for payment of $200,000 at the close of the second year and $100,000 at the close of the third, and if the lease further provides that $100,000 of the $200,000 payment is allocable to the first year of use, the agreement does not qualify. If the rent for the last year were $150,000, however, the

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agreement would be a §467 rental agreement. Assuming the agreement is not a disqualified leaseback or long-term agreement, and, therefore, not subject to rent leveling, it is not entirely clear how the rents should be reported. The $100,000 in rent payable for the first year of use is clearly "rent to be paid after the close of the period," and, therefore, under §467(b)(1), it is to be accrued by taking into account such rent "in an amount determined under regulations which shall be based on present value concepts." Is this what Congress intended? The legislative history implies that this treatment of deferred rental is not to apply unless the deferral qualifies under one of the two conditions for qualification as a §467 agreement, *i.e.*, rent allocable to one calendar year is not paid until after the close of the succeeding calendar year. If the deferral, taken alone, would not qualify the agreement as a §467 agreement, should it nevertheless be subject to the §467 rules? The statute seems clearly to provide an affirmative answer.

Assume there is accrued for the one year in the future $89,000 (based on a discount rate of 12 percent compounded semiannually, assuming this is 110 percent of the AFR). Must interest be accrued under §467(a)(2)? The statute provides there must be taken into account for any taxable year "interest for the year on the amounts which were taken into account under this subsection (which incorporates subsection (b)) for prior taxable years and which remains unpaid." As of the close of the second year, however, the rent has been paid. If the lease runs from January 1 to December 31, and the lessor is a calendar year taxpayer, no rent remains unpaid at the end of the second year. On the other hand, if the lease term began on July 1, at the end of the lessor's calendar year in which the second year of the lease begins, there would remain unpaid the amount taken into account for the first year of the lease.

Under the House bill, where rent was deferred, the lessee was to be treated as if he had issued a debt instrument with OID. In the committee report's example, in a three-year lease providing for payment of $300,000 at the close of the last year, which provides that $100,000 was allocable to each year of the lease, the lessee is treated as if he had issued to the lessor a debt instrument at the close of the first year. That instrument would have an issue price equal to the present value of $100,000 due in two years (discounted at 120 percent of the AFR) with a stated redemption price at maturity of $100,000. The lessee would also be treated as if he had issued a debt instrument at the close of the second year with an issue price equal to the present value of $100,000 payable in one year and a stated redemption price at maturity of $100,000. The OID rules were to apply to require inclusion of the OID in the lessor's income and to allow the lessee to deduct this amount. This statutory scheme survived, to some extent, in the provisions adopted by the Conference Committee, but without any references to the OID rules or debt instruments. The requirement of rent leveling in situations involving stepped rents not justified by non-tax related factors was added to the House provisions by Senate amendments. The coupling of these two independent approaches to deferred payments for the use of property makes for a somewhat confusing statutory pattern.

In the case of the three-year lease with a single $300,000 lump-sum payment at the close of the third year, if the parties to the lease specify that it provides a rent holiday for the first two years and the $300,000 is allocated to the third year, and if the lease is neither a leaseback nor a long-term agreement, it would appear that neither party is required to take any portion of the rent into account for the first two years. It is unlikely, however, that persons dealing at arm's length would agree to such terms.

b. The Wide Net of Section 467

Section 467 can be seen as embodying the following two concepts: (1) where rent allocable to one period is not payable until more than a year after the close of the period, some portion of the deferred payment should be attributed to interest; and (2) where a rental agreement calls for uneven rents (increasing or decreasing - "stepped" or "frontloaded") *and*, in addition to being the kind of transaction commonly used to avoid taxes (a leaseback or long-term agreement), there do not appear to be any commercially reasonable grounds for the uneven payments, the rents should be leveled. A third principle is that, in any of these cases, the lessor's inclusion of rent in income, and the lessee's deduction therefor, should be governed by accrual principles, regardless of the parties' respective methods of accounting for other items of income and expense.[45] Thus, the lessor and lessee in any §467 agreement are placed on the accrual basis with respect to any rentals allocable to their taxable years.

Finally, where a stepped rental agreement is not subject to leveling, the appreciation of the property attributable to future rents receivable in excess of the property's fair rental value are too subject to recapture rules similar to those applicable to §1245 or §1250 property to prevent ordinary income from being converted into capital gain.

c. Analyzing a Lease for Section 467 Purposes

In determining whether an agreement is a §467 rental agreement, the agreement's terms should be analyzed in light of the statute's language and purposes.

Every lease must have a lease period or periods. Lease periods are normally uniform (days, months, years, etc.). Some leases, however, may have irregular periods. Also, every lease will specify the amounts to be paid as rent and the time such payments are due. The rent payments usually coincide with the lease periods. Where regular, even payments are to be made at the beginning or end of each lease period of the same duration, it may be inferred that such payments are allocable to the lease periods. Where such payments increase over the life of the lease, while this may be inferrable, it is not necessarily the case. Where the payments to be made for lease periods are not regular and in even amounts, and where the agreement does not specifically allocate the payments to the lease periods covered, the Commissioner, under §467(b)(3)(B), is to compute the constant rental amount for each period. The parties must accrue and take into account such constant rental amounts for tax purposes.

Assuming the rent payments have been allocated in the agreement, it is then necessary to ascertain whether any portion of any payment allocated to a lease period falling in one calendar year is not payable until after the close of the following calendar year. Any such deferred rental payment is subject to §467(a)(1) and (2).

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Next, whether or not there is such deferral of rent, it must be ascertained whether the rent allocable to any lease period is greater than the rent allocable to any other lease period of the same duration.

Example: A lease calls for a rent payment allocable to January, 1985 to be made at the close of December, 1986. The rent deferral is not sufficient to require classification of the agreement as a §467 agreement.

Assume that a lease calls for equal payments to be made at the beginning of each month over a two-year period, but the lessee is given a "rent holiday" for the first month, *i.e.*, no payment at the beginning of January, 1985, but equal payments at the beginning of each month through December, 1986. While there is not sufficient deferral here to classify the agreement as a §467 agreement, it is so classifiable because there is an increase in the amount to be paid as rent. If, in such a case, the parties fail to allocate the rent payments to the monthly lease periods involved, the rent is automatically subject to leveling without regard to whether there was a tax avoidance purpose in granting the one-month holiday.

If a lease calls for increasing rent payments to be made over the lease's life, but these payments are allocated to the lease periods in equal amounts (*e.g.*, payments of $10x, $15x, $20x, $25x and $30x are allocated $20x each to each of the five lease periods) there is no increase in the amount to be paid as rent, but there may be rent deferral sufficient to classify the agreement as a §467 agreement. This will depend on the length of the periods and their timing with respect to the calendar years involved. If the payments to be made of the $ 10x and $ 5x deferred rentals for the first two periods (the last two payments) are not to be made after the close of the calendar year following the calendar year in which either of the first two lease periods fall, the agreement is not a §467 rental agreement.

The statute poses a number of interpretative problems. Consider a lease entered into January 1 for a term of three years providing rents payable at the end of each year in the respective amounts of $10x, $20x and $30x. The parties allocate $20x to each year. There would not appear to be "increases in the amount to be paid as rent" here. There is, however, definitely a deferral of rent for the first year. When is the $10x of deferred rent considered as paid? May $10x of the $20x payable at the close of the second year be taken as payment of the deferred amount, with a second deferral of $10x from the second to the third year? Assume the agreement provided for $60x to be paid at the end of the third year with no payments for the first and second years and with the same $20x per year allocation. Does this involve increases in the amount to be paid as rent? There is, in effect, one lease period of three years with a single payment. As to the first year, there is definitely one amount allocable to the use of property during a calendar year which is to be paid after the close of the succeeding calendar year, and the statute provides for the present value of the deferred amount to be taken into account for such first year.

d. Acounting for Deferred Rentals and Leveled Rentals

There are three time periods involved in applying the statute: (1) the calendar year; (2) the taxable year of the lessor or lessee; and (3) the lease period to which rent is allocable. A lease will provide either for periodic payments, in even or uneven amounts, or for a single payment covering the entire lease term. The parties to the lease are free to determine the lease periods and to allocate to each period some portion of the payment or payments to be made. What Congress seems to have intended was that, regardless of the length of the lease periods and of the allocation made of rents to such periods, the interest element must be taken into consideration in any case where payment for the use of the property during any portion of a calendar year is deferred beyond the close of the following calendar year.[46] Thus, rent allocable to January, 1985 may be deferred until December 31, 1986 without taking interest into consideration.

The second principle Congress adopted was that, regardless of whether the parties specifically acknowledge rent deferral, the IRS may impute deferral where the parties' allocate rent to one period in an amount that is greater than that allocable to another and there exists no non-tax purpose for the difference. This imputed deferral will have the same consequences as acknowledged deferral.[47] In the $10x, $20x and $30x example, if the parties allocate the amount payable at the close of each one-year lease period to that period, there is no deferral. In certain circumstances, however, the Commissioner may determine that $10x of the first year's rent has been deferred until the close of the third year.[48] In that case, the parties must take into account for the first year $10x in rent currently payable plus the present value of the deferred $10x. They must also take into account interest on the deferred $10x until it is paid on a compound basis.

To recap the above discussion, to determine whether an agreement is a §467 rental agreement because of rent deferral, the following steps are necessary.

First, determine whether the agreement provides for an allocation of rents. The amounts payable as rent must be allocated to some definite lease period or periods.

Comment: This is probably unnecessary where the lease calls for regular periodic payments at intervals of no less than one year in even amounts, but even here, the agreement should provide allocations to insure there is no question of deferral.

Second, if there is deferral, but there are no differences in the amounts allocated to each lease period, ascertain whether any deferral is for more than one year. The rent allocation schedule should be compared with the payment schedule to determine this. If the rent allocable to any lease period falling within a calendar year is payable later than the close of the following calendar year, the agreement is a §467 agreement because of rent deferral.

If the agreement is not a §467 agreement because of rent deferral, it must then be analyzed to ascertain whether the amount allocable to any lease period is greater or less than the amount allocable to any other period of the same duration. This appears to be the meaning of "increase in

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the amount to be paid as rent under the agreement." If there are such variances, the agreement must then be further analyzed to determine whether accrual by the parties of a constant rental amount will be required.

3. Operation of §467(a) and (b): Examples and Commentary

There are a number of interpretative problems relating to rent deferrals.

Assume that, in a five-year lease, commencing January 1 with yearly lease periods, rent payable for the first year is deferred until after the close of the second. Assume, also, that rent for the second year is not payable until the close of the third. The first deferral qualifies the agreement as a §467 agreement. The second deferral, alone, does not. The question then arises, as to whether §467(a) and (b) apply to the second deferral. Similarly, assume that, in a second five-year lease, rent for the first year is deferred until the close of the second, but this is the only rent deferral provided. The lease, however, provides for increasing rents and this feature qualifies it as a §467 agreement. Do §467(a) and (b) then apply to the rent deferral?

The statute seems to be clear that, while rent deferral for a period falling in one calendar year to a date no later than the close of the following calendar year will not, standing alone, qualify the lease as a §467 agreement, once the agreement so qualifies due to other provisions, §467 applies to the deferred rent.

Assume a lease for a term of calendar years commencing January 1, 1985. Rent allocated to January 1985 is not payable until December 31, 1986. This deferral does not, alone, trigger §467. Assume §467 does apply, however, because the rent allocated to the final year is greater than that allocated to the next-to-last year. Section 467(b)(1)(B) provides that there must be taken into account "any rent to be paid after the close of the period in an amount determined under regulations which shall be based on present value concepts." The meaning of "period" is somewhat ambiguous. Does it mean "taxable year," lease period, or the calendar year period? In the above case, if the lessor is a calendar year taxpayer, the rent for the first year is payable after the close of all three periods. Based on the legislative history, it would appear that this deferred rent is subject to §467(a) and (b) and must, therefore, be taken into account for taxable 1985 in an amount equal to its present value (unless regulations otherwise provide).

Next, there is the question of whether interest on the amount deferred is includible in the lessor's income for 1986. Section 467(a)(2) provides that there is to be taken into account (for 1986 in the example) interest for the year "on the amounts which were taken into account under this subsection for prior taxable years and *which are unpaid.*" (emphasis added). Here, the rent is paid as of the close of 1986. How is §467(a)(2) to be interpreted here? Again, based on the legislative history, by analogy to the OID rules, interest on the deferred rent taken into account in a prior year is taken into account for the period prior to its payment. In the above case, this is 11 months and 30 days.

The following example illustrates some of the above principles.

Example: A lease for a three-year term commencing July 1, 1985 provides for a payment of $200,000 on June 30, 1987 and another of $100,000 on June 30, 1988. The parties allocate $100,000 to each one-year lease period. This is a §467 agreement since an amount allocable to the use of the property during calendar 1985 is not payable until after the close of the following calendar year. If the payment schedule provided for a $200,000 payment on December 31, 1986 and another payment of $100,000 on December 31, 1987, it would not be a §467 agreement.

Assume that the above lease commenced on July 1, 1985, and that lessor was a calendar year basis taxpayer for the taxable year ending December 31, 1985. Here, the lessor would have to take into income (regardless of his accounting method) the amount of rent accruing under §467(b). Section 467(b) provides that the amount of rent which accrues during any taxable year is determined by allocating rents in accordance with the agreement. The agreement allocated $100,000 to the period ending June 30, 1986. Thus, $50,000 of this amount would appear to be accruable for the lessor's 1985 taxable year. Section 467(b) also provides, however, that there must be taken into acount any rent to be paid "after the close of the period in an amount determined under regulations which shall be based on present value concepts." There are three "periods" involved here: (1) the lessor's taxable year, (2) the calendar year in which the use of property occurred, and (3) the one-year lease period. The rent allocable to the period July 1 — December 31, 1985 is to be paid after the close of all three periods. The statute would appear to require that the lessor take into account for his taxable year ending December 31, 1985 the present value of $50,000 payable on June 30, 1987 discounted at 110 percent of the AFR. Assuming this is 12 percent, the rent includible would be $41,980. Similar problems are encountered in determining the rent to be included in the return for calendar 1986. Consistent with the above analysis, there is accrued for the first six months of 1986 the present value of $50,000 payable in one year ($44,500). Then, there is a present value to be paid after the close of all three periods. The statute would appear to require that the lessor take into account for his taxable year ending December 31, 1985 the present value of $50,000 payable on June 30, 1987 discounted at 110 percent of the AFR. Again, assuming this to be 12 percent, the rent income includible would be $41,980. Similar problems are encountered in determining the rent to be included in the return for calendar 1986. Consistent with the analysis above, there is accrued for the first six months of 1986 the present value of $50,000 payable in one year ($44,500). The question then arises: is a present value computation to be made with respect to the rent accruable for July 1 — December 31, 1986? The rent allocated to July 1, 1986 — June 30, 1987 is payable at the end of that lease period. Arguably, then, no present value computation need be made, and $50,000 is accruable for the period July 1 — December 31, 1986. Also includible for 1986 is interest on the deferred payment for July 1 — December 31, 1985 ($5,189). No interest on the deferred payment for January 1 — June 30, 1986 would appear to be includible since, on this amount, there is no "interest for the year on the amounts which were taken into account under [subsection (a)] for prior taxable years and which

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are unpaid." [49] For the taxable year ending December 31, 1987, under this analysis, $50,000 is includible for the period January 1 — June 30, 1987, and another $50,000 for the period July 1 — December 31, 1987. Is additional interest includible with respect to the rental deferred for 1985? It would seem that there is, even though the deferred rent was paid during 1987; it was unpaid for the first six months of the year. This interest is $2,830. In addition, interest is accruable on the rent deferral with respect to the period January 1 — June 30, 1986. This interest is $5,500. For calendar 1988, the lessor takes into account $50,000 for the final six-month period of the one-year lease period ending June 30.

To summarize, the lessor would include in income the following amounts:

Taxable year ending:	Rent	Interest
December 31, 1985	$ 41,980	0
December 31, 1986	$ 94,500	$ 5,189
December 31, 1987	$100,000	$ 8,330*
December 31, 1988	$ 50,000	0
	$286,480	$13,519

* ($5,500 + $2,830 from the foregoing fact situation

Computations become much more complex where a §467 rental agreement involves monthly lease periods or lease periods of irregular length. More complex calculations are also necessary where the lessor's fiscal year, the lease term, and the lease periods are all other than calendar year periods.

Comment: Regulations may clarify some of the above problems. For instance, the computation of the present value amount to be included with respect to deferred payments is to be provided by regulations. The Conference Report states that the rent allocable to a taxable year will be determined from the lease terms. The Conference Report further provides that, if the lease specifies amounts that are allocable to particular periods but these amounts are not paid until more than one year after the year to which they relate, the rent to be accrued for each period will be an amount determined under Treasury regulations based on present value concepts. The Report adds that it is anticipated that these regulations could provide different methods for determining the appropriate amount, depending on the type of lease involved.[50] It is unclear precisely what the conferees envisioned in making this latter statement.

4. Constant Rental Accruals

a. Why Rent Leveling?

As stated above, where different amounts are allocated to lease periods of the same duration, the lease is a §467 rental agreement regardless of whether there is rent deferral. Also, where rents are deferred, the agreement is a §467 agreement regardless of whether different amounts are allocated to lease periods of the same duration (where the deferral is for more than one year, as explained above). Where a lease calls for uneven rent allocations, there is a potential for abuse, since uneven allocations may disguise deferral.

Example: A five-year lease provides for payments at the end of each year in the respective amounts of $10x, $15x, $20x, $25x and $30x. If the property's fair rental value is about $20x per year, there is a possibility that, despite the parties' allocation, rent has actually been deferred from the early to the later years. If, in this situation, an accrual basis lessee were entitled to deduct the rent on a level basis of $20x per year, while a cash basis lessor was only obligated to take rent into account when received, a mismatching to the Treasury's detriment would result. Under §467(a) and (b)(1), this would not be possible where the parties must make and adhere to a rent allocation. The lessee, regardless of his accounting method, could deduct no more than the rent allocable to each period. Even in this situation, however, where the lessor is subject to a higher tax rate than the lessee, such an agreement would produce revenue loss since the lessor is deferring the realization of income taxable at a higher rate than the lessee. Similar results would occur if the lessee were, by reason of loss carryover, credits or even tax-exempt status, in a position where he would suffer very little tax disadvantage by not being able to deduct the deferred rents and interest thereon. Also, if the parties made no allocation of rents, without §467, the lessor, if a cash basis taxpayer, would report rental income only when it was received. The lessee, however, if an accrual basis taxpayer, could claim rent deductions of $20x per year when the liability arose.

Congress, after considering one version of remedial legislation proposed in the Senate bill,[51] decided to require rent leveling in situations like the one above where either: (1) the circumstances indicate a principal tax-avoidance purpose; or (2) the parties fail to allocate rents in the rental agreement.

Drafting legislation to deal with the tax-avoidance situation was difficult in view of the fact that, often, non-tax considerations will call for varying amounts to be charged for rental periods of the same duration. Rent leveling was therefore confined in tax-avoidance purpose cases (*i.e.*, where the parties allocate rent in the agreement) to two types of leases. These are the "leaseback transaction," and the "long-term agreement." A transaction is a leaseback transaction "if it involves a leaseback to any person who had an interest in such property within two years before such leaseback (or to a related person).[52]

b. Leasebacks: What is a "Related Person?"

The statute reads: "if [the leaseback transaction] involves a leaseback to any person who had an interest in such property at any time within two years before such leaseback (or to a related person)." Which party to the lease is modified by "related" is unclear. Does it modify "person," or does it mean "related to the lessor?" The Conference Report is not too helpful here. It states, "(or to a person related person to such person) [sic]." [53] Probably

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what is meant is "(or to a person related to such person)," *i.e.*, the lessee. Congress could also have intended, however, that a leaseback transaction will exist where the property is leased to a person related to the *lessor*.[54] Either view is probably within the meaning of the statute in view of its purposes.

c. Long-Term Leases

Long-term leases often have tax-avoidance facets. Many such leases are on the borderline separating a lease from a conditional sale, and rental payments have many of the characteristics of purchase payments. Such a transaction, if it is determined to be a lease, will escape §483 relating to deemed interest on certain deferred payments. Payments made thereunder may well reflect an interest element. The drafters of §467 decided to draw a somewhat arbitrary line in defining as long-term a lease with a term in excess of 75 percent of the property's "statutory recovery period" [55] under §168.[56] For §467 purposes, the property involved does not have to be property with respect to which §168 ACRS deductions are allowable. To determine the recovery period, the property is treated as if it were "recovery property." [57]

Note: Section 467 applies only to rental agreements involving tangible property. The Conference Report also makes it clear that it is not intended in any way to affect the IRS' ability to challenge purported leases on the ground that they are, in substance, sales.[58]

d. The Tax Avoidance Factor - Safe Haven Rules

Given a §467 rental agreement that qualifies as a leaseback or long-term agreement, rental payments are accruable in accordance with the allocations agreed to by the parties in the lease unless the Commissioner determines that a principal purpose for providing increasing rents is tax avoidance.[59] Regulations are to be issued providing safe harbors, *i.e.*, setting forth circumstances which will not be viewed as reflecting a tax-avoidance purpose.[60] The non-tax avoidance purposes enumerated in the statute are:[61]

(i) Changes determined by reference to price indices. The conferees comment that they intend that the regulations will provide that rents increasing at a variable rate equal to the rate of increase in the CPI (or some other formula coming within such parameters) will not be considered to have a tax avoidance purpose. Such increases may be aggregated and made in intervals of five years or less.

(ii) Rents based on a fixed percentage of the lessee's gross receipts.

(iii) Rent changes based on costs incurred by the lessee and paid to third parties. It is cautioned, however, that no inference is intended as to the effect of a pass-through to the lessee of increases in the lessor's debt service obligations upon the IRS' determination of whether the lease is, in fact, a sale.

(iv) Rent holidays. The conference committee indicates that reasonable rent holidays of up to 12 months, but in no event longer than 24 months, may be acceptable where this is shown to be prevalent in the particular market.

The regulations may also allow reasonable rent fluctuations where it appears that this is commercially reasonable under the circumstances. Fluctuations within 10 percent of average rent have been determined by the IRS to be reasonable (for purposes of determining whether a purported lease is a lease for tax purposes) in transactions involving personal property.[62] Leases involving real estate, however, may be subject to more lenient standards.

The conference committee emphasized that a major factor in determining the existence of tax avoidance as a principal purpose of a stepped rental lease is the extent to which the tax brackets of the lessor and lessee differ at the time of the lease or may be expected to differ over its life.[63] Such leases, and so-called "sandwich" leases which interpose a cash basis entity between an accrual basis lessor and the lessee or use a tax-exempt lessee-sublessor, will be subject to special scrutiny. It was also pointed out that the involvement of tax-exempt entities or taxpayers with low marginal tax brackets or NOL carryovers will not automatically lead to a determination of tax avoidance. Each case will be judged on all the facts and circumstances. Note, however, that, where a deficiency has been determined on the basis of rent leveling in a leaseback or long-term lease situation, the taxpayer has the burden of proving that the lease terms did not have a principal tax-avoidance purpose. Since the Commissioner's determination, aside from the safe harbor factors enumerated in the statute, appears to be completely discretionary, taxpayers seeking to contest such a determination must prove an abuse of discretion - always a difficult task. The Conference Report may furnish the only solid ground for contesting rent leveling adjustments under §467. Significant departures from those guidelines could be open to challenge.

Finally, the conferees viewed as indicating tax avoidance motives renewal options in a stepped rent lease providing for payments during the renewed term of amounts approximating the constant rental amount.

The statute provides that rent leveling may be appropriate in "front-loaded" leases as well.[64]

e. The "Constant Rental Amount"

Once a leaseback or long-term lease has been determined to be "disqualified" by reason of a tax avoidance purpose, the rent leveling is effected by allocating to each lease period equal rentals in amounts such that the sum of the present values of such rentals will equal the sum of the present values of the payments called for in the lease. No particular interest rate is provided by the statute for determining constant rental amounts. The statute provides only that the constant rental amount is the "amount which, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement."

5. Recapture

Assume a leaseback or a long-term agreement as defined above which is a §467 rental agreement but which is not "disqualified" (*i.e.*, has not been determined to have a principal tax-avoidance purpose). The agreement may be characterized as a §467 agreement for either of two reasons: (1) rent deferral; or (2) uneven rent allocations. In the

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case of rent deferral, the deferred amount is taken into account for the taxable year in which falls the lease period (or portion thereof) to which the deferred amount is allocable, in an amount equal to its present value. Where property subject to a §467 agreement is sold, the tax consequences must be considered.

Example: A lessor (L) enters into a five-year lease on July 1, 1985. Under its terms, $100,000 in rent allocated to the period July 1 - December 31, 1985 is not payable until January 1, 1987. This is a §467 agreement. L must, therefore, take into account for his taxable year ending on December 31, 1985 the present value of $100,000 payable in one year and a day. Assume this is to be $89,000 (using a 12 percent rate). Assume next that L sells the property to P on June 30, 1986. The purchase price will reflect the fact that the purchaser (P) will be entitled to receive the deferred rental payment in 1987 and should evaluate this payment at its present value. For tax purposes, the new lessor (P) steps into the shoes of the previous lessor (L). L must include in his return for calendar 1986 interest on the deferred payment through June 30, 1986 ($5,340).[65] P, for his calendar year ending December 31, 1985, must include $5,660 in interest.[66] Since the rent allocated to the period July 1 to December 31, 1985 has been included in L's income, P will not include the $100,000 payment made on January 1, 1987 in income for his calendar year 1987.

In the above situation, it can be seen that L derives no tax advantage. To the contrary, he is taxed twice on the same amount: once when it was included in 1985 income and again when it was included in the capital gain (if any) realized from the sale of the property.

Consider now the following examples.

Example (1): Assume that the fair market value of the property is about $190,000 year, and that the rental agreement provides for rent payments, allocated by the parties to the one-year lease periods preceding such payments, of $100,000 at the end of the first year (*i.e.*, payable on June 30, 1986), $150,000 at the close of the second year, and $200,000, $250,000 and $300,000, respectively, at the close of the three remaining years. Level rent, using a discount rate of 12 percent, is approximately $188,500. While this is a §467 agreement, assume the Commissioner determined it not to be disqualified. On June 30, 1986, Lessor (L) sells the property to P. The sales price will reflect the fact that, during the lease's remaining life, P will receive rents having a present value that is greater than the present value of rents for such remaining term if no more than the property's fair rental value were payable. If one computes the present value of the remaining payments to be made under the lease and the present value of four equal payments of $188,500 on the above facts, the difference is $88,500. This, presumably, is the premium the purchaser would pay. Under §467(c), this $88,500, defined as "prior understated inclusions," would be subject to recapture. It would, thus, be treated as ordinary income to the extent of any gain realized from the disposition of the property.[67]

Gain realized from the disposition of the property means, in cases other than a sale, exchange, or involuntary conversion, the excess of the property's fair market value over the Lessor-transferor's basis therein.[68] Thus, recapture rules similar to §§1245 or 1250 are to apply as if the prior understated inclusions were allowable depreciation. The exceptions applicable under §1245 and §1250 are to apply in determining the recapture amount.[69] If any gain is treated as ordinary income under either of these sections (or any other Code section) the §467 recapture amount is reduced by the amount of such gain.[70] Under §§1245 and 1250, certain dispositions (nonrecognition transactions and gifts, for example) are excepted from the general rule. Any transferee in a disposition of property subject to a §467 agreement which is excepted by the §§1245 or 1250 rules who has a transferred basis in the property is to be treated in the same manner as the transferor.[71]

Example (2): In the case in Example (1), above, involving a recapture amount of $88,500, if the property had been transferred to a controlled corporation in a §351 transaction, and no gain was recognized by the transferor in such transaction, the corporate transferee would step into the transferor's shoes for all tax purposes. That is, any disposition of the property by the corporation would be subject to the same recapture rules as would be the transferor if the property had not been transferred. If gain had been recognized by the transferor, the amount of such gain allocable to the property subject to the §467 agreement would increase its basis in the transferee's hands and, hence, would reduce the amount of any gain upon disposition by the transferee.

Sections 163(d), 170(e), 341(e)(12), 453B(d)(2), and 751(c) contain provisions relating specifically to §1245 and §1250 property. For purposes of these provisions, §467 recapture property is to be treated as §1245 or §1250 property.[72]

Note: The recapture provisions apply only to property subject to a leaseback transaction or a long-term agreement as those terms are defined in §467(e)(2) and §467(b)(4), respectively,[73] which are §467 rental agreements. Note that the statute prescribes no interest rate to be used in computing the constant rental amount (the Senate bill specified 120 percent of the AFR). In the agreement used in the example (annual rents of $100,000, $150,000, $200,000, $250,000, and $300,000) the constant rental amount using a rate of 12 percent is about $188,500. Using 20 percent, it is about $181,500.

Observation: Assume a lease called for stated dollar amounts of rents for the first two years, allocable to such years without deferral, and then provided that rents for the third and succeeding years were to be based on a percentage of gross receipts (or some similar quantum reflecting the income from use of the property). This would clearly be a §467 rental agreement, but, in the event it was a disqualified leaseback or long-term agreement, how could a constant rental amount be determined? The question seems academic since such a provision would probably come within the safe harbor rules. Yet, if gross receipts were sufficiently large, the rents would be increased from the first two to the third and later years. Would recapture be required in this case? Apparently, recapture is not possible where the constant rental amount cannot be determined with any degree of accuracy. This situation would probably not call for leveling in any event, since the purchaser is not assured of receiving any definite amount of rent. On the

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other hand, if the lessor were a merchant with a proven volume of sales in his former location, the effect of such an agreement might be the same as a stepped rental agreement. The first two years' rent might be artificially low to permit the lessee to recoup moving expenses and to build up clientele in the new location. Then, a high percentage of gross receipts could be required for the next two years to make up for the partial rent holiday, followed by a lower percentage in the succeeding years. Such a situation would post difficult problems in administering §467.

6. Additional Observations

a. Possible Conflict with Section 482

Assume the lessor and lessee of a §467 lease are organizations, trades or businesses controlled by the same interests. Assume, further, that the rent charged by the lessor is deemed not to be an arm's length rental within the meaning of Regs. §1.482-2(c). An allocation is therefore made requiring recognition by the lessor of additional rent (if inadequate rent was charged) or reducing the lessee's rent deduction (if there was an overcharge). Is §482 to be applied first and then §467, or the other way around? Of course, under §482, no indebtedness arises by reason of an allocation. If the lessor has not charged adequate rent, its gross income is increased to reflect what the rent would be had an arm's length charge been made. The lessee, however, does not thereby become obligated to pay the additional rent. The lessee is entitled to a correlative adjustment increasing its rent expense deduction, as if it had paid the additional rent. Is §467 to be applied by deeming the parties to have agreed to pay an arm's length rent as determined under §482? Or are appropriate adjustments to be made? The answer is unclear.

b. Bad Debt Deduction; Discharge of Indebtedness Income

The Conference Report states in a footnote [74] that Congress intended that any rent or interest accrued by the lessor under §467(a) and (b), as well as under the rent leveling provision, will be treated in the same manner as a receivable or other debt owed to an accrual basis taxpayer. The lessor will, thus, be entitled to claim a bad debt deduction if the lessee, for any reason, fails to pay the rent accrued under §467 when due, subject to the general bad debt deduction principles. Simlarly, where rent or interest so accrued is forgiven or otherwise goes unpaid, the lessee will have discharge-of-indebtedness or tax benefit income to the extent of such forgiven or unpaid accruals.

c. Lessee's Assumption of Liabilities

It is common for a lessee under a long-term lease to agree to assume the burden of any increases in the lessor's debt service on the property. Rent increases due to such a lease provision will not generally be considered to have a tax-avoidance purpose. The Conference Report cautions, however, that this should raise no inference as to the effect of such a provision in the determination of whether the arrangement is a true lease.[75]

d. Interest Surcharge Under Section 6621(d)

Section 6621(d), added by Act §144, imposes an interest rate of 120 percent of the rate otherwise payable on substantial underpayments (*i.e.*, in excess of $1,000) attributable to "tax motivated transactions." In addition to some transactions enumerated in the statute, regulations are to provide a list of accounting methods the use of which may result in a substantial distortion of income. Underpayments attributable to such methods will be deemed attributable to tax-motivated transactions. The Conference Report [76] anticipates that, among the deductions and claimed tax benefits which might be considered to arise from accounting methods that may result in a substantial distortion of income, should be included "(f)ailure to take into account deferred rental payments in accordance with the principles of §467 as added by this Act. . ." [77]

e. Accrual Method Required for All Lessors and Lessees?

Almost all commercial leases will be §467 rental agreements, since virtually every commercial lease provides for some increase or decrease in rent, usually based on commercially reasonable provisions unrelated to tax. Under §467(a), if a lease is a §467 agreement, the parties, irrespective of their accounting methods, must take into account for their respective taxable years "the amount of rent which accrues during such taxable year under subsection (b)." Section 467(b), in turn, provides that the determination of the amount which accrues during any taxable year is made by allocating rents in accordance with the agreement. Assume that rent for the month of December, for example, is payable on January 15 of the following year. The December rent, under §467(b), must be accrued and taken into gross income of a cash basis lessor as of the close of December. Likewise, a cash basis lessee may deduct such rent on the same basis, *i.e.*, accrue it as of the close of December. This, in effect, places virtually all lessors and lessees on the accrual basis with respect to rent payments except in the relatively rare instance where a lease does not provide for any "increases in the amount to be paid as rent under the agreement."

7. Effective Date, Etc.

Section 467 is generally effective with respect to agreements entered into after June 8, 1984. *See* TRA §92(c).

There are two exceptions to the general effective date. First, §467 does not apply to any agreement entered into pursuant to a written agreement which was binding on June 8, 1984 and at all times thereafter.[78] Second, §467 does not apply, subject to a schedule of deemed rental payments set forth in Act §92(c)(3), to any agreement to lease property if:

> (i) There was in effect a firm plan, evidenced by a board of directors' resolution, memorandum of agreement, or letter of intent on March 15, 1984, to enter into such agreement, and construction of the property was commenced (but such property was not placed in service) on or before March 15, 1984,[79] *and*
>
> (ii) To any agreement to lease property if certain circumstances obtained.

Note: The description of these circumstances is so detailed that this exception seems obviously drafted to apply to a transaction which had been carefully planned prior to the completion of the conference committee action on Act §92 and which the committee believed persuaded

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merited special relief. This exception is clearly not of general application.

The schedule of deemed rental payments mentioned above and contained in Act §92(c)(3) is supplemented by certain operating rules. Further, §92(c)(3) does not apply where the sum of the present values of all payments to be made under the agreement is greater than the sum of present values of all the payments to be made or received under the schedule. Such present values are to be determined using a discount rate of 12 percent compounded semiannually. The Conference Report is silent as to the reasons for the exceptions provided by Act §92(c)(2)(B) and (C).

II. Loans with Below-Market Interest Rates

A. Background

The tax consequences of interest-free loans, especially loans made by a corporation to its controlling shareholder, have remained a matter of concern over the years to the IRS. In 1961, the Tax Court held in *Dean v. Comr.*,[80] that the Commissioner improperly included in the gross income of a shareholder the economic benefit received by him as the result of an interest-free loan made by the corporation, such benefit being measured by the interest foregone by the lender. The court reasoned that, had interest been charged, or were it imputed, the shareholder would be entitled to a deduction under §163 in an equal amount (unless it were shown that the proceeds were invested in tax-exempt securities) creating a wash for tax purposes. The IRS appeared to accept this decision. In 1972, a refund was reported to the Joint Committee on Taxation under §6405 involving taxable years in which the taxpayer was indebted to his controlled corporation. Bowing to the authority of Dean, the IRS, after having proposed inclusion of interest in the taxpayer's income based on the economic benefit theory, conceded the issue. The Chief of Staff of the Committee disagreed with the Tax Court's conclusion in *Dean*, however, and recommended that the IRS reconsider its position. As a result, the IRS in 1973 issued a belated nonacquiesence [81] and began litigating the issue in appropriate cases. In this effort, it was unsuccessful, since the courts declined to overturn *Dean*, a case of long standing.[82] Legislation appeared to be the only solution.[83]

On another front, the government was more successful. In 1973, a ruling was issued [84] taking the position that, in the case of an interest-free loan by a father to a corporation owned by his son, there is a taxable gift equal to the value of the right to use the funds loaned. This position was upheld by the Supreme Court in *Dickman v. Comr.*, decided in 1984,[85] which held that an interfamily interest-free loan gives rise to a gift in the amount of the foregone interest for gift tax purposes. Whether such a loan may also have income tax consequences has not been ruled on or presented to a court for decision.

Exactly how the income tax treatment of interest-free or below-market interest loans should be handled is not clear. While there has always been some sentiment supporting the view that gross income should include all economic benefits received by a taxpayer, this has never been fully recognized by U.S. tax laws, and would probably be unworkable in practice. An economic benefit analysis of what should be included in income, however, has gradually made its way into the law in a number of areas (*e.g.*, employee fringe benefits, officer/shareholder use of corporate property without adequate consideration, etc.). Foregone interest inclusion has at least the virtue of permitting a readily ascertainable determination of the quantum of income. The more difficult problem is posed by the fact that the benefit received (foregone interest) would, in most cases, be fully deductible by the recipient. On the other hand, any interest paid would be fully includible in gross income of the lender. It is interesting to compare the interest-free, non-gift loan situation with the treatment required under §482. Under §482, where inadequate interest is charged on a loan from one commonly controlled entity to another, the lender's income is increased to reflect what it would be had interest been charged at an arm's length rate.[86] The borrower is allowed a "correlative" interest deduction in the same amount. Thus, the bestower of the benefit, the lender, is the one penalized, whereas the recipient is given an additional deduction. The TRA provisions follow this same pattern, except that they take into consideration the fact that the borrower is receiving a benefit measurable in money which should, in some fashion, be recognized. The rules devised by Congress not only give legislative effect to *Dickman* for gift tax purposes, but create a set of rules governing the income tax consequences of such transactions.

B. Overview

Section 7872 (Treatment of Loans with Below-Market Interest Rates) was added to the Code by TRA §172. Section 7872 provides both the gift and income tax consequences of below-market rate interest loans.

1. Basic Rules

Section 7872 posits two basic categories of below-market interest (BMI) loans: (1) gift and demand loans, and (2) other loans. Category (1) includes term and demand loans which are gift loans and all demand loans. Category (2) includes term loans which are other than gift loans. A BMI loan is, in the case of a demand loan, one providing for interest at a rate below the applicable federal rate (AFR). A BMI term loan is one where the principal amount is greater than the present value of all payments to be made thereunder discounted at the AFR compounded semiannually. A demand loan is a loan all of which is payable upon demand of the lender. A term loan is any other kind of loan.

2. Gift and Demand Loans

In any gift loan (whether a term or a demand loan) and any demand loan (gift or non-gift), the lender is treated as having transferred to the borrower any foregone interest.[87] "Foregone interest" is, with respect to any period for which the loan is outstanding, the excess of the interest which would have been payable for such period if interest accrued at the AFR and was payable annually on the last day of the calendar year over any interest payable on the loan properly allocable to such period.[88] Except as provided by regulations, any foregone interest attributable to periods during a calendar year is treated as transferred by the lender to the borrower on the last day of such calendar year.[89] The amount considered transferred by the lender to the borrower is also treated as having been retransferred on the same

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date by the borrower to the lender *as interest.*[90] As to any demand loan, these provisions apply for both income and gift tax purposes. As to term loans, they apply only for income tax purposes. The gift tax consequences of a gift loan which is a term loan are governed by §7872(b).[91]

Example: On February 1, 1985, L makes a $50,000 non-gift loan to B, payable on demand. On the day the loan is made, the AFR is 10 percent. The loan provides for the payment of 5 percent simple interest at the end of each year the loan is outstanding. This is a BMI demand loan to which §7872(a)(1) applies. L also loans $50,000 to B2. This loan is repayable in two $25,000 installments to be paid at the end of the first and second years of the loan, respectively. Interest is provided at a rate of 5 percent simple interest payable at the time of each $25,000 installment. The recipient of the loan is L's son, and it qualifies as a gift loan. This, too, is subject to §7872(a)(1).

In the case of the first loan, as in the case of any demand loan, for purposes of determining the foregone interest, the AFR is the federal short-term rate (as defined in §1274(d)) for the period for which the amount of interest is to be determined.[92] While the statute does not so specifically provide, it may be inferred from the committee reports[93] that, for purposes of determining foregone interest, a demand loan is treated as a series of one-day term loans. Consequently, the foregone interest must be computed on a daily basis. Thus, should the AFR change while the loan is outstanding, such changed rate must be applied in determining foregone interest. Assuming no change in the AFR occurred and that B had made no repayments as of December 31, 1985, the amount of the foregone interest is computed to that date. In keeping with the basic principles underlying the TRA's time value of money amendments, when applying the AFR semiannual compounding would appear to be called for.[94] Thus, in the example above, the amount of foregone interest is $2,500 (for the first six-month period the loan was outstanding) plus $2,187.50 (5/6ths of the $2,625 in interest accrued for the second six-month period) making a total of $4,687.50, less the interest payable on the loan properly allocable to the period February 1 - December 31. The latter amount is $2,500 x 11/12 = $2,291.66. The lender must therefore include in gross income as interest for the year $2,395.84. The borrower is entitled to an interest deduction in the same amount. The parties' respective accounting methods are irrelevant since the transfer and retransfer are deemed to have occurred on December 31.[95] L is treated as having received this same amount as interest income. B is entitled to treat this amount as an interest expense, deductible as such subject to any other applicable Code provisions (*e.g.*, §163(d), §267).

In the case of the gift term loan, the foregone interest is determined by reference to the AFR (short, mid, or long-term depending on the loan term) in effect on the date the loan was made. Discounting the payments to be made under the loan to B2 in the example above at 10 percent compounded semiannually, the present value of the two $25,000 payments, plus the interest provided, is $46,539. Since this is less than the $50,000 principal amount, the loan is a BMI loan. The foregone interest on this loan is the same amount as that computed for the demand loan. L is therefore treated as having transferred to B2 $2,396 on December 31, 1985. B2 is treated as having retransferred this same amount to L as interest. It is therefore treated as an interest expense to B2 and as interest income to L. The gift tax consequences of such a loan are discussed below.

The statute treats as a demand loan any term loan which is not transferable where the benefits of the interest arrangements are conditioned on future performance of services by an individual. *See* §7872(e)(5) and discussion, *infra.* The AFR to be used in determining foregone interest in this type of loan, however, is not necessarily the short-term rate. If the loan is, in fact, for a term longer than that to which the federal short-term rate applies (not more than three years), the loan term will determine the proper AFR to be used.

3. Other Loans (Non-Gift Term Loans)

For a term non-gift loan, the income tax consequences are somewhat different from those described above. The first step is to determine, as of the date the loan is made, the excess of the principal amount over the present value of all payments to be made (both principal and interest (if any)) using the appropriate AFR. This amount is considered as having been transferred by the lender to the borrower, in cash *on that date.* As in the case of the loans described above, the tax consequences of such deemed transfer will depend on the parties' relationship. The borrower is treated as having issued a debt instrument having original issue discount (OID) equal to the amount deemed to have been received in cash.[96] This OID will be in addition to any OID determined independently of §7872.

Example: On June 30, 1985, L makes a loan to B of $50,000. The loan calls for repayment on December 31, 1986 of the $50,000 with interest at 6 percent compounded semiannually. The short-term AFR in effect on June 30, 1985 is 12 percent. This is clearly a BMI term loan. The present value of all payments due under the loan (one payment of $54,636 on December 31, 1986) discounted at 12 percent compounded semiannually is $45,873. B is, therefore, treated as having received $4,127 from L in cash on June 30, 1985. Also, B and L are treated as if B had issued a debt instrument with $4,127 of OID. This amount is currently includible in L's income (and deductible by B as interest) under §1272 (and §163(e)). If L were a corporation and B were a shareholder (irrespective of the amount of stock held), the $4,127 would be treated as a distribution to B taxable as a dividend to the extent of L's earnings and profits. If the positions were reversed, L would be treated as having contributed $4,127 to B's capital. If B were an employee of L, the transfer of cash would be treated as compensation. If the loan were a gift loan, while the income tax consequences would be determined under §7872(a), the amount of the gift would be the $4,127 determined as described above.

4. Loans to Which Statute Applies

Section 7872 applies to the following types of loans:

(i) any BMI *gift* loan,

(ii) any *compensation-related* loan.

(iii) a BMI loan directly or indirectly between an employer and employee, or an independent contractor and the person for whom services are rendered.

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(iv) any BMI loan directly or indirectly between a corporation and any shareholder,

(v) any BMI loan if one of the principal purposes of the interest arrangements is tax *avoidance*,

(vi) to the extent provided by regulations, any BMI loan not described above if its interest arrangements have a significant effect on the tax liability of the lender or the borrower.[97]

5. De Minimis Exceptions

There are two "de minimis" exceptions. The first relates to gift loans between individuals. The second relates to compensation-related and corporation-shareholder loans.

In the case of a gift loan between individuals, §7872 does not apply to any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000.[98] This exception does not apply, however, to any gift loan directly attributable to the purchase or carrying of income producing property.[99] Further, if the gift loan is a term loan, and if on any day the aggregate amount of loans between the individuals exceeds the $10,000 exception amount, §7872 will apply to such loan for the remainder of the period during which it is outstanding even though the balance drops below $10,000. This last rule applies, however, only for gift tax purposes.[100]

The same $10,000 de minimis exception is extended to compensation-related and corporation-shareholder loans, except where the loan had a principal tax-avoidance purpose.[101] The exception to the de minimis exception described above, *i.e.* where the balance of a term loan exceeds $10,000, also applies to these types of loans, and *is* effective for income tax purposes.[102]

6. Special Rules for Gift Loans

In the case of a gift loan directly between individuals [103] the amount considered as retransferred by the borrower to the lender as interest at the close of any year is not to exceed the borrower's net investment income for the year. This rule does not apply when the interest arrangements have a principal tax-avoidance purpose.[104]

Note: Recall that foregone interest in the case of a gift loan is accrued on the last day of the calendar year. That is the day on which the transfer and retransfer are deemed to have taken place with respect to any loan made or outstanding during such calendar year. The year referred to in the provisions discussed above is, therefore, the calendar year.

Where more than one gift loan is outstanding during a calendar year, the borrower's net investment income is to be allocated among such loans in proportion to the amounts which would be considered as retransferred (without regard to the above provision).

The above limits do not apply to any loan for any day on which the outstanding balance of loans between the borrower and lender exceeds $100,000.[105]

Note: This limit applies to a loan or loans between each individual lender and individual borrower. Thus, where a borrower has two or more loans outstanding, each from a different lender, the limit applies on a lender-by-lender basis. Also, where a lender has outstanding two or more loans to different borrowers, the same principle applies.

Example: Individual B borrows $75,000 from his brother, L, in an interest-free gift loan. During the same calendar year, B also borrows $75,000 from his father, F, under similar terms. During the year, B has no net investment income. Under the exception provided by §7872(d), the amount treated as transferred by B to L and to F is zero, *i.e.*, while the foregone interest is taxable as a gift, neither L nor F is treated as having received interest on the loan.

For all purposes of §7872, a husband and wife are considered one person.[106]

Section 7872(d)(1)(E) defines "net investment income" for purposes of the above rules. That term is to have, in general, the same meaning as it has in §163(d), to wit, the excess of investment income over investment expenses.[107] Further, if the net investment income of any borrower for any year does not exceed $1,000, it is considered to be zero.[108] Investment income includes any amounts includible in the borrower's income under §1272 (relating to the current inclusion in income of original issue discount) as if that section applied to all deferred payment obligations.[109] "Deferred payment obligations" include any market discount bond, short-term obligation, U.S. savings bond, annuity or similar obligation.[110]

7. Miscellaneous Provisions

Section 7872 does not apply to any loan to which §483 or §1274 applies (these sections relate to obligations arising from the sale or exchange of property).[111]

No amounts are to be withheld under Chapter 24 with respect to amounts treated as transferred or retransferred under §7872(a).[112] (Chapter 24 contains rules governing the withholding of employment taxes on wages and backup withholding on certain reportable payments including compensation for the rendition of services, dividends and interest).

Note: Amounts deemed transferred under §7872(b) by the lender to the borrower as the result of a BMI term loan, however, would seem to be subject to withholding where such amounts are considered compensation or a dividend. Further, amounts considered interest under §7872 may be subject to information returns under §6049.

8. Regulatory Authority

The Secretary is given broad authority to issue regulations "necessary or appropriate" to carry out the purposes of §7872.[113] This includes the issuance of rules "adjusting the provisions" of §7872 where, by reason of varying interest rates, conditional interest payments, waivers of interest, disposition of the lender's or borrower's interest in the loan, or other circumstances the statutory provisions do not carry out the purposes of §7872.[114]

Such regulations are to insure that the positions of the lender and borrower are consistent as to the application (or nonapplication) of §7872.[115] The regulations may also exempt from §7872 any class of transaction the interest arrangements of which have no significant effect on the tax liability of either party.[116]

Regulations are also to provide that any BMI term loan made with donative intent is to be taken into consideration

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for purposes of Chapter 11 (Estate Tax) in a manner consistent with §7872(b).

9. Effective Dates

Except as provided by paragraph (2) thereof, Act §172(c) provides that §7872 applies to (a) terms loans made after June 6, 1984 and (b) demand loans outstanding after that date.

Section 172(c)(2) provides that §7872 does not apply to any demand loan which was outstanding on June 6, 1984 and was repaid before September 16, 1984 (60 days after the enactment of the 1984 TRA).

Section 7872 also does not apply to loans made before June 6, 1984 to a continuing care facility by a resident which is contingent on continued residence at the facility.

The AFR for periods before January 1, 1985 (the first determination of the AFR to be made within 15 days after September 30, 1984 becomes effective on January 1, 1985),[117] to be applied for purposes of §7872 is 10 percent, compounded semiannually.[118]

Any loan renegotiated, extended, or revised after June 6, 1984 is to be treated as a loan made after that date.[119]

For purposes of the effective date provisions, "demand loan," and "term loan" have the meanings they have in §7872, except that the special rule for an employee term loan (benefits conditional on performance of substantial services, etc. See §7872(e)(5)) which is to be treated as a demand loan under certain circumstances does not apply.[120]

C. Detailed Analysis

1. Examples of the Statute's Operation with Commentary

As previously indicated, where an interest-free or below-market interest loan is made, the transaction is treated as if the lender had advanced to the borrower the funds with which to pay an arm's length rate of interest at the AFR and the borrower is considered to have paid such interest with the funds advanced. This results in three distinct tax consequences:

(1) If the loan is a gift loan, the transfer is taxed as a gift. If the loan is not a gift loan, the tax consequences depend on the parties' relationship. If the borrower is an employee of the lender, the transfer is treated as compensation. It is thus deductible by the lender unless the compensation is unreasonable. If the borrower is a shareholder of the lender, the transfer is treated as a distribution to which §301 applies. If the borrower is a corporation and the lender a shareholder, the transfer is treated as a contribution to capital.

(2) The deemed payment of the amount deemed transferred in (1) to the borrower back to the lender as interest, applicable to gift and demand loan transactions, is treated as interest expense, deductible by the borrower subject to any applicable restrictions on deductibility (*e.g.*, §163(d)- investment interest, and §267- deductibility of payments between related persons). Where transfer described in (1), above, is treated as an item of gross income to the borrower, this will be offset by the deduction provided by (2) in many, if not most, cases. These deemed transfers, however, must be reported in parties' returns as if they actually took place.[121]

(3) The deemed payment of interest is includible in the lender's gross income.

The above analysis applies to all gift loans for income tax purposes, and to all demand loans both for income and gift tax purposes. A different treatment is afforded non-gift term loans, although the same basic analysis applies. That is, the lender is deemed to have transferred to the borrower the funds with which to pay the difference between the interest charged (if any) and interest at the AFR. This amount is the excess of the amount of the loan over the sum of the present values of all payments to be made thereunder.

Note: The "foregone interest" in a gift or demand loan will always be greater than the excess of the principal amount of the loan over the present value of all payments to be made by the borrower. Consider the simplest case, a loan of $100 for a one-year accrual period (for compounding purposes). Assuming an AFR of 10 percent, the foregone interest, ignoring compounding, is $10. On the other hand, if the $100 is payable at the end of the year, the difference between $100 and the present value of $100 payable in one year is $9.09 ($100 — $90.91 —). This deemed transfer, in the case of a term gift loan, is the amount of the gift for gift tax purposes. In the case of a non-gift loan, its treatment, like the treatment of the deemed lender-to-borrower transfer in the case of a non-gift demand loan, depends on the parties' relationship. In addition, since the borrower must pay the lender, over the loan term, an amount in excess of the amount deemed borrowed, the term loan is treated as an OID debt instrument.

Example: If L lends B $100, without interest repayable at the close of one accrual period, and the AFR is 10 percent, B is treated as having received from L (as wages, dividend, contribution to capital, etc.) $9.10 plus a loan of $90.90. B must repay L $100. Therefore, the deemed issue price of B's obligation is $90.90 and its stated redemption price at maturity is $100. There is, therefore, $9.10 of OID. This amount is deductible by B over the life of the obligation and is includible in L's income as interest.[122] Again, assuming the AFR is 10 percent (and ignoring semiannual compounding), if L wants to allow B to use $100 of L's money for one year, a term loan is more advantageous. If, on January 1, L advances $100 to B, and B repays the $100 on December 31, the tax consequences are as follows:

(1) If the loan is a demand loan, L is deemed to have transferred $10 to B on December 31. B is allowed a $10 interest expense and L must take $10 into income as interest.

(2) If the loan is a one-year term loan, the deemed transfer to B is only $9.10, and this same amount is the interest expense allowed to B and the amount includible in L's income as interest. The deemed transfer to B is considered to have occurred on January 1. Interest on the $90.90 of principal runs from January 1 to December 31 and is currently taken into account by L and B regardless of their respective accounting methods.[123]

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According to the Conference Report, term gift loans are treated for income tax purposes like demand loans because, in light of the relationship likely to obtain between the parties, they may not consider the loans as binding. Also, in the case of a non-gift term loan, OID must be determined and each party must compute the applicable amount of current income or deduction by applying the complex rules of §§1271 - 75. In the case of a gift term loan, this is avoided.[124] As previously indicated, in the case of a gift term loan, the spread between the amount loaned and the sum of the present values of all payments to be made thereunder, using the appropriate AFR, must be determined for purposes of measuring the amount of the deemed gift from the lender to the borrower.

Example (1): Individual A lends $50,000 to individual B. B gives A his personal note under which the $50,000 is to be repaid without interest in four equal semiannual installments. This is a gift loan. If the short-term AFR is 12 percent for gift tax purposes, A is deemed to have transferred to B $6,686 on the date of the loan. For income tax purposes, however, the parties must compute the interest on the unpaid principal balance each year the loan is outstanding through December 31, using a 12 percent rate with semiannual compounding. A is considered to have transferred this amount to B on December 31. B is considered to have retransferred the same amount on the same date to A as interest. Since this is a gift loan, there are no income tax consequences.

Example (2): Assume that the loan in example (1), *supra*, was made on March 31, 1985. Interest at 12 percent, compounded semiannually, is computed on the $50,000 principal amount through September 30, at which time B makes the first $12,500 payment reducing principal to $37,500. Interest on this amount, and on the unpaid interest previously computed, is then computed through December 31. The total is $4,215, reportable by A as interest income received during calendar 1985. An equal amount is allowed to B as interest expense. For 1986, the amount computed would be $3,632, and for 1987, $592.

Note: If the above loan had not been a gift loan, but simply a below-market interest term loan, the deemed transfer to B of $6,686 on March 31, 1985 would have income tax consequences depending on B's relationship to A. The OID rules would require inclusion in A's income of the $6,686 of OID. This would require computation on the basis of four serial maturities, with the OID allocated to each series. If A had loaned B $49,000 and taken back a note providing for four equal $12,500 semiannual payments, the debt instrument would have $1,000 of OID without the §7872 computation. To this, there would be added another $5,686 in OID, as explained above. How OID is computed for obligations having serial maturities is explained in Chapter 21, *supra*.

2. What is a "Gift Loan"?

Where a loan is made bearing a rate of interest below the market rate (measured by the applicable federal rate for purposes of §7872), it is a gift loan unless it is a sale, exchange, or other transfer made in the ordinary course of business (*i.e.*, a transaction which is bona fide, at arm's length and free from any donative intent).[125] The question of donative intent is relevant only where the taxpayer seeks to establish that the loan was made for full and adequate consideration. Thus, a below-market interest loan made without any ostensible quid pro quo is automatically a gift. While the committee reports often refer to gift loans as "family loans," it is made clear that the lender and borrower do not have to be related for there to be a gift loan.[126]

3. Revocable Trusts

The Conference Report, at pages 1018-19, notes that, if a taxpayer makes a below-market demand loan to a trust, and the loan is treated as a revocable transfer of property for purposes of subpart E[127] the provisions of subpart E govern since it would be anomalous to give effect for tax purposes to a loan made by the taxpayer to himself.

4. Certain Employee Loans Treated as Demand Loans

As previously indicated, §7872(e)(5)[128] provides that a "demand loan" is a loan all of which is payable in full at any time on the demand of the lender. Also treated as a demand loan is any loan which is not transferable where the benefits of its interest arrangements are conditioned on the future performance of substantial services by an individual. The Conference Report points out that a benefit is treated as nontransferable and conditioned on future performance of substantial services under §7872 if it would be treated as nontransferable and conditioned on such future performance under §83, if that section applied.

Example: A loan provides that the interest rate will automatically increase for the remainder of its term to the market rate (applicable federal or higher) in the event of the borrower-employee's employment with the employer terminates for any reason.[129]

5. Types of Loans To Which The Statute Applies

The Senate, in amending the House version of §7872, enumerated the types of loans covered by the provisions. This was adopted by the conference committee. The statute's drafters probably foresaw numerous instances in which the question would arise as to whether a loan, while clearly not made with donative intent, nevertheless was within the intended scope of the provisions. A business person, for example, may make a below-market loan to a customer or prospective customer to generate goodwill, or to obtain a favorable contract. Section 7872(c)(1) provides that §7872 applies to the following types of loan: (a) gifts, (b) compensation-related loans, (c) corporation-shareholder loans, (d) "tax avoidance" loans, and (e) such other loans as may be provided by regulations where the interest arrangements "have a significant effect on any Federal tax liability" of either party (an "E type" loan).

a. Compensation-Related Loans

The Conference report states that, to qualify as a compensation-related loan, there must be a debtor-creditor relationship between an employee and an employer (or, presumably, an independent contractor and the person for whom the contractor renders services). The report provides as an example a payment made by an employer to a third-party lender to induce the lender to make a mortgage loan to an employee.[130] If the facts and circumstances

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indicate the payment was to secure a valuable benefit for the employee it will be treated as compensation, not as a loan. Where the employer, in substance, lends the money to the employee, and the putative third-party lender merely acts as the employer's agent, however, the §7872 rules apply.

A compensation-related loan can result where an employee receiving payment (sale proceeds, for example) on behalf of his employer is permitted to retain the proceeds for a meaningful period of time without paying interest. In some instances, allowing the employee to retain moneys received on behalf of the employer may be regarded as being in lieu of a part or all of a fee which would otherwise have been charged. Where this is not clearly established, however, such a transaction could be considered an E type loan, (one covered under regulations to be issued) where the arrangement has a significant impact on the tax liability of either party.[131]

The report clarifies that, in a compensation-related loan, the deemed payment by the lender to the borrower is treated as wages for purposes of Chapters 21 -23 and that, unless regulations otherwise provide, such deemed payment must be included in the recipient's gross income even though he may be entitled to an offsetting interest deduction.[132] Lastly, even though the payment is not subject to wage withholding under Chapter 24, it may be subject to information reporting.[133]

It is conceivable that an employee could make a below-market interest loan to his financially troubled employer (other than a corporation-shareholder loan). This would clearly not be "compensation-related." Such a loan would not seem to be covered by §7872 unless provided for in the regulations to be issued under §7872(c)(1)(E) (*i.e.*, having a significant impact on tax liability).

b. Other Loans

The corporation-shareholder loan is more or less self-explanatory. Where the lender is the corporation, the deemed payment to the borrower will normally be considered a distribution to which §301 applies. This will be true regardless of whether the shareholder controls the corporation. Where a family-owned corporation makes a below market rate loan to a family member who is not a shareholder or who is a minority shareholder, will the deemed payment to the borrower be considered a constructive dividend to the controlling shareholder(s)? This would appear to be the result where the loan is made to someone other than a family member and where its purpose is to secure some benefit for the controlling shareholders. The deemed payment to the family member may also be regarded as a gift, however. The controlling shareholder(s) would then be subject both to income tax on the constructive dividend and to gift tax, as if the funds had first been withdrawn from corporate solution by way of a dividend and then given to the beneficiary.

What constitutes a tax avoidance loan is not discussed in the Conference Report. How does one distinguish a tax avoidance loan from an E-type loan? The report gives as an example of an E-type loan the making of a refundable deposit by a club member in lieu of payment of dues.[134] Had the money been invested at interest to generate the funds needed for payment of nondeductible dues, income tax would have been payable on such interest.

6. Coordination With The OID Rules

Section 7872(e)(8) provides that §7872 does not apply to any loan to which §483 or §1274 applies. Section 7872 applies principally to loans of money. It would not, therefore, ordinarily apply to a purchase money loan transaction where the seller receives the purchaser's debt obligation in payment for all or part of the sales price. What if the seller lends the money to the purchaser who then pays the amount borrowed to the seller in satisfaction of the purchase price, however? The section of the Conference Report relating to the OID and §483 rules seems to deal with this situation. The report states that the conferees do not intend that taxpayers be able to circumvent the 120 percent of AFR rule (the rate for imputing interest where interest of at least 110 percent of the AFR is not provided for) simply by coupling a low interest loan with a sale of property. If the seller agrees to lend the buyer the money with which to pay the sales price, charging interest at 100 percent of the AFR to avoid any adjustments under §7872, the loan will be treated as a purchase money loan subject to the 110 percent of AFR test and the 120 percent of AFR imputed interest rate of the OID and §483 rules rather than the 100 percent of AFR rule that applies to below-market interest loans.[135]

Comment: This raises an interesting problem. Assume the loan is a gift loan to the borrower, and that the property in question is "personal use property." Under the principle above, the loan is treated as a purchase money loan to which either §1274 or §483 applies. But, under the special rule of §1275(b), these sections will not apply to the obligor (the borrower); they apply only to the lender-obligee. Does §7872 then apply to the borrower?

Example (1): Husband and wife own a house which is not used by them as a principal residence. The house has a fair market value of $250,000. They plan to sell the house to their son for $250,000. They are willing to take in payment for the house Son's note for $250,000, payable in 120 equal monthly installments without interest. The house is personal use property. Assume that the long-term AFR is 10 percent. The note has OID of $104,791. (Present value of 120 monthly payments of $2,083 discounted at 12 percent compounded semiannually is $145,209; $250,000 - $145,209 = $104,791). Applying §1274 to the Son's debt instrument, the purchase price (imputed principal amount) paid for the house is $145,209. The difference between this and the fair market value of the Son's note is a gift.[136] The OID computed must be currently included in the obligee's income over the life of the debt instrument under §1272.[137] The Son, however, is not entitled to any interest deductions, since, as to him, §1274 does not apply and, as a result, §1273(b)(4) (relating to debt instruments issued for untraded property to which §1274 does not apply) provides that the note's issue price is the stated redemption price at maturity, *i.e.*, it has no OID. But may the provision of §7872 be applied here? It was suggested above that §7872 applies only to loans of money, but this is not specified in the statute. A purchase money loan is a "loan," in common parlance. While §7872 does specify that the section does

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not apply to any loan to which either §1274 or §483 applies [138] (which would not seem to be necessary if §7872 applied only to loans of money), since §1274 and §483 do not apply to Son in the above example, the way seems open to treating the transaction, as to Son, as a term gift loan. In this case, using 100 percent of the AFR to discount the note, a small gift amount is computed. In addition, Son will be entitled to deduct interest each year under §7872(a)(1) at the 100 percent of AFR rate.

Example (2): Assume that Father lends Son $250,000, repayable in 120 equal installments without interest to be used to purchase a house (other than the Father's house). This is clearly a term gift loan to which §7872 applies. Since the "issue price" of the instrument is equal to its stated redemption price at maturity, there is no OID under §1273. But suppose Father and Son agreed to make provision for some interest — say 5 percent, raising the monthly payment from $2,083 to $2,652. The note would have OID of $68,240. This would be currently includible in Father's income and currently deductible by Son.[139] Applying §7872, to determine the amount of the gift from Father to Son, it is necessary to determine the difference between $250,000 and the sum of the present values of 120 monthly payments of $2,652 each using 100 percent of the AFR compounded semiannually. This is, roughly, $200,680.[140] The gift amount is, therefore, $49,320. Annual interest amounts to be included in Father's income (in addition to the OID computed above) are then computed under §7872(a)(1) and a like amount is allowed to Son as interest expense.

7. Exceptions

a. "De Minimis" Exceptions

The first "de minimis" exception applies to gift loans between individuals. Section 7872 does not apply to any day on which the "aggregate outstanding amount of loans between such individuals does not exceed $10,000." [141] The Conference Report clarifies that this "includes all loans between the lender and the borrower regardless of the rate of interest." [142] Thus, if Lender lends to Borrower $7,500 at interest above the AFR and makes a second interest-free loan of $5,000, the two loans are combined for purposes of applying this exception. Note also that the statute is phrased in terms of "loans between such individuals," not just from one to another. Thus, if Lender lends $7,500 to Borrower and, subsequently, Borrower makes a loan to Lender, the loans are combined for purposes of computing the $10,000 limit. This exception does not apply to any gift loan "directly attributable to the purchase or carrying of income producing assets." [143] If the recipient of a gift loan owns stock or securities, the question will arise as to whether the loan is "directly attributable" to the carrying of these assets. As to this, the Conference Report provides no enlightenment. It seems fairly clear, however, that the mere possession of income producing assets by the borrower will not automatically make the exception inapplicable. Something more, perhaps tracing, is required. If a father makes a gift loan to his daughter, who uses the entire proceeds to purchase an item of jewelry or a car, her ownership of interest producing assets will presumably not disqualify the loan as coming within the exception. Note, however, that the exception applies only where the outstanding balance of the indebtedness does not exceed $10,000. If, on any day, the balance exceeds this amount, §7872 applies with respect to the *entire amount* of the indebtedness (not just the amount in excess of $10,000). If the gift loan is a term loan, and on any day the outstanding indebtedness of the borrower exceeds $10,000, the exception no longer applies as to all subsequent days during the life of such term loan. This rule applies, however, in the case of a gift loan, only for purposes of determining the amount of the gift for gift tax purposes.

Example: On January 1, F makes a $5,000 interest-free gift demand loan to D. On September 1 of the same year, he lends D $7,000 to purchase a car. This loan is repayable in 36 monthly installments of $210 (reflecting interest of 5 percent). On the day after the monthly installment that reduces the principal amount of the term loan to $5,000, the loan meets the de minimis exception amount. Section 7872 no longer applies to any day thereafter (unless F makes some additional loans to D) for income tax purposes. For gift tax purposes, however, §7872 still applies to D's indebtedness to F. Assume these loans were made in 1985. As to the term loan, the gift tax consequences are determined in 1985. That is, this is gift in that year of the excess of $7,000 over the present value of the payments to be made under the term loan. The gift tax consequences of the $5,000 demand loan are based on the foregone interest accrued through December 31. This continues during the next year. Assume that D has paid off $2,000 of the principal amount of the term loan with the September installment. Section 7872 still applies to determine the gift tax amount with respect to the outstanding $5,000 demand loan. This will continue to be the case until the last installment of the term loan has been paid. On that date, the exception comes back into effect as to each day thereafter. On the other hand, on the day after the principal of the $7,000 loan has been reduced to $5,000, §7872 no longer applies to either loan for income tax purposes.

The second *de minimis* exception is for compensation-related loans and corporation-shareholder loans. Section 7872 does not apply (*i.e.*, no amounts are considered as transferred from the lender to the borrower and retransferred from the borrower to the lender as interest for any day during which the aggregate outstanding amount of loans between the borrower and lender does not exceed $10,000 *unless* a principal purpose of the interest arrangement is tax avoidance.

For purposes of this exception, again, all loans between the parties are aggregated. The Conference Report makes it clear that in the case of non-gift term loans, the deemed transfers from the lender to the borrower are treated as occurring on the later of the date on which the loan was made or the date on which the exception does not apply by reason of exceeding the $10,000 limit. For example, if an employer makes a compensation-related loan to an employee on April 1 (with no other indebtedness outstanding) of $9,000, and a $2,000 compensation related loan to the same employee on April 20, the parties are treated as if an $11,000 compensation-related loan had been made on April 20. In the event of a reduction of a non-gift compensation

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or corporation-shareholder term loan below $10,000, the exception does not apply to the days after the reduction until the term loan has been paid in full. The lender is treated as receiving from the borrower, and the borrower is treated as retransferring to the lender, the foregone interest on the remaining outstanding balance.

b. Special $100,000 Gift Loan Exception

The third exception is provided by §7872(d), (Special Rule for Gift Loans). In the case of a gift loan *directly between individuals, the amount treated as retransferred by the borrower to the lender* as of the close of any year shall not exceed the borrower's "*net investment income*" for such year. This limitation does not apply, however, to any loan for any day on which the aggregate outstanding amounts of loans between the borrower and lender exceeds $100,000. "Loans," for this purpose, means the principal amount.

"Net investment income" is defined in §7872(d)(1)(E) in elaborate detail. Generally it appears that, where the borrower is engaged in any investment activities, the determination of net investment income will involve numerous technical problems.

The first such problem comes from the general rules that "net investment income" has the meaning given the term by §163(d)(3).[144] This rule, in itself, will require a detailed analysis of the borrower's income other than that derived from the conduct of a trade or business.

The net investment income limit is somewhat softened by the provision that, where such income does not exceed $1,000, it shall be considered to be zero.[145]

Considerable complications may arise, however, from the additional provisions that, in determining net investment income, there is to be treated as interest received for the taxable year "any amount which would be included in the income of such person [the borrower] for such year by reason of §1272 *if such section applied to all deferred payment obligations* (emphasis supplied)." If the borrower is the holder of any debt instruments or has loaned money or sold property, a computation of "quasi-OID" will have to be made.[146] The committee report "anticipates" that regulations will prevent the abuse of these rules through deferral or other distortion of the borrower's investment income, and will deal with situations wherein the borrower can control the timing of the receipt of income (*e.g.*, payment of dividends where purpose is to defer the receipt of investment income). The regulations will also deal with the situation where either the borrower or the lender reports income on a fiscal year basis.[147]

This special exemption for $100,000 of gift loans directly between individuals does not apply where the principal purpose of the interest arrangement is tax avoidance. Where parents (as noted above, husband and wife are treated as one person) make a gift loan to their children to ease their financial burdens, the funds can be used for almost any purpose except investment.

Comment: Congress did not intend to except investment. Nor did they intend to except from §7872 gift loans made as an alternative to revocable or short-term trusts for the benefit of the lender's family members, effectively shifting income and defeating assignment-of-income principles.

The conference committee, foreseeing one possible avoidance technique, specifically referred to the making of a loan bearing adequate (AFR) interest coupled with a gift of funds with which to defray the interest charges. In such a case, it is anticipated that regulations will provide that the amounts to defray interest will be added to loan principal for §7872 purposes, and that the transaction will be treated "in accordance with its substance."[148]

8. Coordination with §482

The situation may arise where §7872 conflicts with §482. Under §482, where one commonly controlled equity makes a loan or advance to another at an interest rate which is not equal to an arm's length rate (deemed, under Regs. §1.482-2(a)(2)(iii), unless established otherwise, to be 120 percent of the AFR) the lender's gross income is increased (and the borrower is allowed a deduction) equal to the excess of the arm's length rate over the amount of interest charged (if any). Section 7872 applies to all taxpayers: individuals, corporations, and other entities (unless specifically excepted. Where, in a typical §482 case, a U.S. corporation lends money to (or sells goods on credit to) its controlled foreign subsidiary without interest or at an interest rate that is less than an arm's length rate, how are §§7872 and 482 to be applied? If §7872 is applied first, how is §482 then to be applied, if at all?

Example: Corporation A, a U.S. corporation, on January 1, 1985 lends to its wholly owned foreign subsidiary $1,000,000 repayable without interest in two $500,000 installments on December 31, 1985 and December 31, 1986. Presumably, this cannot be a gift loan. Assume a short-term AFR of 10 percent. Under §7872(b), A is treated as if it transferred $135,135 to its subsidiary on January 1, 1985. In addition, the foreign corporation is treated as if it had issued a debt instrument with OID of $135,135. This amount is taken into account by A under §1272 over the two-year life of the loan. A similar deduction is allowed to the foreign entity. But 100 percent of the AFR still does not equal an arm's length interest charge. Is §482 then to be applied to increase A's income to reflect additional 2 percent in interest? Suppose §482 is first applied, increasing A's income to reflect a 12 percent interest charge on the outstanding balance of the indebtedness ($1,000,000 the first year and $500,000 the second year). Does this effectively take §7872 out of the picture entirely? If §7872 is applied first, there is a deemed contribution by A to the subsidiary's capital, (increasing A's basis in its stock, of $135,135. This does not occur when §482 is applied. Regulations may provide some answers here.

[144] *See* §467(d) defining a "§467 rental agreement." While §467 also applies to agreements for the rendition of services, the statutory provisions all relate to the use of property. Section 467(g) provides that regulations are to be issued containing rules "comparable to the rules of §467(a)(2)" to be applied in the case of payments for services which meet the requirements of §467(d). Section 467(a)(2) requires that the interest element of any unpaid deferred payment be taken into account currently (*i.e.*, as in the case of OID) by both parties to an agreement.

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[2] "Stepped rent," increases from one lease period to another.

[3] While the statute does not specifically so provide, as did the Senate bill the regulations will undoubtedly provide that §467 does not apply to any payments which are subject to §§83, 267, 404, 404A, or 706(a).

[4] *See* footnote 1 and 3, *supra.*

[5] §467(d)(1).

[6] Thus, if the agreement calls for rent of $X per month (or other lease period) payable at the beginning (or close) of each month (or other lease period) throughout the agreement's life, it is presumably not a §467 rental agreement provided that payment for the use of property in one calendar year is not deferred until after the close of the following calendar year. A lease covering more than two calendar years which provides for a single payment at the termination of the lease term is, therefore, a §467 agreement. If the parties specify that no rent is allocable to the first year (a reasonable rent holiday), while the agreement may not be a §467 agreement by reason of rent deferral, it would be a stepped rent agreement and, therefore, a §467 agreement.

[7] §467(d)(2).

[8] §467(a)(1).

[9] §467(a)(2). This provision, as indicated in the examples below, is somewhat ambiguous. If rent allocated to Year 1 is not payable until Year 3, for example, while no amount of the Year 1 rent deferred remains unpaid at the close of Year 3, the statute seems to require that interest on such deferred rent be computed and included in income in Year 3 for any period during such year that the rent remains unpaid.

[10] §467(b)(1)(A) and (B).

[11] The present value of $25,000 payable in two years discounted at 12 percent compounded semiannually. Semiannual compounding would appear to be required even where the lease period is one month, *i.e.*, where rental for the first three months of Year 1 is deferred until some time after the close of Year 2. The present value of each month's deferred rent is computed on this same basis (12 percent compounded semiannually).

[12] This interprets §467(a)(2) to require the accrual of interest on any deferred rent taken into account in a prior year which remains unpaid for any length of time during the year. This interpretation carries out the purpose of the statute. Regulations will undoubtedly make this clear.

[13] §467(b)(2). Rent leveling applies to (1) §467 agreements where the parties have failed to allocate the rent payments to the lease period(s), irrespective of any tax avoidance purpose, and (2) "disqualified" leasebacks and long-term agreements, *i.e.*, leasebacks and long-term agreements found by the Commissioner to have a tax avoidance as a principal purpose.

[14] §467(e)(1). Section 467(e)(4) provides for an interest rate of 110 percent of the AFR to be used in "determining present value and interest under subsection (a)(2)." This rate, however, is not specified as the rate to be used in determining the constant rental amount under §467(e)(1). In a stepped rental agreement, the higher the rate used to determine the constant rental amount, the lower the constant rental amount. Since interest on unpaid leveled rents is accruable under §467(a)(2), it would be surprising if some rate other than 110 percent of the AFR were used to determine the constant rental amount. Under both the House and Senate versions of provisions relating to deferred payments for the use of property, interest imputation was computed at 120 percent of the AFR.

[15] *I.e.*, taken into account by both parties to the lease under §467(a)(1) regardless of their respective methods of accounting for tax purposes.

[16] §467(a)(2).

[17] §467(b)(3)(B).

[18] §467(b)(3)(A).

[19] Conference Report, H.R. Rep. No.98-861, 98th Cong., 2d Sess. 892 (1984). (Hereinafter referred to as C. Rep.).

[20] §467(e)(2).

[21] §467(e)(5).

[22] Section 467(e)(3)(A) provides a schedule of the statutory recovery periods identical to those applicable for purposes of §168.

[23] §467(b)(4)(A).

[24] §467(e)(3)(B).

[25] §467(e)(6), except as may be provided by regulations. The length of the lease term is necessary not only to determine whether the lease is a long-term agreement, but also to apply the proper AFR. Section 467(e)(4), providing the discount and interest rate to be applied for purposes of §467(a)(2), provides that the AFR to be used is that "in effect at the time of the agreement is entered into with respect to debt instruments having a maturity equal to the term of the agreement." Thus, if the lease has a 15-year term, present values of any deferred rental payments are computed using the long-term (more than nine years) AFR, even though the deferral in question is only for two years. The long-term rate is invariably higher than the short and mid-term rates.

[26] §467(b)(4)(B).

[27] §467(b)(5).

[28] §467(b)(5)(A)-(D). What circumstances may be relevant is discussed in C. Rep. at 893-894.

[29] §467(c).

[30] §467(c)(1)(A) and (B).

[31] §467(c)(2).

[32] §467(c)(2)(B).

[33] §467(c)(3).

[34] §467(c)(5). Paragraph (5) specifies that the transferee in any transaction excepted under §467(c)(5)(A), (*e.g.*, a nonrecognition transaction — *see* §1245(b)), who has a transferred basis in the property (as defined in §7701(a)(43), added by Act §43(a)(1)) shall be treated in the same manner as the transferor.

[35] §467(f). These are to be supplied by regulations.

[36] §467(g). See footnotes 1 and 3, *supra.*

[37] H.R. 4170. *See* H.R. Rep. No. 98-432, 98th Cong., 2d Sess. at 1249—1250. These provisions appear in §1275(b) as enacted by §41 of the bill.

[38] H.R. Rep. No. 98-432, *supra*, at 1250. The report computes the present value of $100,000 as $76,745 when discounted at 12 percent compounded semiannually. The correct amount would appear, unaccountably, to be 13.68 although the AFR is stated to be 10 percent and 120 percent of this rate is to be used in determining the OID. A similar error is made in the second computation deriving the OID of the instrument deemed to have been issued on December 31, 1986.

[39] This the correct present value of $100,000 discounted at 12 percent compounded semiannually. (89 x .06 = 5.34; 94.34 x .06 = 5.66; 94.34 + 5.66 = 100).

[40] Under the Senate amendments, provisions relating to deferred payments for the use of property and services were removed from §1275 and enacted in a separate section of the Act as Code §467. In both the House and Senate versions, a number of specific provisions were made relating to payments for services. These were all removed, and the application of §467 to payments for services is effected solely by §467(g). Section 467(a) is a brief, one sentence paragraph stating that rules comparable to those of §467 are to be set forth in regulations dealing with payments for services. The Senate version of §467 is explained in S. Rep. No. 98-169, 98th Cong., 2d Sess. at 260-3 (hereinafter S. Rep.).

[41] §467(d) enacted by §74 of title I of the Deficit Reduction Tax Act of 1984.

[42] §467(a) as enacted by the Senate before amendment by the Conference Committee.

[43] *See* C. Rep. at 890.

[44] Is "consideration received for the use of property" different from "the amount to be paid as rent under the agreement" as the latter language is used in §467(d)? Suppose the lessee allows the lessor to continue to occupy a portion of the premises rent-free. Is this consideration "*received by the lessor*?" It clearly is not "an amount to be paid as rent."

[45] Section 467(a) provides that, in the case of the lessor and lessee in a §467 rental agreement, "there shall be *taken into account*. . . for any taxable year" the amount of rent which accrues under §467(b) plus interest for the year on any amount *taken into account* for prior taxable years which are unpaid.

[46] *Id.* "The Senate amendment requires that both the rent and interest elements of a deferred rent transaction be included in the lessor's income and deducted by the lessee anually, unless rent is paid before the end of the year following the calendar year in which the property is used." The Conference Committee voiced no objection to this portion of the Senate amendments.

[47] This is effected by requiring accrual of the constant rental amount.

[48] That is, if the agreement is a "disqualified leaseback or long-term agreement," or if the parties fail to allocate the rentals to the lease periods covered by the lease.

[49] §467(a)(2). While the $50,000 allocated to January 1 — June 30, 1986 is not payable until June 30, 1987, and is, consequently, accruable only to the extent of its present value under §467(b)(1)(B) since it is not to be paid until after the close of the period (*i.e.*, taxable 1986 or the lease period ending June 30, 1986, whichever is the proper meaning of "period" as used in the statute) no interest on the deferred amount is accruable under §467(a)(2) since it was not "taken into account. . . for prior taxable years."

[50] C. Rep. at 892.

[51] *See Legislative History, supra.*

[52] §467(e)(2).

[53] C. Rep. at 892. This passage of the report also points out that "The conferees do not intend that a de minimis ownership interest be deemed an interest for this purpose."

[54] For this purpose related person has the meaning given by §168(d)(4)(D).

[55] §467(b)(4)(A).

[56] *See* §467(e)(3)(A).

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[57] §467(e)(3)(B). Of course, land does not have a statutory recovery period and, as to such property, there apparently can be no long-term lease. The same would seem to be true of any property which does not fall under any of the classes set forth in the schedule provided by §467(e)(3)(A).
[58] C. Rep. at 894.
[59] §467(b)(4)(B).
[60] §467(b)(5).
[61] §467(b)(5)(A)—(D). The Conference committee's comments on the non-tax avoidance safe harbor provisions are in C. Rep. 893-4.
[62] Rev. Rul. 75-21, 1975-1 C.B. 715, §5.
[63] *See* explanation at I, C, 4, a, *supra*.
[64] *See* §467(f) "Comparable Rules Where Agreement for Decreasing Payments."
[65] §467(a)(2) requires the lessor to take into account interest for the year on the amounts taken into account in prior taxable years which are unpaid. Presumably, "for the year" means the portions of the year during which the lessor holds the property. "Which are unpaid" presumably means "unpaid at the time the property was transferred."
[66] *See* footnote 65, above, for presumed interpretation of "for the year." "Which are unpaid," presumably, means "unpaid during any period the property is held by the lessor during the taxable year."
[67] §467(c)(1).
[68] §467(c)(2)(B).
[69] §467(c)(5). Rules similar to those of §1245(b) will apply when the property is personal property; §1250 types rules will apply where the property is real estate. These rules are to be supplied by regulations to be issued.
[70] §467(c)(2). The recapture amount is reduced by the amount of any gain treated as ordinary income on the disposition under any Code provision, *i.e.*, such other provisions take priority.
[71] "Transferred basis property" is defined in §§7701(a)(43) as added by §43(a)(1) of the 1984 TRA.
[72] §467(c)(5)(C).
[73] §467(c)(4).
[74] C. Rep. at 892, n. 4.
[75] C. Rep. at 893, n. 5.
[76] C. Rep. at 984.
[77] C. Rep. at 985.
[78] Act §92(c)(2)(A).
[79] Act §92(c)(2)(B).
[80] 35 T.C. 1083 (1961).
[81] 1973-2 C.B. 4.
[82] *Greenspun v. Comr.*, 72 T.C. 931, aff'd, 670 F.2d 123 (9th Cir. 1982). *See also Beaton v. Comr.*, 664 F.2d 315 (1st Cir. 1981); *Martin v. Comr.*, 649 F.2d 1133 (5th Cir. 1981); *Suttle v. Comr.*, 625 F.2d 1127 (4th Cir. 1980); *Baker v. Comr.*, 75 T.C. 166 (1979); *Zager v. Comr.*, 72 T.C. 1009 (1979).
[83] Legislation dealing with interest-free or below-market interest loan was introduced by Rep. Corman in 1976, but was never acted on.
[84] Rev. Rul. 73-61, 1973-2 C.B. 408.
[85] 465 U.S. _____ (1984).
[86] 120 percent of the applicable Federal rate under regulations to be issued within 180 days from July 18, 1984 — *se* §44(b)(2) of the Act.
[87] §7872(a).
[88] §7872(e)(2).
[89] §7872(a)(2).
[90] §7872(a).
[91] §7872(d)(2).
[92] §7872(e)(2)(B).
[93] C. Rep. at 1014.
[94] *See* C. Rep. at 1013 which explains the House version of §7872. The House version contained provisions that were substantially identical to those finally adopted with respect to gift and demand loans. While the statute mandates semiannual compounding for term loans, (§7872(e)(2)(A)) it does not in the case of a demand loan. §7872(e)(2)(B). The matter is thus unclear.
[95] The tax consequences of this deemed transfer depend on the parties' relationship. *See* discussion, *infra*.
[96] *Query*: If the term is not more than 1 year, do the provisions of §§1281-1283 apply? Other than these sections, the OID rules do not apply to short-term obligations.
[97] §7872(c)(1)(A) through (E).
[98] §7872(c)(2)(A).
[99] §7872(c)(2)(B).
[100] §7872(f)(10).
[101] §7872(c)(3)(A) and (B).
[102] §7872(f)(10).
[103] This does not apply to a case such as the one described in Rev. Rul. 73-61, *supra*, where a father transferred funds to a corporation owned by his son.
[104] *See*, §7872(d)(1)(A), (B).
[105] §7872(d)(1)(D).
[106] §7872(e)(7).
[107] §7872(d)(1)(E)(i).
[108] §7872(d)(1)(E)(ii).
[109] §7872(d)(1)(E)(iii).
[110] §7872(d)(1)(E)(iv).
[111] §7872(e)(8).
[112] §7872(e)(9).
[113] §7872(g).
[114] §7872(g)(1)(A).
[115] §7872(g)(1)(B).
[116] §7872(b)(1)(C).
[117] *See* §1274(d).
[118] Act §172(c)(4).
[119] Act §172(c)(5).
[120] Act §172(c)(6).
[121] C. Rep. at 1019.
[122] Ignoring, for purposes of this example, the fact that the OID rules and §63(e) do not apply to short-term obligations (except to the extent of §128-83).
[123] *See* footnote 122, *supra*.
[124] *See* C. Rep. at 1020, n. 11.
[125] *See* C. Rep. at 1018.
[126] *Id.*
[127] Of Part of subchapter J; §§671-79.
[128] Subsection (e) contains definitions.
[129] C. Rep. at 1018.
[130] C. Rep. at 1018-19.
[131] C. Rep. at 1019.
[132] C. Rep. at 1019.
[133] *See* §§6041(a) and 6041A. To be reportable, payments of wages or compensation for services must aggregate $600 or more in a calendar year.
[134] C. Rep. at 1020.
[135] C. Rep. at 88.
[136] In valuing the note for gift tax purposes, is the Commissioner is under an obligation to use the AFR? In fact, a considerably higher rate may be appropriate in most cases.
[137] Section 1274 as enacted by the Senate contained an exception for transactions to which §267 (transactions between related parties) applies. The conference committee deleted this exception, and the Conference Report clearly states that "the interest element of a deferred payment sale between related parties will be subject to the OID rules." C. Rep. at 88.
[138] §7872(e)(8).
[139] According to the payment schedule, if any payments were delayed, and Son was a cash basis taxpayer, he is entitled to deducted interest sooner than when actually paid. *See* §1275(b)(2).
[140] This is the present value of 120 payments of $2,652 using a 10 percent interest rate, but this does not reflect semiannual compounding, but monthly compounding.
[141] §7872(c)(2)(A).
[142] C. Rep. at 1021.
[143] §7872(c)(2)(B).
[144] §7872(d)(1)(E)(i).
[145] §7872(d)(1)(E)(ii).
[146] For this purpose, U.S. saving bonds are deferred payment obligations. *See* C. Rep. at 1023.
[147] *Id.*
[148] C. Rep. at 1021.

Editor's Note: For text of legislative change made in October, 1984, see page B-414, infra.

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CHAPTER 23

PREMATURE ACCRUALS

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I. Economic Performance Limitation on Accrual of Deductions [Act §91(a)] — Code Section 461(h)

A. Introduction

1. Statutory and Judicial Background

Under §446(a), there are two accounting methods which are generally applicable for federal income tax purposes — the cash receipts and disbursements method, and the accrual method. The cash method allows a taxpayer to recognize income when it is actually or constructively received and deduct expenses when they are paid.[1] Under the accrual method, income becomes taxable when all events have occurred which fix the right to receive income and the amount can be determined with reasonable accuracy.[2] Expenses are deductible in the taxable year in which all events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy. The deduction of expenses of an accrual basis taxpayer equals the face amount of the accrued expense.

A number of cases have disallowed deductions for estimated future expenditures, when the taxpayer has an obligation to incur costs to perform certain activities in the future, but those expenditures may not be estimated with reasonable accuracy. For example, in *Spencer, White & Prentis, Inc. v. Comr.*,[3] a subway construction contractor was not allowed to deduct the estimated cost to restore damaged property when the work had not been performed. Recent court cases have allowed taxpayers to deduct expenses which they have an obligation to perform in some later year if the taxpayer can reasonably estimate the cost to perform that obligation. One taxpayer has been allowed a deduction for reasonably estimated surface mining reclamation costs which the taxpayer was obliged to perform even though it would not actually perform those activities until a later year.[4] In addition, when an employer does not contest its responsibility to an employee under a workmen's compensation law, the employer has been allowed a deduction for the reasonably estimated amount of liability even though the medical expenses may not be paid until a future time.[5] Generally, courts have allowed an estimate based on industry-wide experience or on the experience of a taxpayer as reasonable. The Ninth Circuit Court held the amount of a reserve for anticipated liabilities may be estimated by aggregating the amount of liability anticipated rather than estimating each individual claim.[6]

Taxpayers cannot generally deduct a contingent liability because all events necessary to establish the fact of liability have not occurred. Nevertheless, a taxpayer was allowed to accrue its "contingent liability" to fund benefits under a negotiated supplemental unemployment benefit plan.[7] Under the terms of the agreement, the taxpayer was required to pay the amounts at some future time as required to either a supplemental unemployment benefit plan or to a vacation benefit plan. All amounts of the "contingent liability" were required to be paid and no amount would revert to the taxpayer. The fact that the liability was payable to a group of employees rather than a specific individual and that the time for the future payment was indefinite did not bar accrual of the expense under the all events test. Generally, the length of time between accrual of an expense and the taxpayer's performance does not affect its accrual.

There have been several instances where a court held that the interval between the accrual of an expense and its payment was too long. In *Mooney Aicraft, Inc. v. U.S.*,[8] the court noted that the likelihood of payment decreases as the time between accrual and payment increases.

The IRS takes the position that there must be a current liability to allow deduction under the all events test.[9] In addition, if there is any contingency as to payment of the obligation (other than the obligor's ability to pay), deduction would not be allowed until that contingency is removed. The Service believes that the amount of a liability is determinable with reasonable accuracy only when the exact amount of liability can be calculated based on presently known or knowable factors. For example, the Service has held that a strip miner could not deduct estimated reclamation expenses because it did not know, and it was not possible to know, the amount of the expenditure since the work was to be rendered by the taxpayer and the taxpayer did not have a contract with the third party to perform these services.[10]

The 1954 Code as originally enacted contained a provision which would allow accrual method taxpayers to establish a reserve for estimated business expenses and deduct reasonable additions to that reserve.[11] Congress repealed this version in 1955, primarily to prevent sizable losses of revenue.[12]

2. Legislative Background

Congress decided to defer to the time at which taxpayers may take deductions. Congress felt that the accrual of the amount of a deduction in a year prior to the time it would be paid should reflect time value of money.[13] Both Congressional tax committees noted that allowing a current deduction for an amount to be paid in the future overstates the true cost of the expense. The deduction is overstated by the amount which the estimated value of the expense exceeds the present value of that estimate. Congress was

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concerned about the potential revenue lost from these "overstated" deductions. In addition, the failure of pre-TRA 1984 law to take into account the time value of money had become a cornerstone for a variety of tax shelters. For example, a tax shelter partnership could legally obligate itself to a person who would perform research and development at a future time. In this situation, the partnerships claimed a current deduction for the undiscounted amount of the cost to be incurred.

Congress recognized that it could allow a taxpayer a deduction either for the full amount of the liability when there was economic performance or a deduction for the discounted value of the liability at some earlier time. Congress felt that determining discounted values for different types of future expenses could be extraordinarily complex and extremely difficult to administer. An example of such complexity would occur when liabilities previously deducted were overstated or understated because they were eventually satisfied at an amount different from that originally projected. To avoid the complexity of another system of discount valuation, Congress decided to allow the accrual of expenses only when economic performance occurs.

B. Overview

1. Summary of New Provision

For taxpayers who use the accrual method of accounting, the all events test which establishes liability for such amount will not be satisfied until economic performance of the liability has occurred. The general principles determining economic occurance are discussed *infra*.

The economic performance requirement will not apply to items to which other sections of the Code already apply. §461(h)(5). For example, the deductions for additions to a reserve for bad debts (§166), accrual of vacation pay (§463), and qualified discount coupons (§466). Though economic performance to employees occurs as the employer renders services, liability created by a qualified pension, profit-sharing or stock bonus plan or other deferred compensation arrangement under §§404 or 404A are deductible under those sections. The economic performance requirement will not apply to contributions to deferred compensation, deferred benefit, and funded welfare benefit plans so that the changes included in other portions of the Act will control the deduction of those contributions.

2. Effective Date

Code §461(h) will apply to amounts for which a deduction would have been allowable under prior law after July 18, 1984.[14] Thus, in general, amounts incurred on or before July 18, 1984, are subject to the pre-TRA 1984 all events test unmodified by the economic performance requirement. Those amounts incurred on July 19, 1984, and thereafter, may be deferred for accrual basis taxpayer's if economic performance has not occurred.

Note: The effective date provisions as drafted in the original Act did not conform with the intention of the conferees as expressed in the Conference Committee Report.[15] Section 32 of House Concurrent Resolution 328 altered the effective date provisions to conform to the conference committee agreement.

A taxpayer may elect to have the amendments made by §461(h) apply to amounts incurred on or before July 18, 1984.[16] An election under this paragraph will be considered a change of accounting method for purposes of §481 of the Code. The change in method of accounting shall be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury.[17] The period over which any §481 adjustment shall be spread is reduced from ten years to three years.[18] The effect of this election is to defer a deduction to a later period.

The Conference Committee Report indicates that this election will apply to each type of deductible item and not to all items in the taxpayer's income.[19] With substantial amounts, an election may provide significant savings to taxpayers.

This amendment shall be treated as in effect to the extent necessary to carry out any amendments made by §91 which take effect prior to §461(h).[20]

C. Detailed Analysis

1. General Rule

Section 91(a) of the Act adds subsection (h) to §461 of the Code. This subsection provides that in determining whether an amount accrues during a taxable year, the all events test shall not be treated as met any earlier than when economic performance occurs with respect to such amount.[21] For purposes of this section the all events test is satisfied for an item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.[22] The general principles which determine when economic performance occurs are as follows:

(1) If a taxpayer's liability arises from services which another person provides to him, economic performance occurs as that person provides the services, §461(h)(2)(A)(i);

(2) If the taxpayer's liability arises when another person provides property to him, economic performance occurs when that person provides[23] the property, §461(h)(2)(A)(ii);

(3) If the taxpayer's liability arises from his use of property, economic performance occurs as the taxpayer uses the property, §461(h)(2)(A)(iii);

(4) If the taxpayer's liability requires him to provide property to another person, economic performance occurs as the taxpayer provides such property, §461(h)(2)(B);

(5) If the taxpayer's liability arises from his duty to provide services to another person, economic performance occurs as the taxpayer performs such services, §461(h)(2)(B);

(6) If the taxpayer has a liability to a person which arises from a workers compensation act or from any tort, economic performance occurs as the payments are made to such person, §461(h)(2)(C); and

(7) If the taxpayer's liability arises from any other cause, the Treasury Department has the authority to prescribe regulations to determine when economic performance occurs, §461(h)(2)(D).

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Comment: The statute does not address the situation where both the taxpayer and the service or property provider are both exchanging non-cash items (*i.e.*, bartering property for services). If performance by the parties is not simultaneous, the taxpayer would prefer that economic performance by one party would be sufficient to allow accrual of a deduction.

Comment: It is not clear from the statute when economic performance occurs with respect to an individual if the responsible party pays a third party (typically an insurance company) a lump sum with the third party agreeing to cover the responsible party's liability. The person to whom payment is made in §461(h)(2)(C) could be the injured party or the party who will make payment to the injured party. If the Treasury regulations allow deductions only as payments are made to the injured party, there may be a disincentive to have the liability for structured long-term settlements assumed by third parties.

The economic performance requirement will only affect taxpayers who use the accrual method of accounting, not those on the cash receipts and disbursements method. It does not put accrual method taxpayers on the cash method for expenses for which economic performance is delayed. As is currently permitted, expenses may be deducted on the accrual method before they are paid as long as the requirements for accrual are met. The addition of this requirement to the all events test, economic performance, increases the complexity of determining when an amount is properly accruable. There are, however, several exceptions to this rule which should help decrease its applicability.

2. Exception for Existing Statutory Treatment

Section 461(h) contains specific exceptions to the economic performance rule for the deduction of certain expenses which are governed by specific provisions of the Code. Those sections of the Code which deal with a deduction for a reserve for bad debts,[24] vacation pay,[25] and discount coupons [26] are not covered by the economic performance requirements. In addition, any provision of the Code which specifically provides a deduction for a reserve for estimated expenses is still effective.[27]

3. Exception for Recurring Items

The conferees added an exception to the economic performance rules to avoid disrupting normal business and accounting practices and imposing undue burdens on taxpayers.[28] That provision waives application of the economic performance test if an item meets the following four requirements:

> (1) The item meets the all events test (as defined above), without regard to economic performance, during the year;
>
> (2) Economic performance of the item occurs within a reasonable period after the close of the taxable year, but no more than 8½ months after the close of the taxable year of deduction;
>
> (3) The item is recurring in nature and the taxpayer consistently treats items of this type as deductible in the year in which the all events test is met; and
>
> (4) Either (1) the item is not a material item or (2) accrual of the item in the taxable year will result in a more proper match of the deduction against income than deducting such amount in the year that economic performance occurs.[29]

The exception does not apply to workers' compensation or tort liabilities.[30]

a. Recurring and Consistent Treatment Exception

In determining whether an item recurs, a taxpayer should consider the frequency with which the item and similar items occur. If the taxpayer is starting up a new trade or business, it may consider the frequency with which new items are expected to be incurred. The conferees indicated that a new type of expense or expense that does not recur every year is not necessarily excluded from this exception.[31]

The consistency of reporting of an item should consider the Federal income tax reporting. The fact that this is a new type of expense should not necessarily preclude a taxpayer from using this exception.

b. Material Item Exception

There are two major considerations in determining if an item is material for purposes of the recurring item exception. The first consideration is the size of the item. A taxpayer should compare the size of an item to its income and expenses and the size of the item in absolute terms.[32] Secondly, the financial statement treatment of an item must be considered in determining if an item qualifies for the exception.[33] An item may be immaterial for financial statement purposes, but still be material for purposes of this exception.

The materiality of an item that is directly related to an activity will be compared with that activity and not all the activities of a taxpayer. Often, for financial statement purposes, materiality will only be addressed from the view of the entire enterprise. However, the materiality of an item of overhead expense that relates to several activities of a taxpayer will be compared with the aggregate amount of those activities.[34]

> *Example*: An item of expense may be immaterial for purposes of financial statements which combine the results of affiliated corporations (*i.e.*, consolidated financial statements). The taxpayer must still consider the materiality of the item when compared with the separate financial statements.

Regulations interpreting the materiality exception will consider materiality at both the entity and owner level for pass-through entities (*i.e.*, partnerships, trusts, estates, and S corporations). Thus, an item may be immaterial at the partnership level, but may be material at the partner level. If an item is material, then the recurring item exception will not be available unless the item qualifies under the proper matching alternative.

> *Example*: An individual may invest in an accrual method partnership which makes a special allocation to the partner. The item which is specially allocated may not be material as to the partnership but may be material as to the partner.

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The conferees indicated that they did not want the Service to apply this rule in a manner which would impose a significant additional reporting burden on partnerships and other flow-through entities in nonabusive situations.[35]

The materiality standard set forth for this section is not to be used for other sections of the Code. Specifically, this standard should not be used in determining material items for purposes of false and fraud statement provisions of the Code in §7206(1). In addition, an item which is not material for purposes of this section may still be material for purposes of an accounting method change under §446(c).

c. Proper Matching of Income and Deductions

The basic principle of the matching alternative is for a better pairing of income and expense by use of the recurring item exception than use of the economic performance rules. In determining whether there is a proper matching of income with expenses, generally accepted accounting principles are an important, but not a dispositive, factor.[36] Costs that are directly associated with the revenue of a period are properly allocable to that period.[37]

Example: A taxpayer may have entered into a contract which requires it to perform certain services after it has received the revenue from the contract. For example, an automobile dealer may sell a new car with an obligation on his part to perform certain maintenance services on the car after it has been driven 1,500 miles without charge to the purchaser. If the services are not performed prior to the end of the taxable year and the amount of the dealer's liability can be reasonably estimated, the amount of that liability may have met the all events test. Proper matching of revenue and expense would indicate that the expense should be deducted in the year in which the automobile is sold. Thus, even though economic performance will not occur until the following taxable year, accrual of the expense in the current taxable year may be appropriate.

Example: If a commission agent has an agreement which may require collection activities in a year after the sales commission are collected, economic performance as to that expense may not occur until the collection activity is performed. Nonetheless, there is a better matching of revenue and expense if the amount of the collection activity is deducted in the year in which the income is collected.

Example: If income from the sale of goods is recognized in one year, but the goods are not shipped until the next year, the costs of shipping those goods are more properly matched against the revenue in the year the goods are sold.[38]

The conferees indicated that advertising expenses and other such costs which cannot practically be associated with the income of a particular period may be assigned under generally accepted accounting principles to the period in which they are incurred. They intend that the matching requirement will be met with respect to advertising expenses if the period to which the expenses are assigned for income tax and financial statement purposes are identical.[39]

Since the matching test is an alternative to the materiality test, a taxpayer may use the recurring item exception if an item is determined to be immaterial, regardless of whether there is proper matching against income. Likewise, if an item is more properly matched against income in a period prior to economic performance, it is insignificant whether the item is material.

4. Economic Performance In Special Cases

a. Interest

The economic performance of interest occurs with the passage of time rather than as payments are made. Interest incurred by accrual method taxpayers will be deductible on a constant interest basis with respect to debts incurred in transactions occurring after June 8, 1984. Interest on obligations issued on or prior to that date are not subject to the statutory prohibition on noneconomic accruals of interest and the conferees intended no inference about interest accruals which are inconsistent with the principles of Rev. Rul. 83-84.[40]

b. Nuclear Waste Disposal Payments

The conferees instructed the Treasury Department to issue regulations which provide that economic performance of required payments under the Nuclear Waste Disposal Act of 1982 will occur as the payments are made to the federal government.[41]

c. Natural Gas Refunds

Recently some regulated natural gas utilities have received refunds for overcharges by their suppliers. Generally, the utility commissions which regulate the utility will condition the refund on the utility passing the refund through to its customers within 8 to 12 months after receipt. Under Rev. Rul. 63-182,[42] the utility can deduct the amount to be refunded to customers in the year in which the refund is received even though the amount is not refunded to customers until the following taxable year. The conferees intend that the Treasury will have the authority to allow utilities to deduct refunds from suppliers in the year in which they are received if the refunds to its customers meet the following qualifications. The refunds must be passed through to customers within a reasonable time in the following taxable year and that an adequate interest is paid to the consumers and is includable in their income.[43]

Comment: The language in the Conference Committee Report is somewhat obscure as to what should be the definition of a "reasonable time." It is not clear whether this language is intended to delete the 8½ month requirement for economic performance of these obligations. The report indicates that it sometimes takes 12 months for a utility to refund amounts to its customers and a refund near the end of a taxable year might not be refunded to customers within 8½ months. Presumably this issue will be clarified by Treasury Regulations.

d. Compensation for Services Rendered

Economic performance of liabilities to employees generally occurs as the employee renders service to the employer. If, however, compensation is paid in a year after there is economic performance, the existing provisions of the Code, as amended by the Act, which apply to deferred compensation, deferred benefits and funded welfare benefits will govern.[44]

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Vacation pay may be deducted by a taxpayer either under §162 or under §463 if an election has been made. If a taxpayer was deducting expenses under §162, the provisions of §461(h) may delay the deduction until the employee renders the sevices to which the vested vacation pay relates. If such a taxpayer elects application of §463 of the Code for its first taxable year ending after July 18, 1984, the opening balance of the account containing the taxpayer's liability for vacation pay must be determined as if the taxpayer had maintained a vested vacation pay account in his prior taxable year.[45] Otherwise the balance in this account would have been the largest closing balance the taxpayer would have had in the three taxable years immediately preceding the year of election. Depending on a taxpayer's liability for vested vacation pay in the prior three years, it may be advantageous to make a §463 election under the transition rules.

5. Reliance on Existing Rulings and Regulations

There are rulings which may be inconsistent with the post-TRA 1984 economic performance standard. The conferees expect that the Treasury Department will review these materials to determine if they are consistent with the economic performance doctrine. Until new regulations or rulings are issued, taxpayers may only rely on them to the extent that they are not inconsistent with the economic performance doctrine and the recurring item exception. In addition, taxpayers may rely on present law for agreements with the IRS (for example, under §§446 or 7121 or under Rev. Proc. 80-51 [46]) until new regulations are issued.[47]

6. Contested Liabilities

The economic performance rules will apply to contested liabilities and to payments to trusts under §461(f). If the payment to such a trust relates to a worker's compensation or tort liability, economic performance occurs only as required payments are made to a person. Payment to the trust will no longer accelerate the deduction since payment to the trust does not discharge the taxpayer's liability to the claimant.[48] However, for other types of liability, a §461(f) trust arrangement may be effective.

Example: A taxpayer is contesting the amount which must be paid upon the delivery of a manufactured item, the event upon which economic performance depends, delivery of the merchandise, has already occurred. The all events test with respect to that liability is also satisfied since the fact of liability is not disputed (merely the amount) and the amount placed beyond the control of the taxpayer is readily determinable. Thus the accrual basis taxpayer should still have a deduction for the amount placed beyond his control.

7. Burden of Proof

The conferees indicate that compliance with this provision should not impose substantial new reporting burdens on taxpayers. Unless there are unusual circumstances, the existence of a valid contract requiring a person to provide property or services by the end of the taxable year (or within 8½ months of the end of the taxable year for recurring items) will establish compliance with the economic performance standard for that expense.[49] Thus the burden of proof on this issue will shift fairly quickly to the Service to prove that there is no economic performance. In addition, in the case of items incurred by foreign corporations,[50] a more lenient standard may be appropriate. The ability of a taxpayer to obtain information from its affiliate, especially if it owns only a small portion of the affiliate, may be limited. The conferees expect that Treasury regulations will determine that economic performance has occurred if the best available evidence indicates that it has occurred.[51]

II. Estimated Mining and Solid Waste Deductions [Act §91(b)] — Code Section 468

A. Background

1. Present Law

The Surface Mining Control and Reclamation Act of 1977 [52] and similar state laws impose specific reclamation requirements on surface mine operators. These mine operators must guarantee their compliance with the statutory requirements by posting a bond or otherwise proving their financial responsibility. In addition, federal and state laws now require reclamation of land used for the disposal of solid, liquid or hazardous waste.[53]

Prior to 1978, several courts allowed surface mine operators to accrue and deduct the estimated expenses of reclamation as mining operations progressed.[54] In 1978 the IRS issued a private letter ruling which stated that reclamation expenses were not incurred until the year in which the taxpayer renders the work or enters into a binding contract for someone to perform the work.[55] Notwithstanding the Service's position, the Tax Court later held that surface mining reclamation costs that could be estimated with reasonable accuracy and properly accrued.[56]

2. Legislative Background

In 1982 legislation was introduced in the House which would have allowed taxpayers to deduct the estimated cost of surface mining reclamation over the life of the mine as minerals were extracted.[57] Similar bills had been introduced in the Senate in the 97th and 98th Congresses.[58] In hearings on those bills, the Treasury Department testified that *Ohio River Collieries* was incorrectly decided and that the all events test does not permit the accrual of estimated reclamation costs.[59] The Treasury Department advised that a current deduction for future estimated expenses did not consider the time value of money. Accordingly, these proposals would allow taxpayers too large a deduction for these expenditures. Code §461(h) enacted in the TRA of 1984 would have required that the deduction for reclamation expenses would only be allowed as reclamation activities were performed.[60] The Senate Finance Committee believed that more liberal rules were appropriate for the deduction of statutorily mandated reclamation and closing costs associated with mining and the disposal of solid, liquid or hazardous waste.[61]

B. Overview

1. Explanation of New Provision

A taxpayer may now elect to deduct an estimate of mine and waste disposal site reclamation and closing costs associated with a particular site ("the reserve property") as required by certain federal and state statutes prior to

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economic performance of the reclamation activities. The amount of the deduction allowed in any taxable year equals the current reclamation or closing cost allocable to the portion of the property disturbed during the year or the amount of production from a property or the amount of a property's capacity which was used. There are certain limitations on annual deductions to make sure that the cumulative deductions do not exceed the actual cost to reclaim or close a property. Hazardous waste disposal sites to which the Comprehensive Environmental Compensation and Liability Act of 1980 apply are excluded from this provision.

The amounts expended for qualified reclamation and site closing activities, allocable to land disturbed or units of production or capacity, subsequent to the date of election, are deemed withdrawn from the applicable sinking fund in the year paid. The amount paid for reclamation or closing activities for a reserve property which exceeds the sinking fund balance for that property is deductible in the year paid. The balance of each reserve property fund is recaptured (*i.e.*, included in taxable income) when reclamation of the parcel to which deductions were claimed is substantially completed. If the balance in a site reclamation or closing sinking fund is in excess of the amount reasonably necessary to reclaim or close all portions of any property to which the fund applies, that excess will be included in the taxpayer's income.

A taxpayer may revoke his election to deduct these expenditures in advance payment of the cost, but the balance of the site reclamation or closing fund must be included in income in that tax year and there may be no new election as to that property. The sale or other disposition of a mining or waste disposal site prior to the completion of site reclamation or closing costs will be treated as substantial completion of the reclamation or closing. A partial disposition of a site will result in partial inclusion of the fund balance in the operator's income.

2. Effective Date

This provision applies to reclamation and closing costs which under prior law would have been deductible after July 18, 1984.[62] The Senate Finance Committee indicated that the election should only apply to production or capacity used after July 18, 1984.[63] The election will apply only to the incremental reclamation and closing costs for production or use after July 18, 1984 which have not been deducted previously.

If, on March 1, 1984, a taxpayer was regularly computing his deduction for mining reclamation activities under a current cost method of accounting as allowed by *Ohio Collieries* and other cases, the liability for land disturbed before July 18, 1984 shall be treated as having been incurred on the date the land was disturbed.[64] Accordingly, the operator will not be able to obtain the benefits of this provision for portions of property disturbed before enactment of the Act.

If a taxpayer has a fixed price supply contract entered into before March 1, 1984, which has not been extended or renegotiated, the provisions of this section will not apply to minerals extracted from the property which are sold pursuant to the contract.[65] However, if the operator was using the current cost method of accounting for reclamation and closing costs, deduction for those costs will be allowed as the land is disturbed. Minerals are sold on a fixed price agreement if the price is determined strictly in accordance with a formula which was fixed as of March 1, 1984. The agreement may not directly or indirectly allow an adjustment in the formula price to account for the tax liability of the operator.[66] However, operators may make the election allowed by §468 for any extension of a fixed price supply contract or upon the renegotiation or other change in the terms and conditions of a contract in effect on March 1, 1984.[67]

The Conference Committee Report indicates that to determine the annual deduction allowed for reclamation and the closing costs, the fixed price agreement exception should apply on a pro-rata basis for mining production.

> *Example*: If an operator supplies 40 tons of minerals under a fixed price agreement and produced a total of 100 tons of minerals from that property, 60 percent of the estimated site closing and reclamation costs for that year would be deductible under the new reserve provision if an election has been made. The remaining 40 percent of the estimated reclamation and closing costs will be deductible under the method of accounting which the taxpayer used on July 18, 1984. If it did not accrue an estimate of reclamation and closing costs, then no deduction may be made as to those costs. If the operator used a current cost method to accrue an estimate of such costs, it may continue to currently deduct the estimated costs. The Service is still capable of challenging the reasonable accuracy of a taxpayer's estimate of reclamation and closing costs under the current cost method.[68]

Comment: Operators who have not used the current cost method of deducting reclamation and closing costs but have fixed price supply agreements might want to renegotiate or terminate these contracts so that they can make an election for the reclamation costs allocated to the fixed price supply agreement. Changes of this nature may tend to subvert the intent in these provisions and the Treasury might prescribe regulations which aggregate certain fixed supply contracts if they feel there is an abuse in this situation.

If a taxpayer uses the transition rule for fixed supply mineral contracts, withdrawals from the reserve fund are based on the aggregate units of production.[69]

> *Example*: Assume that since it made an election for a site, an operator has mined 500 tons of minerals from a site at the end of a taxable year and sold 300 tons of that production pursuant to fixed price supply contracts and deductions have been claimed in accordance with the transition rule. If the taxpayer pays $1000 for qualified closing costs, then only 40 percent (200/500), or $400, of the costs are deductible from the reserve for that property.

If a mine operator using the transitional rule disposes of a mining property without paying for those costs, the tax benefit rule would effect a recapture of the previously deducted amount.[70]

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C. *Detailed Analysis*

1. Election and Current Deduction

a. Election and Amount of Deduction

A taxpayer may elect under §468 to establish a reserve for reclamation or closing costs for each of its mining and solid waste disposal properties. The Congressional Conferees intend that an election must be made for an entire site (which may include several parcels), and not just a portion of it.[71] If several taxpayers are liable for a reclamation or closing cost, on a particular site, each taxpayer may claim a deduction for his share of the liability.[72]

Section 468(d)(3) defines the term "property" for the purposes of mining sites according to the definition contained in §614. That section defines property, in the case of mines, wells, and other natural deposits, as each separate interest owned by a taxpayer in each mineral deposit in each separate tract or parcel of land. This section, however, allows taxpayers to aggregate certain operating mineral interests and treat them as a single property for purposes of this section.[73]

In each taxable year, the taxpayer may deduct from its income the portion of the current reclamation costs allocable to the portion of the property which was disturbed during the taxable year.[74] Similarly, a taxpayer is allowed a deduction for that portion of the qualified closing costs allocable to the production from the property during the taxable year.[75]

b. Deductible Costs

The current reclamation or current closing costs which are used in calculating the portion allocable to a tax year are the amounts which the taxpayer would be required to pay for qualified reclamation or qualified closing costs if the reclamation or closing activities were performed currently.[76] Qualified mining reclamation costs include any expenses incurred or any land reclamation or closing activity which is conducted in accordance with a reclamation plan (including an amendment or modification thereof) which meets the following requirements:

> (1) It must be submitted pursuant to the provisions of §§511 or 528 of the Surface Mining Control and Reclamation Act of 1977 (as in effect on January 1, 1984) and is part of a surface mining and reclamation permit granted under the provisions of Title V of such Act (as so in effect); or
>
> (2) Which is submitted pursuant to any other federal or state law which imposes surface mining reclamation and permit requirements substantially similar to the requirements imposed by Title V of such Act.[77]

In addition, any expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site which is conducted in accordance with any permit issued pursuant to any provision of the Solid Waste Disposal Act (as in effect on January 1, 1984) requiring such activity, or any other federal, state, or local law which imposes requirements substantially similar to the requirements imposed by the Solid Waste Disposal Act.[78] Qualified reclamations or closing costs do not include any expenses incurred for land reclamation or closing activities on solid waste disposal sites which are disturbed after such sites are listed in the national contingency plan established under Section 105 of the Comprehensive Environmental Compensation and Liability Act of 1980.[79]

2. Rules Governing Reserves

a. Additions to Reserve

In establishing reserves, a taxpayer must maintain separate reserves for each property and for qualified reclamation costs and qualified closing costs for each property for which there is an election.[80] The opening balance of a reserve in the first taxable year shall be zero.[81] The balance of the reserve is increased in each taxable year by the amount of interest computed at the applicable federal short-term rate (AFR) determined under §1274 (compounded semiannually) on the opening balance of the reserve for the taxable year.[82] In taxable years ending before 1987, there is a phase in of this imputed interest rate. For taxable years ending in 1984 or 1985, the amount of interest added to the reserve is 70 percent of the AFR. For taxable years ending in 1986, the imputed interest rate is 85 percent of the AFR.[83]

Observation: The reserve should also be increased for the amount of any qualified reclamation or closing costs allowed as a deduction in the taxable year. The statute, however, does not require such increase. Discussions with staff of the Joint Committee on Taxation have indicated that they definitely intended that the amount of a reserve would be increased by the estimated deductions allowed under §468(a) for the property. They add that there may be a technical correction to this section to assure that result.

b. Deductions from Reserve

When a taxpayer pays an amount during a taxable year for qualified reclamation or closing costs for which there is an election in effect, it shall reduce the reserve by the amount of that payment.[84] If an election is in effect only for a portion of the property, then only a pro-rata portion of the reclamation or closing costs will be deductible in that taxable year under regulations to be promulgated by the Treasury Department.[85] If the amounts paid by the taxpayer in a taxable year exceed the closing balance of the reserve for the taxable year prior to charges for qualified reclamation or closing costs, then all excess amounts will be allowed as a deduction against taxable income for that year.[86] Thus, if a taxpayer underestimates the cost to reclaim or close a site, he will not lose his full deduction of that amount.

c. Limitation on Reserve Balance

To ensure that the balance in a reserve account will not be unreasonable, §468 provides a limitation on a closing balance in a reserve at the end of any taxable year. If the closing balance of a reserve for qualified reclamation costs exceeds the current reclamation costs for the portions of the reserve property which have been disturbed in any taxable year, then the amount of that excess shall be included in the gross income of the taxpayer.[87] There is a similar provision which requires the taxpayer to include in gross income the amount by which the closing balance of a reserve for qualified closing costs exceed the current closing

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costs with respect to that property determined as if all production on the property had occurred in that taxable year.[88] In effect, these provisions limit the deduction for qualified reclamation of closing costs to the amount which will increase the reserve to cover the current estimated cost of closing or reclaiming the site. The limitation provision is applied after all other adjustments are made to the reserve for the taxable year.[89]

Example: If 20 acres of a site for which an election has been made had been disturbed and the current cost of reclamation is $10 per acre, then $200 may be deducted in that taxable year and the sinking fund balance is limited to that amount. In the next taxable year an additional 20 acres are disturbed, the current cost of reclamation has risen to $11 per acre and no reclamation work has been performed on any portion of the site. The deduction for that year is limited to $220 (20 acres x $11/acre). The balance in the sinking fund is limited to $440 (40 acres x $11/acre).

Example: The limitation on the balance in a site closing sinking fund may be illustrated as follows: Assume the capacity of a site is 500 units, that 100 units are produced (or utilized) during the first taxable year of the taxpayer and the current cost of closing the entire site is $1,000. Since 20% of the estimated units of production or capacity have been utilized, then 20% of the estimated current closing costs of the site, or $200, may be deducted in the first taxable year and the balance of the reserve is limited to that amount. Assume that at the end of the second tax year an additional 100 units are produced and the current cost of closing the site has risen to $1,100. The deduction allowed in the current year is $225 [$900 ($1,100 - $200) x 100/400]. One hundred is the current year production from the site and 400 is the remaining units of production or capacity (500 minus 100). The balance of the closing cost reserve will be limited to $440. That is calculated by multiplying the current cost of closing the entire site ($1,100) by a fraction the numerator of which is the number of units produced or capacity utilized by the end of the taxable year (200) and the denominator of which is the total number or units or production or capacity (500 units).[90]

3. *Recapture of Reclamation and Closing Cost Deductions*

If a taxpayer revokes an election to apply §468 to a mining or solid waste disposal property, the balance in the site reclamation and closing fund must be included in the taxpayer's income in that tax year[91] and that election may not be reinstated with respect such property.[92] The Treasury Department will prescribe the time and the manner in which a taxpayer may revoke its §468 election.[93]

Furthermore, when the closing or reclamation of a property is completed, or when any portion of a property to which a §468(a)(1) election is made is disposed of by a taxpayer, the balance of the reserve fund will be included in the income of the taxpayer.[94] If a portion of a §468 property is disposed of, then that portion of the site's reclamation and closing funds are also subject to recapture.[95] If a waste disposal site is listed on the national contingency plan under §105 of the Comprehensive Environmental Compensation and Liability Act of 1980 at any time after an election is made for the site, the balance of the reserve fund is also subject to recapture.[96]

III. Nuclear Power Plant Decommissioning Deduction and Income [Act §§91(c) and (f)] — Code Sections 88 and 468A

A. *Background*

1. *Statutory Background*

Under federal and state law, utility companies that operate nuclear power plants are obligated to close and dismantle these plants at the end of their useful lives. This process, known as decommissioning, is a very expensive process which attempts to render the plants safe by eliminating the high levels of residual radiation at the site. This process takes place many years after the plant is placed in service, but often a portion of the estimated cost of decommissioning is collected from the utility's current customers as cost of service for ratemaking purposes. Such amounts may be placed in an unsegregated reserve on the utility's books, in a segregated internal reserve, or in an independently administered trust fund. Under Code §461(h), enacted in the 1984 TRA, a deduction for these expenses would be allowed as the actual decommissioning activities took place. There is also litigation pending on how a utility should treat the amounts collected from customers and paid into a decommissioning fund for income tax purposes.

2. *Legislative Background*

In 1983, several congressmen introduced legislation that would have allowed a deduction for additions to a reserve for decommissioning costs incurred by a regulated public utility in connection with a nuclear power plant.[97] The House of Representatives and the administration took note of the special problems of nuclear decommissioning costs and proposed to allow utilities to deduct nuclear decommissioning costs in the year in which their economic performance rule would allow them, and to also allow a carryback of any net operating loss arising from that deduction to any year in which the utility had a liability for the decommissioning costs (*i.e.*, beginning with the year in which the plant was placed in service).[98]

The Senate Finance Committee, which originated this provision in its current form, noted that it was of national importance that utilities establish a segregated reserve fund for paying future nuclear decommissioning costs. It decided to encourage this activity by providing a tax deduction subject to certain limitations, for amounts contributed to a qualified fund. This appears to be a departure from general industry practice which is to deduct decommissioning expenditures at the end of a plant's life when the decommissioning is performed. The Finance Committee intended to allow utilities to spread the deduction of decommissioning expenses over the life of the plant as contributions are made into a segregated decommissioning reserve fund. Consistent with one of the major policy themes of this tax bill, the Committee did not intend that the deduction would lower the tax paid by owners of a nuclear power plant in present value terms.[99]

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B. Overview

1. Summary of New Provisions

Utilities which operate nuclear power plants will now be able to deduct contributions to a reserve fund dedicated to paying future nuclear decommissioning expenses. This method is elective, but is the exclusive method for obtaining a deduction for nuclear decommissioning expenses prior to economic performance of the decommissioning. Contributions to a qualified decommissioning reserve are deductible only to the extent the amount is currently included in the cost of service charged to customers and is included in the taxpayer's taxable income in that year. Contributions must be made to a separate reserve fund, funded exclusively with contributions eligible for deductions under this provision and the earnings on those contributions. Taxpayers must obtain a ruling from the Treasury which establishes the maximum annual deduction in order that the contributions to decommissioning reserve will qualify for deduction. Generally, deductions will be allowed for the amount necessary to fund the future cost of decommissioning over the remaining plant life through an annuity.

The nuclear decommissioning reserve must be a segregated fund whose proceeds are solely used to pay decommissioning costs, taxes on fund income, and management costs of the fund. The reserve is treated as a separate taxable entity and taxed at the maximum corporate tax rate under §11(b). Contributions to the fund are not considered taxable income to it. Its assets may only be invested in the same assets which may be owned by black lung disability trust funds. There are rules which would prohibit the purchase of assets of related parties and prohibit self-dealing.

If the nuclear decommissioning reserve fund fails to comply with the qualification requirements, it may be disqualified by the Treasury. In the event of disqualification, the Treasury may require that some or all of the income and principle accumulated in the reserve fund be included in the taxpayer's taxable income. No deduction will be allowed for contributions to a disqualified reserve fund. Withdrawals from a qualified decommissioning reserve fund are included in the taxpayer's taxable income unless used in payment of taxes imposed on the fund or the cost of managing the fund. A taxpayer who makes withdrawals from the funds will also be allowed an income tax deduction for the reasonable decommissioning expenditures paid in a year. Theoretically, the utility should have no income consequence from payment of decommission expenses from the reserve since the increase in its taxable year occasioned by the withdrawal should be offset by a decrease in its taxable income for the amount of the expenditure paid. When the plant decommissioning is completed, any funds remaining in the qualified nuclear decommissioning reserve must be included in the taxpayer's taxable income.

A utility must also include in its income the amount of any nuclear decommissioning costs which are included in its cost of service for ratemaking purposes.

2. Effective Date

This amendment is effective for decommissioning fund contributions made after July 18, 1984.[100]

Comment: Since the Treasury Department must provide taxpayers with a ruling as to the amount of contributions allowable, the speed with which the Treasury Department issues those rulings may practically determine when deductions will begin.

C. Detailed Analysis

1. Deduction for Nuclear Decommissioning Costs and Contribution to Reserve Fund

Section 468A gives operators of nuclear powerplants an election to deduct payments made to a Nuclear Decommissioning Reserve Fund during a taxable year. The purpose of the fund, described more fully below, is to insure payment of future nuclear decommissioning expenses. The Treasury Department will presumably promulgate regulations which describe the manner in which the election is made.

The amount which a utility may pay into the fund in any taxable year can not exceed the lesser of (i) the nuclear decommissioning costs allocable to the fund which are included in the taxpayer's cost of service for ratemaking purposes in the taxable year, or (ii) the ruling amount applicable to such taxable year.[101] The limitation which relates to inclusion in a utility's cost of service for ratemaking purposes was included to make sure that this amount was charged to customers of the operator and included in the operator's taxable income in that year.[102]

Nuclear utilities will also be required to obtain a ruling from the Service as to the maximum amount of payments which will be allowed to the fund. If the taxpayer does not request, or the Treasury Department does not approve a request, then a utility may not make any payment to a fund.[103] In the ruling, the Treasury Department is to determine the amount which is necessary to fund the estimated decommissioning attributable to the period in which the fund exists when considering the entire estimated life of the nuclear power plant. To determine which costs may be paid to the fund, the utility must determine the total nuclear decommissioning costs estimated for the nuclear powerplant, the period for which the fund is to operate, and the estimated useful life of the nuclear powerplant.[104]

> *Example*: If two-thirds of a plant's useful life remains when a fund is established, then a utility's deduction would be limited to contributions necessary to fund two-thirds of estimated future decommissioning cost on a level funding basis.

The Treasury Department has the discretion to preclude excessive funding of the costs or funding of the costs at a rate more rapid than level funding. The Treasury Department is directed to issue regulations which set forth the criteria for determining the maximum annual contributions.[105] In determining the maximum annual deduction, the Department must consider inflation and prevailing interest rates as well as the factors stated above.[106]

At least once during the useful life of the nuclear powerplant, the Service is required to review, and revise if necessary, the amount which the Secretary previously determined as necessary to fund the decommissioning cost. A utility may request that this review be done more frequently.[107]

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2. Nuclear Decommissioning Trust Fund

a. Operation of Fund

A utility must establish a nuclear decommissioning trust fund for each nuclear powerplant to which a §468A election has been made. The fund is a separate taxable entity and not just a segregation of assets on the books of the utility. The conferees indicated that where the responsibility for decommissioning a nuclear powerplant is divided between taxpayers, each taxpayer may establish a fund for its share of the liability.[108]

The fund may only accept contributions for which a deduction has been allowed under §468A. The fund shall be used exclusively to satisfy, in whole or in part, the liability of the utility contributing to the fund for decommissioning of a nuclear powerplant and to pay administrative costs (including taxes) and other incidental expenses in connection with operation of the fund. Incidental expenses may include legal, accounting, actuarial, and trustee fees.[109] Federal income tax is imposed on the gross income of the fund less any administrative costs (including taxes), and other incidental expenses of the fund which it pays. The gross income of the fund does not include any payment to it with respect to which deduction is allowed under §468A. Basically, the net investment income of the fund will be subject to tax. The tax rate will equal the maximum rate applicable to corporations under §11(b).[110]

The Senate Finance Committee indicated that the fund could only hold those investments allowed under §501(c)(21)(B)(ii).[111] Those investments include federal, state and local debt obligations, or time or demand deposits in domestic federally insured banks or credit unions.

b. Self-Dealing Prohibition

The Treasury Department is to prescribe regulations which will impose a tax on acts of self-dealing as described in §4951 as if this fund were a black lung disability trust. For purposes of that section, self-dealing is defined as any one of the following activities which is directly or indirectly carried on between a disqualified person and the fund:

(1) Sale, exchange, or leasing of real or personal property between the fund and a disqualified person;

(2) Lending of money or other extension of credit between the fund and a disqualified person;

(3) Furnishing of goods, services or facilities between such a trust and a disqualified person;

(4) Payment of compensation (or payment for reimbursement of expenses) by a fund to a disqualified person; and

(5) Transfer to or use by or for the benefit of a disqualified person of the income or assets of the fund.

A transfer of personal property by a disqualified person to a fund shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien. If a disqualified person furnishes goods, services, or facilities to a fund, there is no self-dealing if such activity is furnished without charge and the goods, services, or facilities are used exclusively for the fund. In addition, the payment of compensation (and the payment or reimbursement of expenses) by a fund to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the fund shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive.[112]

Comment: It appears that the Treasury regulations will revise Item 5 above to prohibit transfer to or use by or for the benefit of the utility other than for its nuclear decommissioning costs. For example, the fund could not pledge its assets to guarantee an obligation of the utility.

A "disqualified person" is generally defined as a contributor to the fund, a trustee of the fund, and a person who owns more than ten percent of the: (a) total combined voting power of a corporation, (b) profits interest of a partnership, or (c) beneficial interest of a trust or unincorporated enterprise, which is a contributor to the trust. In addition, an officer, director, or an employer of a person who is a contributor to the fund, or a person who is a spouse, ancestor, lineal descendant or spouse of a lineal descendant of one of the foregoing persons is also a disqualified person. Finally, a person described in the prior sentences who owns more than 35 percent of: (a) the total combined voting power of a corporation, (b) the profits interest in a partnership, or (c) the beneficial in a trust or estate is also a disqualified person.[113] Indirect stockholding is to be taken into account under §267(c) except that the members of a family described in §267(c)(4) shall only include the individual spouse, ancestor, lineal descendant, or spouse of a lineal descendant.

The regulations will probably impose on the disqualified person a tax at the rate of ten percent of the amount involved in the act of self-dealing. In addition, any trustee who participates in an act of self-dealing, knowing that it is such an act, will pay a tax equal to two and one-half percent of the amount involved, unless his participation was not willful and is due to reasonable cause.[114] If the act of self-dealing is not corrected by the time a notice of deficiency is mailed with respect to an act of self-dealing or the date on which the tax on the self-dealer is assessed, an additional tax of 100 percent of the amount involved will be imposed on the disqualified person. In addition, the trustee will be liable for a tax equal to 50 percent of the amount involved if the trustee refuses to agree to part or all of the correction. Furthermore, the Treasury Department has the discretion to disqualify the fund if it violates the self-dealing rules of §4951. If the fund is disqualified, it is treated as having distributed all of its funds on the date such determination takes effect.[115]

3. Taxation of Actual Decommissioning Expenses

When an amount is distributed from the fund during a taxable year, other than to pay administrative costs and other incidental expenses, that amount will be included in the gross income of the utility. Unless otherwise provided by regulations, the amount (i) of any deemed distribution upon disqualification of the fund, (ii) of any termination of the fund upon substantial completion of the nuclear decommissioning of a nuclear powerplant, or (iii) from any disposition of any interest in the nuclear powerplant will be included in the gross income of the utility.[116] If an interest in a nuclear powerplant is sold, the Treasury Department may allow the purchaser of the nuclear powerplant to make a one-time deductible deposit, in excess of the annual ruling

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amount into a new decommissioning fund. The amount of the buyer's start-up deposit is limited to the balance of the seller's qualified decommissioning fund.[117]

The utility will also be allowed a deduction in any taxable year for the amount of nuclear decommissioning cost with respect to which there has been economic performance as defined in §461(h)(2).[118] Accordingly, if a taxpayer withdraws an amount and makes a payment for nuclear decommissioning costs for which there has been economic performance, there should be no effect on its taxable income. The amount which is withdrawn from the fund is taxable, but would be completely offset by a payment for nuclear decommissioning costs for which there has been economic performance.

4. Income Taxation of Nuclear Decommissioning Costs

Section 91(f) of the Act also adds §88 to the Code dealing with the income tax consequences to utilities for recovery of nuclear decommissioning costs. If nuclear decommissioning costs are included in a utility's cost of service for ratemaking purposes, its gross income includes those costs in the taxable year in which they are included for ratemaking purposes. It does not matter whether or not these amounts are contributed to a qualified nuclear decommissioning reserve fund.[119] This provision applies to amounts included for ratemaking purposes after July 18, 1984.

5. Study on Tax Incentives for Decommissioning Trusts

The conferees indicated that it may be appropriate for the tax writing committees to continue studying the tax treatment of decommissioning costs and consider the merits of providing tax incentives for establishing decommissioning funds.[120]

6. Net Operating Loss Carrybacks

Code §172(k)(2), enacted by §91(c)(2) of the 1984 TRA, extends the period by which losses, which arise from deferred statutory or tort liability losses incurred in the decommissioning of a nuclear powerplant, may be carried back. Those losses may be carried back to the taxable year in which the plant was placed in service instead of the regular three-year carryback period. There may, however, be no carryback to a taxable year beginning before January 1, 1984.[121]

IV. Cash Basis Tax Shelter Deductions Limited Until Economic Performance Occurs [Act §91(d)] — Code Section 461(i)

A. Background

The accounting method which a taxpayer selects to calculate his taxable income for federal income tax purposes will control the year in which it may deduct an expense.[122] Generally, taxpayers select either the cash receipts and disbursements method of accounting or the accrual method. The taxpayer's selection of a method of accounting is restricted to one which clearly reflects income.[123] In addition, if an expenditure of a taxpayer results in the creation of an asset which has a useful life which extends substantially beyond the close of a taxable year, the expenditure may be nondeductible or partially deductible.[124]

Except for restrictions on prepaid interest deductions and prepayments by farm syndicates, a cash basis taxpayer is allowed to currently deduct prepaid expenses which do not create an asset. A prepaid expense is deductible when paid only if (1) the expenditure is a payment and not merely a deposit; (2) there is a business purpose for the prepayment; and (3) the deduction of the expense in the year of prepayment does not result in a material distortion of the taxpayer's income. Interest deductions are allowed only for the year to which the interest relates.[125] For example, if a cash basis taxpayer were to prepay interest on a loan for five years, only the interest accruing in the taxable year of payment will be deductible in that year. The nondeductible portions of interest will be deductible in the year to which they apply. Thus the cash basis taxpayer is put on the accrual basis for deduction of interest.

Cash basis farming syndicates are only allowed to deduct amounts paid for feed, seed, fertilizer, or other similar farm supplies in the taxable year in which such supplies are actually used or consumed.[126] A farming syndicate is a partnership or other pass-through enterprise which engages in the trade or business of farming if interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency regulating sales of securities or if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs, (*i.e.*, individuals who do not actively participate in the management of an enterprise). §464(c).

In determining whether an expenditure results in creating an asset having a useful life extending substantially beyond the taxable year, the Ninth Circuit Court has adopted a "one-year" rule.[127] Under this doctrine, the prepayment of expenses by a cash basis taxpayer will be permitted if the prepayment does not provide benefits that extend beyond one year. Thus, for example, a calendar year, cash-basis taxpayer may deduct the amount of an annual lease payment made in December. Unless this payment substantially distorts the taxpayer's income, it does not matter that a substantial portion of that expense relates to services which will be provided in a subsequent tax year.

The deductibility of prepaid expenditures has become the basis for many tax shelters. Many cash-basis taxpayers shelter income by prepaying expenses (other than interest). This is especially useful for taxpayers who make prepayments in years in which their income is high, and anticipate that income will be lower in future years when the benefit of a deduction would not be as significant. The House Ways and Means Committee believes that taxpayers should not be allowed to deduct expenses until there is economic performance of the activity to which the expenditure relates.[128] The Committee recognized that there were many normal business transactions in which expenses are prepaid. It did not wish to impede normal business transactions and therefore decided to limit the application of the new rules to tax shelters, where it perceives the abuse is most serious. The Committee did not intend any negative inference as to prepaid expenses when incurred outside the tax shelter context.

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B. Overview

1. Summary of New Provision

A tax shelter which uses the cash receipts and disbursements method of accounting for federal income tax purposes may not deduct an expenditure until the activity to which that expenditure relates has been economically performed as contemplated by §461(h). The exception for certain recurring items provided in §461(h)(1) will not apply in this situation. However, if economic performance of an activity is performed within 90 days after the close of the taxable year, the deduction will still be allowed in the year in which the amount is paid, but only to the amount of cash contributed to the tax shelter without regard to its borrowing. For purposes of this 90 day rule, the economic performance of drilling an oil or gas well is treated as occurring when drilling of the well is commenced.

A "tax shelter" is any enterprise, other than a C corporation, if any interest in the enterprise is required to register an offering for sale of interests with any federal or state agency which regulates the sale of securities. In addition, a tax shelter will include (i) any partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during a taxable year are allocable to limited partners or limited entrepreneurs, and (ii) any partnership, other entity, investment plan or arrangement, the principle purpose of which is the avoidance or evasion of federal income tax.

A tax shelter which engages in the trade or business of farming shall first be subject to the limitations contained in §464 and then shall be subject to the limitations contained in this new section.

Economic performance for purposes of this section is the same as that contained in §461(h) as added by the 1984 Act.

2. Effective Date

According to the statute, this section applies to prepaid expenses which would have been deductible after March 31, 1984 under prior law.[129] It is interesting to note that the conferees stated their intention for this provision to apply to prepayments of expenses made after March 15, 1984.[130]

C. Detailed Analysis

1. General Rule

Code §461(i) requires cash basis tax shelters to delay their deduction of prepaid expenses until there has been economic performance (as defined in §461(h)) of the activity to which the expenditure relates.[131]

Example: Management fees will be treated as incurred when management services are rendered. Prepaid supplies will be expensed as used. Mine development expenditures will be deducted as incurred when mine development activity is performed.[132]

Tax shelters will not have the benefit of the exception allowed for consistently recurring items for which economic performance occurs within 8½ months after the close of the taxable year. Instead of the recurring item exception contained in §461(h)(3), tax shelters will be allowed to deduct prepaid expenses if the economic performance of such an expenditure occurs within 90 days after the close of the taxable year in which the deduction is taken.[133] The amount which may be deducted under this section, however, is limited to the investor's cash basis in the investment. Thus, for purposes of determining the amount of prepaid expenses included in this exception and deductible by a partner in a tax shelter partnership, the limitation on deductions contained in §704(d) is changed from the partner's adjusted basis to the partner's cash basis.[134]

A partner's cash basis in a partnership equals his adjusted basis in the partnership determined without regard to any liability of the partnership and any amount borrowed by the partner which was arranged by the partnership or by any person who participated in the organization, sale, or management of the partnership (or a person related to such person as defined below), or secured by any assets of the partnership.[135] In the case of tax shelters other than a partnership, the Secretary of the Treasury has the authority to prescribe regulations which limit the amount of deductions allowed for expenses which qualify for the 90 day exception, in a manner similar to those for partnerships.[136]

These amendments do not affect existing law concerning the deductibility of prepaid expenses. Deductibility of a payment made by a cash basis taxpayer requires that: (1) The expenditure be a payment rather than a deposit; (2) There must be a business purpose for the prepayment; and (3) There must be no material distortion of the taxpayer's income.[137]

Solely for the purposes of this exception, the economic performance with respect to intangible drilling costs ("IDC") of an oil or gas well are treated as occurring when the drilling commences (*i.e.*, upon "spudding" the well).[138] The limitations of present law still apply so that the prepaid expenses must not be a deposit, must be made for a business purpose and must not result in a material distortion of income.

Example: If a taxpayer contributes cash (which was not borrowed) to an oil drilling tax shelter late in the last month of his taxable year and the spudding of a well commences within 90 days after the close of the taxable year, the entire amount of the IDC would be deductible to the extent paid from the taxpayer's cash. If the taxpayer did not qualify for the 90-day exception, the economic performance principles of §461(h) will apply. Only that portion of the IDC attributed to drilling before the end of the taxable year would be deductible.

Any person who is related within the meaning of §168(e)(4) to such a participant in the organization, sale or management of the tax shelter is also prohibited from arranging financing for a partner. Presumably such determination will be made as of the time the participant arranges the borrowing.[139]

2. Definition of "Tax Shelter"

Section 461(i)(3) defines the term "tax shelter" as an enterprise (other than a C corporation) if at any time interest in such enterprise has been offered for sale in an offering required to be registered with any federal or state agency which regulates the sale of securities. A tax shelter also includes any partnership or other entity (including

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those corporations which are S corporations) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or persons who have an interest in an entity but do not actively participate in its management.[140] The third and final definition for a tax shelter is a partnership, other entity, plan or arrangement (including investment plans and arrangements) if the principle purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax.[141] The Committee intends that any offering filed with, or with respect to which notice is given to, a federal or state agency has met the requirement that it be registered with such agency.[142]

In determining whether an investment constitutes a tax shelter, the Treasury regulations will probably consider whether there is a reasonable and signficant expectation that either (1) deductions in excess of income from the investment will be available in a year to reduce income from other sources; or (2) tax credits in excess of the tax attributable to income from the investment will be available to offset federal income taxes on income from other sources in that year. The expectations of these benefits will depend on the objective facts and circumstances in each case. Significance will be given to the expectations described in the investment's offering materials. In addition, the determination of tax shelter expectations will focus on the percentage of total expenses of the plan or arrangement which are prepaid expenses.[143]

3. *Special Rules for Farming Syndicates*

If any farming syndicate (as defined in §464(c)) is in the trade or business of farming whose principal purpose is to avoid or evade federal income tax (*i.e.*, one defined in §6661(b)(2)(C)(ii)), then the rules of §464 will be applied to limit deductions of the farming syndicate (whether cash basis or accrual basis). After application of the rules in §464 to such tax shelters, then the economic performance rules of this section will be applied to limit deductions.[144] This change will equalize the treatment of cash and accrual farming tax shelters.[145]

The only individuals to whom the prepaid expense provisions will apply are those individuals who engage in farming activities with the principal purpose of tax avoidance. The Conference Committee report indicates that arrangements in which individuals carry on farming activities utilizing the assistance of a common managerial or administrative service may be presumed to have the principal purpose of tax avoidance. If the taxpayers prepay a substantial portion of their farming expenses with borrowed funds, they should generally be presumed to have a principal purpose of tax avoidance.[146]

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[1] Regs. §1.446-1(c)(l)(i).
[2] Regs. §1.461-1(c)(1)(ii).
[3] 144 F.2d 45 (2nd Cir. 1944).
[4] *Harrold v. Comr.*, 192 F.2d 1002 (4th Cir. 1951).
[5] *Crescent Wharf & Warehouse Co. v. Comr.*, 518 F.2d 772 (9th Cir. 1975) rev'g and rem'g 59 T.C. 751 (1973).
[6] *Kaiser Steel Corp. v. U.S.*, 411 F.2d 235 (9th Cir. 1983).
[7] *Lukens Steel Co. v. Comr.*, 442 F.2d 1131 (3rd Cir. 1971).
[8] 420 F.2d 400 (5th Cir. 1969).
[9] Rev. Rul. 72-34 1972-1 C.B. 132 (noting that the IRS will not follow the decision in *Lukens Steel Co); supra*, note 7.
[10] PLR 7831003.
[11] Code §462.
[12] P.L. 84-74, 69 Stat. 134 (1955).
[13] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1254 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 264 (1984).
[14] Act §91(g)(1).
[15] H.R. Rep. No. 861, 98th Cong., 2d Sess. 877 (1984).
[16] *Id.*
[17] Act §91(g)(2).
[18] H.R. Rep. No. 861, 98th Cong., 2d Sess. 877 (1984).
[19] *Id.*
[20] Act §91(g)(3).
[21] §461(h)(1).
[22] §461(h)(4).
[23] The Senate Finance Committee indicated that the time at which a person provides property may be the time it is delivered, or shipped or some other time so long as the taxpayer consistently applies that standard. S. Rep. No. 169 (Vol. I) 98th Cong., 2d Sess. 267 (1984).
[24] §§166(c) and (f).
[25] §463.
[26] §466.
[27] §461(h)(5)(D).
[28] H.R. Rep. No. 861, 98th Cong., 2d Sess. 873 (1984).
[29] *Id.*
[30] §461(h)(3)(C).
[31] H.R. Rep. No. 861, 98th Cong., 2d Sess. 873 (1984).
[32] H.R. Rep. No. 861, 98th Cong., 2d Sess. 873 (1984).
[33] §461(h)(3)(B).
[34] H.R. Rep. No. 861, 98th Cong., 2d Sess. 874 (1984).
[35] *Id.*
[36] *Id.*
[37] Basic Features and Basic Elements of Financial Accounting, AICPA Professional Standards, AC §1025.19; Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 3, ¶¶85-86 (1980).
[38] H.R. Rep. No. 861, 98th Cong., 2d Sess. 874-5 (1984).
[39] *Id.*, at 875.
[40] *Id.*
[41] *Id.*
[42] 1963-2 C.B. 194.
[43] H.R. Rep. No. 861, 98th Cong., 2d Sess. 875-6 (1984).
[44] *Id.*, at 877.
[45] Act §91(i)(l).
[46] 1980-2 C.B. 818.
[47] H.R. Rep. No. 861, 98th Cong., 2d Sess. 876 (1984).
[48] *Id.*
[49] *Id.*
[50] *Id.*, Even though a corporation is not subject to U.S. income tax, its taxable income may be relevant to the determination of the income of a U.S. shareholder.
[51] *Id.*
[52] 30 U.S.C. §1201 et seq.
[53] *See e.g.*, Solid Waste Disposal Act of 1980, 42 U.S.C. §6901 et seq.
[54] *Harrold v. Comr.*, 192 F.2d 1002 (4th Cir. 1951); *Denise Coal Co. v. Comr.*, 271 F.2d 930 (3rd Cir. 1959); *See also*, cases cited in PLR 7831113.
[55] PLR 7831003.
[56] *Ohio River Collieries Co. v. Comr.*, 77 T.C. 1369 (1981).
[57] H.R. 3342.
[58] S 1911, 97th Cong., 2d Sess., (1982); S 2642, 97th Cong., 2d Sess., (1982); S. 237, 98th Cong., 1st Sess., (1983).
[59] Statement of Assistant Secretary John E. Chapotan before Senate Finance Subcommittee on Energy and Agriculture Taxation, 97th Cong.,

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2d Sess. (December 7, 1982); Statement of William S. McKee, Acting Deputy Assistant Secretary for Tax Policy, before Senate Finance Subcommittee on Energy and Agriculture Taxation, 98th Cong., 1st Sess. (May 23, 1983).

[60] *See* Joint Committee on Taxation, "Proposals Relating to Tax Shelters and Other Tax Motivated Transactions," 98th Cong., 2d Sess. 67-70 Joint Committee Print (1984).

[61] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 274 (1984).

[62] Act §91(g). *See also,* H.R. Rep. 861, 98th Cong., 2d Sess. 882 (1984).

[63] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 276 (1984).

[64] Act §91(h).

[65] Act §91(h)(2).

[66] H.R. Rep. No. 861, 98th Cong., 2d Sess. 882 (1984).

[67] Act §91(h)(2)(B).

[68] S. Rep. No. 169 (Vol I), 98th Cong., 2d Sess. 276 (1984).

[69] H.R. Rep. No. 861, 98th Cong., 2d Sess. 882 (1984).

[70] S. Rep. No 169 (Vol. I), 98th Cong., 2d Sess. 276 (1984).

[71] H.R. Rept. No. 861, 98th Cong., 2d Sess. 881 (1984).

[72] S. Rep No. 169 (Vol I), 98th Cong., 2d Sess. 276 (1984).

[73] §614(b)(1)(A).

[74] §468(a)(1)(A).

[75] §468(a)(1)(B).

[76] §468(d)(1)(B).

[77] §468(d)(2)(A).

[78] §468(d)(2)(B).

[79] §468(d)(2)(B)(ii).

[80] §468(c)(2).

[81] §468(a)(2)(A).

[82] §468(a)(2)(B)(i).

[83] §468(a)(2)(B)(ii).

[84] §468(a)(2)(C).

[85] §468(b).

[86] §468(a)(3).

[87] §468(a)(4)(A).

[88] §468(a)(4)(A).

[89] §468(a)(4)(C).

[90] H.R. Rep. No. 861, 98th Cong., 2d Sess. 881 (1984).

[91] §468(a)(5)(A).

[92] §468(c)(1)(A).

[93] §468(c)(1)(B).

[94] §468(a)(5)(B); *see also* H.R. Rep. No. 861, 98th Cong., 2d Sess. 881 (1984).

[95] Footnote 39, *supra.*

[96] *Id.*

[97] H.R. 2820, 98th Cong., 1st Sess. (1983).

[98] H.R. 4170, 98th Cong., 2d Sess., §91(k)(2) (1984). Staff of Joint Committee on Taxation, *Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions,* 98th Cong., 2d Sess., 70 (Joint Comm. Print 1984).

[99] S. Rep. No. 98-169 (Vol. I), 98th Cong., 2d Sess. 277 (1984).

[100] Act §91(g)(1)(A).

[101] §468A(b).

[102] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 278 (1984). This language may unintentionally preclude a deduction for any nuclear powerplant which is privately owned (*e.g.,* for research purposes) and does not provide power to customers.

[103] §468A(d)(1).

[104] §468A(d)(2)(A).

[105] S. Rep. No. 169 (Vol. I) 98th Cong., 2d Sess. 278 (1984).

[106] *Id.*

[107] §468A(d)(3).

[108] H.R. Rep. 861, 98th Cong., 2d Sess., 878 (1984).

[109] §468A(e)(4).

[110] §468A(e)(2).

[111] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 278-9 (1984).

[112] *See* §4951(d).

[113] *See* §4951(e)(4).

[114] *See* §4951(a).

[115] §468A(e)(6).

[116] §468A(c)(1).

[117] H.R. Rep. 861, 98th Cong., 2d Sess., 878-9 (1984).

[118] §468A(c)(2).

[119] §88. S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 879 (1984).

[120] H.R. Rep. 861, 98th Cong., 2d Sess. 879 (1984).

[121] §172(k)(4).

[122] §461(a).

[123] §446(b).

[124] Regs. §1.461-1(a)(1) & (2).

[125] §461(g).

[126] §464(a).

[127] *Zaninovich v. Comr.,* 616 F.2d 429 (9th Cir. 1980).

[128] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1259 (1984).

[129] Act §91(g)(1)(B).

[130] H.R. Rep. 861, 98th Cong., 2d Sess. 885 (1984).

[131] §468(i)(1) and (5).

[132] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1260 (1984).

[133] §461(i)(2)(A).

[134] §461(i)(2)(B)(i).

[135] §461(i)(2)(C).

[136] §461(i)(2)(B)(ii).

[137] H.R. Rep. No. 861, 98th Cong., 2d Sess. 885 (1984).

[138] §461(i)(2)(D).

[139] §168(e)(4)(D).

[140] §461(i)(3)(B); *See* §1256(e)(3)(B).

[141] §461(i)(3)(C); *See* §6661(b)(2)(C)(ii).

[142] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1260 (1984).

[143] *Id.*

[144] §461(i)(4).

[145] H.R. Rep. No. 861, 98th Cong., 2d Sess. 885 (1984).

[146] *Id.; See* §461(i)(4)(C).

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Chapter 24

At Risk Rules Liberalized for Qualified Corporations

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I. Introduction

A. *Background - §465*

The Code generally disallows losses from trade or business or income-producing activities to the extent that such losses are financed from sources other than the assets or personal credit of the taxpayer. Under the "at risk" rules, added as Code §465 by the Tax Reform Act of 1976, the amount of taxable losses incurred in business or investment ventures (with the notable exceptions of real estate and certain equipment leasing activities) cannot exceed the amount of the taxpayer's economic commitment to the business, *i.e.*, the amount exposed to the risk of loss. Losses disallowed by operation of the at risk limitation are carried forward indefinitely and are deductible to the extent the taxpayer increases his investment or has income from the activity in future years.[1] The at risk rules are intended to discourage the use of nonrecourse indebtedness and similar risk-limiting financing devices in tax-sheltered transactions that generate losses in excess of the taxpayer's actual cash outlay (*e.g.*, leveraged leasing arrangements).

Section 465, as in effect prior to TRA 1984, applies to individuals, (including partners in a partnership) and corporations (more than 50 percent in value of the outstanding stock of which is owned, at any time during the last half of the taxable year, by five or fewer individuals).[2] Thus, publicly-held corporations are not subject to §465 loss limitations.

As noted above, §465 applies to all business or income-producing activities, apart from holding real estate and certain equipment leasing businesses.[3] A taxpayer's activity with respect to each of a number of specified properties, including a film or video tape, leased §1245 property, a farm, or an oil, gas or geothermal property, is considered a separate activity for purposes of computing the taxpayer's income, loss, and at risk amount with respect to the activity.[4] Other activities are aggregated and treated as one activity if the taxpayer actively participates in their management as a trade or business or, in the case of a pass-through entity, 65 percent or more of the losses is allocable to active participants in the business.[5]

In keeping with the underlying objectives of the at risk rules, only amounts actually placed at the risk of the business by the taxpayer increase his at risk amount. A taxpayer is considered at risk for an activity to the extent of (1) the amount of cash and the adjusted basis of other property contributed by him to the activity, plus (2) amounts borrowed for use in the activity, to the extent that the taxpayer is personally liable for repayment of the debt or has pledged property (other than property used in the activity) as security for repayment.[6] Consequently, nonrecourse borrowing has no effect on the taxpayer's at risk amount unless repayment is secured by property of the taxpayer. Also excluded are amounts borrowed from any person who has an interest in the activity (other than as a creditor) or who bears a relationship to the taxpayer that is described in §267(b),[7] and any other amounts as to which the taxpayer is protected against the risk of loss.[8]

B. *Reasons for Change*

According to the House Report,[9] Congress generally believes that the at risk provisions should apply in the case of tax-sheltered activities in which the taxpayer's equity investment is small in comparison to available losses. However, the Report reflects a concern that the at risk rules have disadvantaged certain closely-held corporations engaged in non-tax shelter activities. The rules have foreclosed the use of nonrecourse financing by these corporations, even where the taxpayer is actively engaged in an operating business and has a genuine equity interest in business property that is not likely to be abandoned.[10] The 1984 TRA amendments to §465 represent an attempt to mitigate the effects of the at risk rules on active businesses by limiting application of the rules to situations in which tax shelter potential is present.

C. *Outline of New Provisions*

TRA §432 adds paragraph §465(c)(7) to the Code and makes minor adjustments to the rules governing aggregation of separate activities and the effect of certain borrowings on a taxpayer's at risk amount. Section 465(c)(7), added by Act §432(a), altogether excludes "qualifying businesses" of "qualified C corporations" from the reach of the at risk rules. To be eligible for at risk immunity, a business must meet certain minimum activity requirements, some of which are modified with respect to corporate general partners, banks and life insurance companies. With some exceptions, equipment leasing and any business involving the use or disposition of sound recordings, films, video tapes or similar tangible or intangible property does not qualify for treatment under the rules. Nevertheless, the exemption for qualified C corporations represents a significant liberalization of the at risk rules.

Section 432(b) of the Act modifies the provisions relating to aggregation of activities in computing income, losses, and at risk amounts. In the case of a partnership or S corporation, all activities relating to §1245 properties leased or held for lease and placed in service during the entity's taxable year will be treated as one activity. In addition, activities deemed to be separate activities under prior rules (*e.g.*, films, video tapes and geothermal proper-

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ties) may be aggregated, in accordance with regulations to be promulgated, if the taxpayer actively participates in each activity.

Section 432(c) of the Act amends Code §465(b)(3) to provide that certain indebtedness previously excluded from the at risk amount will now qualify as at risk. In particular, funds borrowed by a corporation from its shareholders may now qualify as at risk.

D. Effective Dates

The §465 amendments apply to taxable years beginning after December 31, 1983. Any loss from an activity described in new §465(c)(7) that would have been allowed as a carryover, under §465(a)(2), to the taxpayer's first taxable year beginning after that date, will be allowed despite the TRA amendments (which render §465(a)(2) inapplicable to losses from activities of a qualified C corporation).

II. Detailed Analysis

A. General Rule - "Qualified C Corporation"

Section 465(c)(7) provides that in the case of any taxpayer that is a "qualified C corporation," each "qualifying business" of the taxpayer will be treated as a separate activity, and losses attributable to the business will not be subject to the general at risk limitation of §465(a). This provision effectively eliminates any prerequisite that a qualifying taxpayer commit its personal financial resources before deducting losses generated by qualifying business activities.

The term "qualified C corporation" is defined as any corporation described in §465(a)(1)(B), other than (1) a personal holding company as defined in §542(a), (2) a foreign personal holding company as defined in §552(a), or (3) a personal service corporation as defined in §269A(b).[11] A corporation described in §465(a)(1)(B) (which was not affected by TRA) is any corporation which at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned by five or fewer shareholders. The stock ownership attribution rules of §544 continue to apply for purposes of this definition.[12]

B. Eligible Activities

1. In General

Section 465(c)(7) applies only to losses derived from a "qualifying business." Section 465(c)(7)(C) defines this term as "any active business" that meets specific tests relating to the number of active employees and the amount of out-of-pocket expenses incurred during the taxable year.

Note: The statute does not indicate whether a business satisfying the foregoing tests will be regarded *ipso facto* as an "active business," or whether the phrase "active business" imposes an additional precondition, *e.g.*, some particular level of operating activity. The Conference Report notes that the House language was specifically amended to include the word "active" in the definition of a qualifying business. However, the Conference Report also reflects a legislative intention that the creation of an active business be treated as the conduct of an active business.[13]

The specific activity requirements for treatment as a qualifying business are as follows:

(a) The corporation must have had at least one full-time employee, substantially all of the services of whom were in the active management of the business at all times during the taxable year; and

(b) The corporation must have had at least three full-time, "non-owner employees," substantially all of the services of whom were directly related to the business, at all times during the taxable year; and

(c) The amount of deductions generated by the business that are permitted solely by reason of §162 (trade or business expenses) and §404 (employer contributions to qualified plans) exceeds 15 percent of the gross income from the business.[14]

A "non-owner employee" is any employee who does not own, at any time during the taxable year, more than five percent in value of the outstanding stock of the taxpayer (determined by application of the §318 attribution rules, with "5 percent" substituted for "50 percent" in §318(a)(2)(C)).[15]

Comment: It would appear that the use of three non-owner employees in an activity, one of whom is responsible for management, will satisfy the first two minimum activity requirements. Note, however, that since under the general rule of §465(c)(7) each qualifying business is treated as a separate activity, each individual business presumably must satisfy the minimum activity requirements. Unfortunately, the statute does not define the term "business."

The purpose of these minimum activity requirements is to ensure that corporations with little or no operating expenses or personnel requirements (*i.e.*, passive, investment-type companies) continue to be subject to at risk restrictions. For similar reasons, the statute excludes certain types of activity from the definition of qualified business. These include equipment leasing [16] and any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.[17] Presumably, these activities are excluded because of their potential as tax shelter vehicles. However, activities involving master sound recordings and the like are treated as qualified businesses if the taxpayer is at risk "with respect to all amounts paid or incurred (or chargeable to capital account)" in connection with the acquisition or creation of the properties used in the business.[18] The provision of services, such as cable television, pursuant to a license or franchise conferred by the Federal Communications Commission (or any other domestic governmental authority) may also qualify for exemption from the at risk rules if the minimum activity requirements of §465(c)(7)(C) are satisfied.[19]

2. Special Rules

a. Qualified Corporate Partner

A qualified C corporation that owns an interest in a partnership conducting an active business may be permitted to take into account, for purposes of the minimum activity tests, its proportionate share of the activities of the partnership. If the taxpayer is a "qualified corporate partner," and

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during the entirety of the partnership's taxable year there was at least one full-time employee of the partnership (or of the qualified corporate partner) substantially all of whose services were in the active management of the business, then the corporate partner's proportionate share (based on its interest in the profits) of the partnership's nonowner employee's income and deductions will be attributed to the corporate partner in determining whether the corporation is engaged in a qualifying business.[20] The Act provides no guidance as to the proper treatment of a corporate partner whose interest in profits fluctuates during the partnership's taxable year.

Note: The Conference Report states that a qualified corporate partner may aggregate its share of the partnership's business (determined in accordance with the above rules) with any portion of the business that the corporation conducts directly. Presumably, the business in question, whether conducted by the corporation directly or through a partnership, must constitute a "single business" before aggregation will apply.

Section 465(c)(7)(D)(ii) defines the term "qualified corporate partner" as any corporation[21] that: (1) Is a general partner in the partnership, (2) Has a 20 percent or greater interest in the profits and losses of the partnership, and (3) Has contributed property to the partnership in an amount not less than the lesser of $500,000 or ten percent of its net worth. For purposes of this last criterion, non-cash contributions will be taken into account based on fair market value.[22]

b. Income and Deductions of a Qualifying Business

As previously discussed, one of the characteristics of a qualifying business is that the amount of deductions attributable to the business and allowable solely by reason of §§162 and 404, exceeds 15 percent of gross income from the business. The Act specifies that compensation for personal services rendered by any employee (other than a non-owner employee) of the taxpayer, or by any member of such employee's family,[23] does not count towards the required 15 percent of gross income.[24] Thus, the taxpayer must satisfy the 15 percent test through compensation of non-owner employees and other costs deductible under §§162 and 404.

In the case of a bank (as defined in §581) or a financial institution (to which §591 applies), gross income for purposes of the 15 percent test must be determined by including interest otherwise excluded from gross income under §103 (relating to certain governmental obligations).[25] However, in addition to the deductions allowable under §§162 and 404, a bank or financial institution may also take into account deductions allowable under §§163 or 591 for amounts paid or credited to depositors or account holders as dividends or interest.[26]

The 15 percent test does not apply at all to any "insurance business" of a "qualified life insurance company." The term "insurance business" means any business that is not a noninsurance business under §806.[27] A "qualified life insurance company" is any company that would be considered a life insurance company under §816 if unearned premiums were disregarded under §§816(a)(2) and (c)(2).[28]

c. Treatment of Affiliated Groups

For purposes of the exemption from at risk limitations for qualified C corporations, the component members of a §1504(a) affiliated group that files, or is required to file, consolidated returns will be treated as a single corporation.[29] This rule presumably applies for all purposes under §465(c)(7), including the definitions of qualified C corporation and qualifying business. Losses attributed to a qualifying business of a component member will offset affiliate group income. The Act provides, however, that the losses of one member of an affiliated group may not be used to offset the income of any other member that is a personal holding company or personal service corporation.[30]

C. Aggregation of Activities

Under pre-existing §465(c)(2), a taxpayer's activities with respect to certain properties, such as films, video tapes, leased §1245 property and farms (hereinafter "§465(c)(2) properties"), were required to be treated as separate activities. Thus, for example, amounts at risk with respect to one video tape could not be used to offset losses attributable to another video tape (as to which the taxpayer had no at risk investment). The Act retains the general rule against aggregation of §465(c)(2) properties, but provides for certain exceptions. First, in the case of any partnership or S corporation, all activities with respect to §1245 properties that are leased or held for lease, and that are placed in service in any taxable year, will be treated as one activity.[31] Second, the exception for active participation by the taxpayer, previously applicable to other activities, will now apply to all §465(c)(2) properties,[32] subject to regulations to be promulgated by the Secretary of the Treasury.[33] As previously explained, a taxpayer may treat activities that constitute a trade or business as one activity for at risk purposes, provided that the taxpayer actively participates *in the business* (in the case of a partnership or S corporation, if 65 percent or more of the losses are allocable to active participants). The House Report on TRA emphasizes that with respect to §465(c)(2) properties, a taxpayer may aggregate activities only if he actively participates in the management of *each separate activity* (*i.e.*, property).

> *Example:* A owns two oil-producing properties (X and Y) and actively participates in the management of each. With respect to X, which has produced losses of $20,000 for the taxable year, A is at risk in the amount of $10,000. A is at risk for an initial investment of $5,000 with respect to Y, which also has retained earnings of $5,000 for the taxable year. A will be entitled to deduct the entire $20,000 loss on property X, since A's amount at risk, on an aggregate basis, is $20,000.

The House Report on TRA defines "active participation" as follows:

> "The determination of whether a person actively participates in the management of an activity depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the activity, actually performing services for the activity, or hiring and discharging employees. Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of

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the activity, having authority only to discharge the manager of the activity, or having a manager of the activity who is an independent contractor rather than an employee." [34]

Presumably, the forthcoming regulations will incorporate these factors and allow aggregation of activities with respect to which the taxpayer personally plays an active role in ongoing management and/or operation.

D. Related Party Indebtedness

In a significant relaxation of the rules relating to the effect of borrowings on the taxpayer's at risk amount, TRA §432(c) amends §465(b)(3) to permit funds borrowed from certain related parties to be included in computing this amount. Former §465(b)(3) excluded amounts borrowed from any person related to the taxpayer under §267(b), regardless of whether the related person had any interest in the activity financed by the borrowed funds. Section 465(b)(3) provides that a taxpayer will not be considered at risk for amounts borrowed from any person having an interest in the relevant activity, or from a person related to a person (other than the taxpayer) having such an interest. Under this formulation, includibility of indebtedness for at risk purposes hinges on whether the lender has an interest in the financed activity (thereby decreasing the borrower's economic risk), rather than whether the lender is related to the taxpayer. Of course, the financing must still be full-recourse as against the taxpayer in order to be includible in the at risk amount. Nonetheless, these rules should facilitate financing for activities covered by the at risk rules.

Section 465(b)(3) also provides that the lender's interest as a creditor will not require exclusion of the loan proceeds from the taxpayer's at risk amount.[35] In addition, shareholders lending to a corporate borrower will not be considered as having an interest in the corporation's activity by virtue of their ownership in the corporation.[36] If the shareholder-lender has an interest in the activity other than in his capacity as a shareholder of the borrowing corporation, however, the loan would probably be excluded under this rule.

The definition of the term "related person" provided in §168(e)(4)(D) will apply for purposes of the rules on inclusion of indebtedness.[37] The specified relationships include those described in §§267(b) and 707(b)(1) (applied by substituting "10 percent" for "50 percent") and the relationship between persons engaged in trades or business under common control (as defined in §§52(a) and (b)).

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[1] §465(a)(2).
[2] §465(a)(1). The stock ownership attribution rules of §544, with minor adjustments, apply for purposes of this provision.
[3] §465(c).
[4] §465(c)(2); Prop. Regs. §1.465-42(c). The proposed regulations provide that in the case of, *e.g.*, a partnership or S corporation owning interests in several films or video tapes, the films and tapes will constitute one activity of each partner or shareholder.
[5] §465(c)(3)(B). The statute directs the Secretary to prescribe regulations for aggregating activities not treated as separate by statute. These regulations have yet to be issued.
[6] §465(b). Net income of the taxpayer that is retained in the business will also increase the at risk amount. Conversely, withdrawals decrease the at risk amount. *See* S. Rep. No. 938, 94th Cong., 2d Sess. 50 (1976); Prop. Regs. §1.465-22(b) and (c).
[7] §465(c)(3). The specified relationships include, *inter alia*, members of a family, an individual and his 50 percent-owned corporation, two corporations 50 percent-owned by the same individual (where one is a personal holding company), and a grantor and fiduciary of any trust.
[8] §465(b)(4).
[9] The Senate bill did not contain provisions relating to §465.
[10] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1509-10 (1984).
[11] §465(c)(7)(B). For purposes of this section, an owner-employee of a personal service corporation is any employee who on any day of the taxable year owns five percent or more of the outstanding stock.
[12] *See* §465(a)(3).
[13] Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1122 (1984).
[14] §465(c)(7)(C)(i)-(iii).
[15] §465(c)(7)(E)(i).
[16] §465(c)(7)(E)(ii)(I). Equipment leasing is defined in §465(c)(6) as the purchasing, leasing, servicing and selling of §1245 property (not including master sound recordings or similar property). Under §465(c)(4), the at risk rules are inapplicable to equipment leasing by some closely-held corporations.
[17] §465(c)(7)(E)(ii)(II).
[18] §465(c)(7)(E)(iii)(I).
[19] §465(c)(7)(E)(iii)(II).
[20] §465(c)(7)(D)(i).
[21] The structure of the statute suggests that this phrase would not include a corporation that is not a qualified C corporation.
[22] §465(c)(7)(D)(ii).
[23] Family members include: spouses, children (including adopted children), grandchildren and parents. §318(a)(1).
[24] §465(c)(7)(D)(iii).
[25] §465(c)(7)(D)(iv)(I).
[26] §465(c)(7)(D)(iv)(II).
[27] §806(c)(3) defines "noninsurance business," tautologically as any activity that is not an insurance business. See H.R. Rep. No. 432, 98-432, 98th Cong., 2d Sess. 1408 (1984) for amplification.
[28] §465(c)(7)(D)(v). Under this provision, a life insurance company will qualify if its life insurance reserves comprise more than 50 percent of its total reserves (computed without regard to unearned premiums).
[29] §465(c)(7)(F). A "component member" is an includible corporation under §1504(b).
[30] §465(c)(7)(G).
[31] §465(c)(2)(B)(i).
[32] §465(c)(2)(B)(ii).
[33] *Id.*
[34] H. R. Rep. No. 432, 98th Cong., 2d Sess. 1514 (1984).
[35] §465(b)(3)(B)(i).
[36] §465(b)(3)(B)(ii).
[37] §465(b)(3)(C).

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CHAPTER 25

MODIFICATION OF INCOME AVERAGING RULES — Code §1301

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I. Overview

A. Background

A United States citizen or resident is able to reduce his income tax by electing to average his taxable income.[1] The purpose of this procedure is to allow individuals with widely fluctuating incomes to have their income taxed, to a large extent, as if it were earned in equal installments over a five year period.

An eligible individual must first determine that his current taxable income exceeds 120 percent of his average taxable income for the prior four taxable years ("average base period income").[2] If that excess ("averagable income") is greater than $3,000, then the individual will qualify for income averaging.[3]

The income tax is imposed on averagable income at reduced rates. The individual first determines the tax on base period income (*i.e.*, 120 percent of average taxable income for the preceeding four taxable years). He then determines the income tax on average base period income plus 20 percent of averagable income. The individual then multiplies the difference between these two taxes by five (5). The result of this calculation is then added to the income tax imposed on average base period income. In effect, the averaging procedure widens the income tax brackets for this "excess" income by a factor of five.

B. Reasons For Change

Congress felt that the income averaging procedure was currently available to many persons who had no "real" increase in their income, but whose income increased solely in response to inflationary pressures in the economy. The committee reports note that the number of tax returns electing income averaging had increased from 1.35 percent in 1970 to 6.87 percent in 1981.[4]

In addition, the problem of wide spread availability of income averaging would be exacerbated by the imminent introduction of indexation of income tax rates. It is possible that a person who has an increase in taxable income equal to the increase in the cost of living will qualify for income averaging and obtain a reduction in his income tax rate. Beginning in 1985, that individual would also have a reduction in income tax rates in response to indexation of the rates.[5] Congress intended that the introduction of indexation should serve to eliminate an increase in income tax due solely to inflation. Allowing individuals with income increased by inflation to income average would be an unintended double benefit. In addition, the reduction of income tax rates mandated by the 1981 Tax Act justified, in the mind of Congress, less generous terms for income averaging.

II. Summary of New Provisions

A. In General

An individual's current taxable income must now exceed his average base period income by 140 percent (instead of 120 percent) to qualify for income averaging. Further, the base period over which income is "spread" is decreased from 4 years to 3 years.

B. Effective Date

This provision will apply to taxable years beginning after December 31, 1983. Thus, it is currently effective for calendar year individuals.

III. Detailed Analysis

A. Decrease in Amount Subject to Averaging

The Act decreases the amount of taxable income which is subject to income averaging by increasing to 140 percent the amount by which current year taxable income must exceed average base period income.[6] Under prior law, current taxable income only needed to exceed average base period income by 120 percent. The difference between current taxable income and average base period income must still exceed $3,000 as well as the 140 percent limit. Thus, individuals will need a more dramatic increase in their income to take advantage of the income averaging provisions.

In addition, this change pushes the averagable income into substantially higher income tax brackets than before. Under prior law, averagable income was added to 120 percent of average base period income. After the amendment, averagable income is added to 140 percent of average base period income. Thus, a smaller portion of an individual's taxable income will be subject to averaging and that portion which does qualify will be subject to higher income tax rates.

B. Base Period Decreased To Three Years

The period over which income may be averaged, known as the base period, is reduced to three years from four years.[7] This change has two main effects. First, in an inflationary economy, this change will generally eliminate the earliest year, which generally has the lowest amount of income. Thus, average base period income will increase in many instances and the amount of income subject to averaging will decrease.

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Example: If an individual has current year taxable income of $100,000 and taxable income in the preceeding four years of $25,000, $30,000, $35,000, and $40,000, his average base period income would be $32,500 under prior law and will now be $35,000. Thus the amount of income which will be subject to reduced tax rates is decreased by $2,500.

Secondly, this change will also increase the width of tax brackets for averagable income to a factor of four instead of a factor of five.[8] The decrease in the width of tax brackets for averagable income occurs because 25 percent of averagable income is now subject to tax in the income tax brackets above base period income, whereas only 20 percent was subject to those brackets prior to the revision of this section. The averagable income is now taxed as if received in approximately equal annual installments over four years instead of over five years. This tends to increase the amount of income taxable each year which increases the amount of income tax.

Example: Using the example above, under prior law, the maximum income tax rate for an individual using income averaging is that applicable to $51,200, calculated as follows:

Average Base Period Income (ABPI)	$32,500
120 % of ABPI	$39,000
Averagable Income (AI) ($100,000 - $39,000)	$61,000
Average Taxable Income (120% of ABPI + 1/5 of AI)	$51,200

Under revised §1301 the maximum income tax rate applicable to the individual is that applicable to $61,750, calculated as follows:

Average Base Period Income (ABPI)	$35,000
140% of ABPI	$49,000
Averagable Income (AI) ($100,000 - $49,000)	$51,000
Average Taxable Income (140% of ABPI + 1/4 of AI)	$61,750

[1] §§1301 through 1305.
[2] §1302(b).
[3] §1301.
[4] H. R. Rept. 432 (Part 2), 98th Cong., 2nd Sess. 1385 (1984); S. Report 169 (Vol. 1), 98th Cong., 2nd Sess. 488 (1984), Worksheet 25, *infra*.
[5] §1(f)
[6] §1301(a)(1).
[7] §1302(c)(2).
[8] §1301.

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CHAPTER 26

MISCELLANEOUS ACCOUNTING CHANGES

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I. LIFO Conformity Requirement Applied To Related Groups [Act §95] — Code Section 472(g)

A. Background

In computing taxable income, a taxpayer engaged in the production, purchase, or sale of merchandise must take into account inventories at the beginning and end of each taxable year.[1] There are three generally accepted methods of accounting for the flow of costs through an inventory — specific identification; first-in, first-out (FIFO); and last-in, first-out (LIFO). If a taxpayer elects to use the LIFO inventory method, it must use that method in all reports to all owners of the business or entity (shareholders, partners, beneficiaries, etc.) and for credit purposes.[2] This restriction is commonly known as the "LIFO conformity requirement."

To prevent minor discrepancies from precluding the use of the LIFO method, the Service has allowed several exceptions to its strict application. For example, a problem arises if the foreign parent of a U.S. corporation publishes its financial statements in a country which does not recognize LIFO as a proper method of accounting. The Service has ruled that if the parent corporation meets certain requirements which indicate that it has substantial foreign operations, then it may publish the results of its U.S. subsidiary on a non-LIFO basis in the parent's consolidated financial statements.[3] There is another exception to the conformity requirement when discrepancies in the valuation of a LIFO inventory occurs because the taxpayer adopted the LIFO method at differing times for financial and tax reporting purposes.[4]

The Tax Court recently held that a domestic subsidiary of a domestic corporation had satisfied the LIFO conformity requirement where it issued its financial statements to its parent on the LIFO basis but the parent published consolidated financial statements which did not reflect the operation of the subsidiary with a LIFO basis inventory.[5] The parent probably received the information that it needed to compute the subsidiary's income on a non-LIFO basis as an internal management document which was not released to owners or to creditors.[6] Thus by creating a holding company structure, a domestic corporation could effectively evade the LIFO conformity requirement.

The original purpose of the LIFO conformity requirement was to ensure that taxpayers would only use it where it conformed to the best practice in the taxpayer's trade or business.[7] If owners or creditors would accept financial statements prepared on the basis of LIFO inventories, then it was considered the best available accounting practice in that industry and acceptable for federal income tax purposes.

In an inflationary environment, LIFO tends to reduce reported income and the FIFO method tends to increase reported income. By relying on the *Insilco* decision, taxpayers could arrange their corporate structure so that their subsidiaries reported income on the LIFO basis for federal income tax purposes, but on the FIFO basis in consolidated statements to owners and creditors. Accordingly, Congress decided to change the LIFO conformity requirement so that it applied to all financial statements in which a subsidiary's financial statements appeared.

B. Overview

1. Summary of New Provision

Code §472(g) enacted by the 1984 TRA treats all members of the same group of financially related corporations as a single taxpayer for purposes of the LIFO conformity requirement. The term "group of financially related corporations" means (1) any affiliated group as defined in §1504 (without regard to the exceptions in §1504(b) and by substituting a 50 percent stock ownership test for the 80 percent ownership test in that section), and (2) any other group which issues consolidated financial statements or reports to owners or creditors. The provision applies whether the LIFO subsidiary's financial results are consolidated with those of the parent and other subsidiaries or whether the parent corporation reports its investment in the subsidiary on the equity method.

LIFO taxpayers whose parents relied on the decision in *Insilco* will have to change their inventory method or have their parent corporation report their income based on a LIFO inventory.

2. Effective Date

Section 472(g) will be effective for all taxable years beginning after July 18, 1984 (the date of enactment). Thus, the financial statements of calendar year taxpayers will not be affected by the provision until their financial statements issued for the period beginning on January 1, 1985.

C. Detailed Analysis

1. In General

Section 95 of the Act adds subsection (g) to the LIFO rules contained in §472 of the Code. This subsection provides that all members of the same group of financially related corporations shall be treated as one taxpayer for purposes of the LIFO conformity requirement. The effect

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of this change is to require that financial reports of all members of a group of financially related corporations to report on the LIFO basis, if any member of the group has elected the LIFO method for federal income tax purposes. This provision does not require that the inventory of all members of a financially related group be on the LIFO basis, but that if the financial results of that group are published to investors or creditors, the LIFO method must be used in calculating income for all members of the group.

2. Group of Financially Related Corporations

There are two groups of corporations which qualify as groups of financially related corporations. The first group is an affiliated group as defined in §1504 without regard to the provisions of §1504(b). The 80 percent rule used in §1504(a) is reduced to 50 percent. Thus a group of financially related corporations will be a chain of corporations connected through stock ownership with a common parent if corporations in the chain directly own 50 percent of the voting power of all classes of stock of an includable corporation and at least 50 percent of each class of non-voting stock. The common parent must also own directly at least 50 percent of the voting power of all classes of stock and at least 50 percent of each class of the nonvoting stock of at least one of the other corporations in the chain.

By disregarding the exceptions contained in §1504(b), §472(g) does not provide any limitation as to the corporations in a chain of ownership whose financial statements are exempt from the LIFO conformity requirement.

To make this provision as broad as possible, the definition of financially related group includes as its second category any other group of corporations which consolidate or combine for purposes of financial statements.[8] It appears that this language is intended to cover all corporations in a group which consolidates its financial statements and any corporations that are included in financial statements on the equity method.

On its face, this LIFO conformity requirement would apply to foreign parents of domestic corporations. However, the Conference Report provides that any existing exception to the LIFO conformity requirement would continue in force. Thus, a foreign parent corporation in a country which does not allow reporting of financial results on the LIFO basis would still be able to report its consolidated financial results with its domestic subsidiary on a non-LIFO basis.[9]

If a corporation owns more than 50 percent of another corporation, it will generally consolidate its financial statements with those of its subsidiary. Under certain circumstances, generally accepted accounting principles will allow the subsidiary to be carried on the "equity" method. In this method, the financial results of a subsidiary are not consolidated with the parent, but the parent's investment in the subsidiary is increased or decreased by the amount of the subsidiary's income or loss. The amendment to §472 is intended to require a parent corporation to use the LIFO method in reporting the financial results of its subsidiary regardless of whether it consolidates the results of its subsidiary or uses the equity method to report its results. In all events, only subsidiaries in which the parent owns a 50 percent interest will be subject to this conformity requirement.[10]

3. Collateral Effects

The Conference Committee Report indicates that the amendment contained in the Act does not affect any interpretation of the LIFO conformity requirement under current law. Accordingly, the Service is still free to challenge the LIFO election of any taxpayer in an *Insilco* situation.

A taxpayer who relied on the *Insilco* case may elect to continue to use the LIFO method for a 50 percent owned subsidiary if it conforms its financial statements to the requirements of this section. In such a situation, the LIFO cost for financial statement purposes may be different than that for federal income tax purposes. The Conference Committee Report confirms that this will not be a violation of the LIFO conformity requirement.[11]

To prevent unwarranted exposure to an adverse decision if the Service successfully challenges a taxpayer's LIFO election because of a conformity violation, the Conference Committee directs the Service to provide a protective LIFO election for taxpayers who wish to continue their current LIFO election. This election should protect the LIFO election in taxable years after the enactment of this Act. Taxpayers could not vary this protective election from the terms of their existing LIFO election. The Committee Report indicates that this provision should not determine the availability of conditional LIFO elections in any other circumstance.

Comment: A protective election might be a "red flag" which will insure a challenge by the IRS of a taxpayer's LIFO election.

If a taxpayer's LIFO election is disallowed by the Service and it has filed a protective LIFO election to continue to use the LIFO method, the change from the method selected by the Service for prior years to the LIFO method in the current year will be governed by Rev. Proc. 80-51.[12] The non-qualifying use of the LIFO method prior to the protective election would not be considered a Category A accounting method (*i.e.*, non-permitted method). Therefore, the taxpayer would not be required to take any adjustment required by the change into income in a single year. The Conference Report does require that the taxpayer take the change into income over a period not exceeding four years.[13] Under the normal rules of Rev. Proc. 80-51, the taxpayer could spread the adjustment over a maximum period of 10 years.

Taxpayers who have adopted the LIFO method in reliance on the *Insilco* decision may wish to revoke their LIFO elections. In that case, the taxpayer will need to apply to the Service for permission to change accounting methods.[14] The House Ways and Means Committee requests the Treasury Department to provide rules which would allow automatic permission to change to a non-LIFO method during an appropriate transition period.[15] The Ways and Means Committee Report indicates that where a taxpayer wished to change from the LIFO method to a non-LIFO method, the adjustment required under §481 will be spread over a maximum period of four years if the taxpayer changes its method in accordance with the prescribed procedures.

If it is determined that a taxpayer has improperly used the LIFO method, the taxpayer will not be allowed to

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spread the §481 adjustment if it wants to change to a non-LIFO method, but will take the adjustment into income in the year of the change.[16]

II. Waiver of Estimated Tax Underpayments Caused by Completed Contract Rules [Act §712(m)]

A. Introduction

As part of the Tax Equity and Fiscal Responsibility Act of 1982,[17] Congress directed the Treasury Department to promulgate regulations regarding timing for contract completion, severing and aggregating contracts and allocating costs to long-term contracts. In response to this direction the Treasury Department proposed new completed contract regulations on March 14, 1983.[18] Section 1.451-3(g)(5) of those regulations allows taxpayers to defer a portion of estimated income tax payments for their first taxable year ending after December 31, 1982, if their taxable incomes include income from contracts completed as a result of the application of the new regulations regarding the time for completion of contracts.[19] The deferral applies only to estimated income tax installments required before April 13, 1983. This seems to be an equitable relief provision for taxpayers who could not be certain as to the content of the new regulations and have sufficient time to consider their effect on estimated income tax payments due shortly thereafter. Generally, there is a general provision in a major tax bill to allow the Treasury Department to waive estimated tax payments required by changes in the law caused by enactment of new legislation. TEFRA did not include such a provision and therefore section-by-section relief was required.

B. Overview and Detailed Analysis

1. In General

Act Section 712(m) amends section 229 of TEFRA to allow the Treasury Department to amend the completed contract regulations in §451 to waive the penalty applied to underpayments of estimated income taxes for a taxpayer's first taxable year ending after December 31, 1982. The waiver only applies to payments which were required to be paid before April 13, 1983. Thus, §1.451-3(g)(5) of the proposed regulations will be valid as originally published.

Example: A corporation with a January 31, 1983 fiscal year might have a contract which is severed into a number of contracts and some of them are considered completed on January 1, 1983.[20] Its final estimated tax payment was due on January 15, 1983. Since these regulations were not published until March 16, 1983, the taxpayer would not have had the regulations available for purposes of determining any of its estimated tax payments. Accordingly, it might not have made estimated tax payments equal to 90 percent of its tax liability.[21] Thus it may make its estimated tax payments as if the new regulations were not effective.

The first estimated tax payment after April 13, 1983 of taxpayers with fiscal taxable years ending after March 30, 1983 will include income from long-term contracts in accordance with these regulations.

Comment: This provision will not affect any taxpayer, either corporation or individual, with a calendar taxable year, since the first estimated payment for both types of taxpayers is due on April 15 — two days after the exception expires.

2. Effective Date

This provision is effective as if it were originally included in TEFRA.[22]

III. Depreciation Recapture In Installment Sales [Act §112] — Code Section 453(i)

A. Introduction

An installment sale occurs when property is sold or exchanged and at least one payment is to be received after the close of the taxable year of disposition. Unless the taxpayer elects otherwise, the gain from an installment sale is taxed as the taxpayer receives payment for the property, not when the property is sold. The amount of gain recognized in any year is a portion of the principal payments received in a year, equal to the gross profit from the sale divided by the total sales price.[23] Thus, if a taxpayer receives only interest on the deferred portion of the sales price, he does not recognize any taxable gain on the deferred portion.

When depreciable property or property subject to the Accelerated Cost Recovery System ("ACRS") is the subject of an installment sale, a portion of the gain recognized may be characterized as ordinary income even though the asset sold is a capital asset.[24] This ordinary income treatment represents a recapture of depreciation previously deducted by the taxpayer. All gain recognized under the installment sale method is first treated as ordinary income until the entire amount of ACRS deduction is recaptured.[25]

Section 179 allows a full deduction against income upon the purchase of certain property which normally is depreciated. If the cost of property sold or exchanged under the installment method was fully deductible under §179, the amount previously deducted is deemed received in the year of the sale, even though there may be no cash payments.[26]

The Senate Finance Committee Report discloses a concern that there can be a mismatch between the depreciation deductions which the new purchaser of the property receives and the recognition of recapture income by the seller.[27] The purchaser will immediately begin to take depreciation deductions while the seller may not report recapture of a previously claimed depreciation deduction until principal payments are made on the deferred purchase price. This appears to be a new concern of Congress that, even among unrelated taxpayers, there should be matching tax consequences to each party involved in a transaction.

The purpose of the installment sale provision was to defer the payment of tax on gain on property from either appreciation or prior depreciation deductions until the seller received cash payments. This allowed the seller the opportunity to obtain cash prior to payment of his income tax liability. The Finance Committee Report now argues that the seller has already obtained cash from the depreciable property because the depreciation deductions reduced taxable income in the year in which they were allowed. Thus a provision which requires the taxpayer to recognize

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all his depreciation recapture in the year of sale, is not unreasonable since the taxpayer received cash for the recaptured deductions as they were taken.[28]

The depreciation recapture provisions of §§1245 and 1250 provide a disincentive for taxpayers to rapidly depreciate a property and then sell or exchange it to acquire another piece of property which they could depreciate. It appears that some persons have used the installment sale provisions to avoid the disincentives for "churning" property contained in the recapture provisions. The deferral of the recapture provisions and capital gains tax accomplished through an installment sale can reduce the disincentive for selling depreciable property. The revision of the installment sales provision contained in the 1984 Act will reduce the incentive for persons to replace property as soon as the tax benefits are exhausted. This change will also make it more difficult for investors to achieve negative tax rates through use of ACRS deductions and rapid sales of property.[29]

B. Overview

1. In General

Section 112 of the Act repeals and replaces §453(i) of the Code providing that in any disposition of real or personal property, all depreciation recapture required by §§1245 and 1250 of the Code will be recognized in the year of the disposition. A taxpayer's basis in depreciable property sold on the installment method will be increased by the amount of the recapture gain recognized in the year of sale. The remainder of the gain from an installment sale will be recognized under the regular installment sale rules.

2. Effective Date

The amendments made by the Act are applicable to dispositions made after June 6, 1984.[30] If a disposition is made pursuant to a contract which was binding on March 22, 1984 and at all times thereafter, prior law should be applied.[31]

C. Detailed Analysis

The Act totally revises §453(i) of the Code. The revised section requires that "recapture income" arising in an installment sale of real or personal property will be recognized in the year of disposition of the property regardless of the amount of payments made in that year. Any gain which is recognized in excess of the recapture income will be recognized on the installment method as currently set forth in §453.[32]

"Recapture income" is defined as the amount which would be treated as ordinary income under §§1245 or 1250 for the taxable year of the disposition if all payments to be received under the terms of the sale were received in that year.[33] Recapture income includes any amounts deducted under §179 since §1245 recaptures deductions taken under §179.[34] Thus the repeal of existing §453(i) will not change the application of recapture when a taxpayer disposes of §179 items.

Although there is no amendment to the provisions of the Code dealing with taxpayer's basis in property, the Senate Finance Committee indicated that this provision would require an adjustment to basis to reflect the amount of recapture income included in gross income. The adjusted basis of property sold should be increased by the amount of recapture income included in gross income in the year of sale. The effect of this adjustment will be to decrease the amount of gain which is subject to installment sale treatment and decrease the portion of each payment which is considered gain from the sale of property.[35]

> *Example*: A taxpayer sold property for $100 in an adjusted basis of $20. The taxpayer had taken $30 of depreciation and all of that amount was subject to recapture. On the sale of the property, the $30 of depreciation subject to recapture would be recognized as ordinary income in the year of sale regardless of the amount of payments received in that year. In addition, the basis of the taxpayer would be increased by the amount of recapture income realized and would accordingly equal $50 (*i.e.*, the original cost of property). The gross profit from the sale is $50 and the gross profit percentage would be 50 percent ($50/$100). Accordingly, 50 percent of each payment the taxpayer receives will be taxable as gain from the sale of property. If the taxpayer receives $50 of principal payments in the year of sale, then it will have $25 of capital gain income as well as $30 of ordinary recapture income.

Comment: This provision not only accelerates the recognition of ordinary income as compared with prior law, but also accelerates the recognition of a capital gain from a sale of property. In the example above, under prior law, the gross profit percentage would be 80 percent. Thus 80 percent of the initial principal payment for such property would be taxable as gain. That gain would be characterized initially as ordinary income to the extent of any depreciation recaptured. Accordingly, the first $37.50 of principal payments would produce ordinary recapture income of $30. In the prior Example, the taxpayer will recognize the $30 relating to recapture income in the year of the sale and the initial $50 of principal payments will include $25 of capital gain under this revision. Under prior law, the taxpayer would have only recognized $30 of ordinary income and $10 of capital gain income in the year of the sale.

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[1] Regs. §1.471-1.
[2] §§472(c) and (e)(2).
[3] Rev. Rul. 78-246, 1978-1 C.B. 146.
[4] Regs. §1.472-2(e)(l)(viii)(A).
[5] *Insilco v. Comr.*, 73 T.C. 589 (1979), aff'd in an unreported decision by the Second Circuit on April 17, 1981.
[6] PLR 8008168.
[7] S. Rep. No. 648, 76th Cong., 1st Sess. 6-7 (1939), reprinted in 1939-2 C.B. 524, 528; H.R. Rep. No. 2330, 75th Cong., 3rd Sess. 34 (1938), reprinted in 1939-1 C.B. 817, 819.
[8] §472(g)(2)(B).
[9] H.R. Rep. No. 861, 98th Cong., 2d Sess. 897 (1984).
[10] Rev. Rul. 78-246, 1978-1 C.B. 146. *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 897 (1984).
[11] *See* Regs. §1.472-2(e)(1)(viii)(A).
[12] 1980-2 C.B. 818.
[13] H.R. Rep. No. 861, 98th Cong., 2d Sess. 898 (1984).
[14] §446(e).
[15] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1381 (1984).
[16] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 487, note 14 (1984).
[17] P.L. 97-34, §229 (1982) hereinafter referred to as "TEFRA."
[18] 48 F.R. 10702.

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[19] *See* Prop. Regs. §§1.451-3(b)(2)(ii), (b)(2)(iii), (b)(2)(iv), (g)(3), and (g)(4).
[20] Prop. Regs. §1.451-3(g)(4).
[21] §6655(b).
[22] P.L. 98-369, 98th Cong., 2d Sess. §715 (July 18, 1984).
[23] §453(a).
[24] §§1245 and 1250.
[25] Treas. Regs. §§1.1245-6(d)(1) and 1.1250-1(c)(6).
[26] §453(i) prior to amendment by The Tax Reform Act of 1984.
[27] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 465 (1984).
[28] *Id.* at 466.
[29] *Id.*
[30] Act §112 (b)(1).
[31] Act §112(b)(2).
[32] §453(i)(1).
[33] 453(i)(2). For a complete discussion of depreciation recapture under sections 1245 and 1250 *see* 129 T.M., *Depreciation Recapture — Section 1245 — General*, and 148 T.M., *Depreciation Recapture — Section 1250 — General.*
[34] 1245(a)(2).
[35] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 466 (1984).

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CHAPTER 27

TAX STRADDLES

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I. Background

A. Pre-ERTA [1] Law and Problems

The term "tax straddles" embraces a wide variety of transactions, many of which do not qualify as "straddles" as that term is usually understood. The term includes, for example, wash sales, *i.e.*, the sale of property at a loss accompanied by the acquisition of substantially identical property to replace the property sold either shortly before or shortly after the loss sale.

A short sale probably does qualify as a straddle, loosely defined. Primarily to prevent holding period manipulation, the predecessor of §1233 was enacted by the Revenue Act of 1950. Section 1233 contains two basic sets of rules, referred to herein as the (b) rules (§1233(b)) and the (d) rules (§1233(d)).

Under the (b) rules, where a taxpayer enters into a short sale, and where he has not, at such time, held property substantially identical to the property sold short for a period exceeding the short-term capital gain holding period, any gain realized from closing the short sale is short-term capital gain. While the short sale is open, the holding period of the substantially identical property is suspended. For purposes of the (b) rules, a put option is a short sale. Such deemed short sale is closed either by the exercise, or the expiration unexercised, of the put.

Under the (d) rules, where, at the time of entering into a short sale, the taxpayer has held property substantially identical to the property sold short for a period that exceeds the short-term capital gain holding period, any loss realized from closing the short sale is a long-term capital loss. These rules apply only where the property is held as a capital asset. Where a dealer sells short stock held as inventory, any gain is ordinary income. Finally, there are the Code provisions affecting transactions in options. Under §1234, the character of an option in the holder's hands depends on what character the property to which the option relates would have if held by the taxpayer. Neither the payment of a premium for an option nor the receipt of a premium by the option's grantor is a taxable event.

The treatment of premiums depends on the eventual outcome of the option transaction. If the option is a capital asset, its holding period commences upon acquisition. If it expires unexercised, it is treated as sold on the day it expires. At that time, the premium paid by the holder is short or long-term capital loss depending on the period for which the option was held. If a call option is exercised by the holder, the premium is added to the cost of the stock to determine the holder's basis. The stock's holding period commences on the exercise date. Where a put option is exercised, the premium is deducted from the amount received by the holder in determining gain or loss. Where an option is sold by the holder, (this includes a closing transactions effected through an option exchange) capital gain or loss will result. Where the option is a stock option, it is almost invariably a capital asset, except where the underlying stock, if held by the taxpayer, would not be a capital asset, or where the option is held by a dealer as a hedge against fluctuations in the value of its inventory.

The tax treatment of option grantors has always presented a problem. Before §1234(b), where a call or put option granted by a taxpayer expired unexercised, the gain was ordinary income. Likewise, where the grantor realized gain or loss from a closing transaction terminating his obligations under an option, the gain or loss was ordinary. This was because the grantor was not considered to hold any property which could be classified as a capital asset. *A fortiori*, the termination of the grantor's obligations under an option did not constitute the sale or exchange of a capital asset. The transaction's tax consequences were, therefore, governed by principles similar to those applicable to the termination of rights and obligations under a contract. Prior to the 1976 TRA, however, it had come to be generally agreed that gains and losses of a grantor were ordinary. Where the grantor of a call option had stock or securities called from him upon the exercise of the option, the premium received was added to the price paid by the optionee in determining gain or loss from the stock or securities. Likewise, where the grantor purchased stock or securities upon the exercise of a put, the premium was deducted from the price paid in establishing his basis in such property.

The 1976 TRA added §1232(b), providing that, in the case of the grantor of the option, any gain or loss from any closing transaction with respect to, and any gain or loss from the lapse of, an option in property, is treated as short-term capital gain or loss. "Closing transaction" refers to any termination of the grantor's obligation under an option other than through the exercise or lapse of the option. "Property," for this purpose, is restricted to stocks and securities (including stocks and securities dealt with on a "when issued" basis), commodities and commodity futures. Section 1234(b) was made inapplicable to any option

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granted in the ordinary course of the taxpayer's trade or business of granting options by §1234(b)(3).

Note: There are no "dealers" in options in the sense of a person holding inventory for sale to customers (as is the case of a dealer in stocks or securities). Also, it is doubtful whether a person who grants options can be considered to be engaged in the trade or business of granting options merely because of the volume of such business or because it provides substantial income, etc., as might be the case for a person who trades in stocks or securities or commodity futures or other similar investment products. This is because the grantor of an option does not purchase or sell property.[2] The committee report explaining §1234(b) appears to assume that, to be considered in the trade or business of granting options, the taxpayer must be a broker-dealer in stocks and securities, and that the options granted by such person, to qualify under §1234(b)(3), must be written in connection with the activities involved as a broker-dealer. Section 1234(b)(3) would apply only to options of the latter sort, as distinguished from options granted in connection with the broker-dealer's investment activities. The report concludes, "(g)enerally, it is anticipated that persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to particular option."[3] A "market maker" in options is a person who is registered with an options exchange as such and who assumes the responsibility for assuring the smooth operation of the exchange in options on a given stock or stock index by making available to brokers with buy orders options in the stock or index. Such "market makers" will also buy options offered for sale, keeping their own trades in balance insofar as possible. They will also grant (or "write") options for their own account. To be entitled to §1234(b)(1) treatment, the latter investment grants of options must be identified as such under a system similar to that applicable to broker-dealers who purchase stocks and securities for investment.[4] Since the grantor of an option acquires no property, compliance with this rule presents certain conceptual problems.

Under the above provisions in place before ERTA, taxpayers discovered and exploited a variety of strategems to obtain what were perceived to be unjustifiable tax advantages.

1. Straddle Losses

Under §1233 (which applies to short sales of stocks and securities and to commodity futures) a futures contract specifying delivery in one calendar month was not treated as property substantially identical to another futures contract, even though it related to the same commodity if it called for delivery in another calendar month.[5] Taxpayers could in Year 1 acquire both a long futures position[6] calling for delivery in, for example, April of Year 2 and a short futures position[7] calling for delivery in, for instance, September of Year 2. In the case of a relatively volatile commodity, such as a precious metal, price fluctuations would result in unrecognized gain with respect to one position and an almost (but not always precisely) equal unrecognized loss with respect to the other. The loss position could be closed out in Year 1 and simultaneously replaced. For example, if the commodity price moved upward, the short position would be closed out and a new short position calling for delivery in, for example, October of Year 2 could be acquired, effectively locking in the unrecognized gain from the long position. That is, any downward movement in the long price would automatically be balanced by an increase in the value of the short position. In the following year, Year 2 in the case postulated above, both contracts could be closed out, and the resulting net gain would almost exactly (but not always precisely) equal the loss realized the previous year. The result was a deferral of tax on unrelated Year 1 income offset by the loss from the closed out short position. At the time of ERTA, the IRS was attacking such strategems on various grounds *e.g.*, Rev. Rul. 77-185, 1977-1 C.B. 48. The basic premises of this ruling have, so far, been rejected by the Tax Court. See Smith v. Comr., 78 T.C. 350 (1982) which disallowed the Year 1 loss on the ground that it was not allowable under §165(c)(2) since the transaction was not entered into for profit. Rev. Rul. 77-185 was premised on the position that the closing out of one leg of a straddle is not a closed or completed transaction. This appeared to remain the IRS' position, *Smith* notwithstanding.[8]

2. Cash and Carry Straddles

The futures price of a commodity increases the farther the delivery date is in the future. In the case of precious metal futures contract, this increase reflects numerous factors such as interest, storage costs, insurance, etc. The purchaser of a commodity who simultaneously enters into a short futures position will, with few exceptions, therefore be assured of a capital gain if the commodity is held for delivery under the contract. If the commodity is purchased with borrowed funds at interest, such interest could be deducted during the period for which the commodity was held, together with storage, insurance, and other costs of ownership. These deductions offset ordinary income, as a general rule. When they were recouped as long-term capital gain, the taxpayer benefitted both from deferral of tax and the conversion of ordinary income to capital gain. This strategem was known as a "cash and carry" straddle. The taxpayer assumed no real risk since at all times, his position was balanced.

3. Foreign Currency Contracts

While foreign currency futures contracts are offered on several exchanges, they are available from most large banks and financial institutions. Similar contracts under which someone undertakes either to purchase a given amount of a foreign currency at a set price in dollars on a specified date, or to purchase an amount of the foreign currency at a set dollar rate at a future date, are sometimes referred to as "forward sales" of the currency. They are often engaged in by business concerns to hedge against fluctuations in the exchange rate or to protect the balance sheet values of foreign assets, which must be converted into current dollars for financial reporting purposes. The proper tax treatment of such contracts was long a matter of dispute. Where the exchange rate moved favorably, the holder of the contract (which was usually a capital asset) could sell it. Any gain was reported as capital gain, long or short-term depending on the holding period of the contract rights. Where the taxpayer's position was a short one, the IRS argued that §1233(b) characterized any gain as short-term capital gain. Where, in the case of a forward sale, the currency itself or a long position was used to close out the holder's obligation, any gain or loss was clearly short-term (unless, as rarely

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occurred, the currency had been held long-term prior to entering the contract). Where the exchange rate moved unfavorably, the holder could negotiate a settlement under which the bank would relinquish its contract rights in consideration of payment measured by the holder's unrealized loss. Here, the loss could be claimed as an ordinary loss since there was no sale or exchange of property, merely the extinguishment of the holder's contractual rights and obligations. Of course, some of these contracts were bona fide hedges protecting against the diminution in value of ordinary income assets or the receipt of future ordinary income. This, too, however, entailed some dispute, since it was not always clear whether a given foreign currency contract qualified as a hedging transaction.

Most of these stratagems assumed intricate patterns. While other tax planning "straddles" evolved, those mentioned above were the most prominently publicized.

B. The ERTA Straddle Provisions

ERTA enacted a comprehensive set of anti-straddle abuse provisions which effectively put an end to the stratagems outlined above, as well as some others. In addition, amendments were enacted by the Technical Corrections Act of 1982 (P.L. 97-448) filling in gaps, perfecting, and making technical corrections to the ERTA provisions. ERTA and TCA 1982 provisions are summarized below.

1. Loss Deferral Rule

This rule was placed immediately after the wash sale rule, in §1092. Section 1092 states that any loss with respect to one or more "positions" shall be taken into account for a taxable year only to the extent such loss exceeds the "unrecognized gain" with respect to one or more positions which are "offsetting positions" with respect to the positions from which the loss arose.[9] A "position," for this purpose, is defined as "an interest (including a futures or forward contract or option) in personal property.[10] "Personal property" was defined as any personal property (other than stock) which is actively traded.[11] "Position" did not include any exchange-traded stock option.[12]

"Unrecognized gain" was defined as, in the case of any position held by the taxpayer at the end of the taxable year, the amount of gain which would be taken into account with respect to such position if it were sold on the last business day of the taxable year for its fair market value.[13]

The loss deferral rule did not apply to any "hedging transaction" as defined in §1256(e).[14]

Where a loss was disallowed, it was deferred until the next taxable year. It was treated as a loss from a position disposed of in that year and again was subject to the same deferral rule if there were any unrecognized gains from offsetting positions at year's end.[15]

The key term in §1092 is "offsetting position" as defined in §1092(c)(2). A taxpayer holds offsetting positions when "there is a substantial diminution of loss" from holding one position with respect to personal property by reason of holding another position with respect to personal property (whether or not of the same kind). The statute enumerated a number of circumstances that raise a (rebuttable) presumption that two or more positions are offsetting.[16]

As indicated above, the price differential between two legs of a straddle should, theoretically, remain constant. For example, if the price of July corn is $6 per bushel, the price of September corn might be $6.45 per bushel (reflecting carrying charges, etc.). If the July price moved to $6.30, the September price could be expected to move to $6.75. Similarly, the price differential between the cost of a spot commodity, such as cash silver, and the silver futures price for a given delivery date will reflect current interest, insurance, storage, etc. costs. An upward (or downward) move in the price for the delivery date (or cash position) will usually be reflected in a similar increase or decrease in the futures price for a later date. These price movements, however, are not always exactly parallel for numerous reasons. A knowledgeable professional may enter into a straddle, or a number of straddles, in the hope of profiting from a divergence or convergence of the price differentials described. If, in the example of the corn futures, the July price rises by $.30, the September price may only rise by $.29. If the July position is long and the September position short, closing out both positions will yield a profit; small, but satisfactory in view of the limited risk involved. Also, in the case of a silver straddle, for instance, price divergences might result where the cash metal is quoted on one exchange and the futures price on another, perhaps, foreign, exchange. Congress excluded such non-tax motivated, profit-seeking straddles (which posed real risk of loss) from the §1092(a)(1) (loss deferral) rule. This was done under §1092(a)(2). That paragraph provides that in the case of an "identified straddle," the loss deferral rule does not apply. Any loss with respect to an identified straddle is to be treated as sustained no earlier than the day on which all of the positions making up the straddle are disposed of.[17] An "identified straddle" means any straddle:

> (1) that is clearly identified in the taxpayer's records before the close of the day on which the straddle is acquired, as an identified straddle,
>
> (2) all of the original positions of which (as identified) were acquired on the same day, and with respect to which:
>
> (a) all of the [original] positions are disposed of on the same day during the taxable year, *or*
>
> (b) none of such [original] positions have been disposed of as of the close of the taxable year, *and*
>
> (c) which is not part of a larger straddle.[18]

Note: A position which is not part of an identified straddle, cannot offset any position which is part of an identified straddle.[19]

Section 1092 also provided a special rule for regulated futures contracts (RFCs). Under this rule, where at least one, but not all, of the positions of a straddle is an RFC, §1092 applies to any RFC and any other position making up the straddle.[20] Further, §1092(b) provides that, under regulations to be issued, in the case of gain or loss with respect to any position of a straddle, rules similar to the rules of §1091(a) and (d) (the wash sale rule) and to §1233(b) and (d) (the short sale rules), which are consistent with the purposes of §1092, shall apply. ERTA also amended §1233(e)(2) defining "property" for the purposes of §1233(b) and (d), to exclude "any position to which

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§1092(b) applies." Since §1092(b) provides for regulations to be issued relating to positions of straddles as defined by §1092(c)(1), and since a straddle includes offsetting commodity futures, §1233 will not apply to a straddle such as that described above consisting of the ownership of a commodity or a long RFC, coupled with a short future position in the same commodity. Instead, substitute wash sale and short sale rules are to be supplied by regulations. As of the date of enactment of the 1984 TRA, no such regulations had been issued.

2. Section 1256 (Regulated Futures Contracts)

Section 1256, as enacted by ERTA and as amended by TCA of 1982, defines a "regulated futures contract" (RFC) as a contract:

(1) with respect to which the amount required to be deposited and the amount which may be withdrawn depend on a system of marking to market, and

(2) which is traded or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission (CFTC) or of any board of trade or exchange which the Secretary determines has rules adequate to carry out the purposes of §1256.[21]

An RFC also included any "foreign currency contract," [22] meaning a contract which requires the delivery of a foreign currency in which positions are also traded through RFCs. A foreign currency contract, for this purpose, must be traded on the interbank market, and must be entered into at arm's length at a price determined by reference to the price in the interbank market.[23] Regulations are authorized excluding any such contracts if their treatment as RFCs would be inconsistent with the purposes of §1256.

Where an investor acquires an RFC, he is required to post with the broker margin (as determined by the CFTC) to insure performance on the contract. At the close of each day's trading, there is either unrealized gain or loss on the contract. The contract holder must post additional margin in the event of a loss (maintenance margin) but is permitted to withdraw (from funds transferred by holders of loss contracts) the amount of any unrealized gain. Thus, in the case of any RFC, the holder is maintained current and, in the event the contract is closed out at a loss, most of the loss will already have been paid in through daily maintenance margin payments. This system is termed "marking to market." It is not required as to purchasers of options who, once the premium has been paid, are not subject to any further payments. On the other hand, grantors of options must maintain margin where the option is not covered. Holders of RFC straddles are required to post only a fraction of the margin which would have been required had each contract been entered into separately since the balanced position guarantees performance. Also, where the price fluctuates, additional deposits on the loss leg are offset by withdrawal rights on the gain leg. These RFCs, as are all RFCs sold on CFTC designated contract markets (trading in futures in the U.S. other than in such markets is illegal) are subject to the marking to market system referred to in §1256(b).

The basic rules of §1256(a)(1), (2) and (3) are:

(1) Each RFC on hand at the year's end is treated as if it had been sold (closed out through the exchange) for its fair market value. Any gain or loss is taken into account for the taxable year (regardless of the taxpayer's method of accounting).

(2) Appropriate adjustments are to be made to any gain or loss subsequently realized from an RFC treated as sold under (1) to take into account gain or loss recognized under that rule.

(3) Any gain or loss with respect to an RFC is treated as:

(a) 40 percent short-term capital gain or loss;

(b) 60 percent long-term capital gain or loss.

Rule (3), above, is referred to as the "60/40 rule."

A straddle (as defined by §1092(c)) may be made up of one or more positions which are not RFCs and one or more positions which are. In the case of any straddle, at least one (but not all) of the positions of which is an RFC, (a "mixed straddle") §1256(d) governs. Section 1256(d) provides that, where each position of the straddle is identified in the taxpayer's records before the close of the day on which the first RFC position was acquired, the taxpayer may elect to have §1256 *not* apply to all RFCs which were part of the mixed straddle.

If a mixed straddle is identified for §1256(d) purposes and is also identified for §1092(a)(2) purposes, the taxpayer may elect whether to have the §1256 rules apply to the RFCs involved.

If a mixed straddle does not qualify for identification under either §1256(d) or §1092(a)(2) (because all of the positions were not acquired on the same day, or one or more of the positions was not identified before the close of such day) then: (a) §1092 applies to all the positions in the straddle, including the RFCs; and (b) §1256 applies to all of the RFCs in the straddle.

Rules (1), (2) and (3) applied to the termination (or transfer) during the taxable year of the taxpayer's rights or obligations under any RFC by offsetting, taking or making delivery, or otherwise.[24]

Where a holder took delivery on an RFC which is part of a straddle containing two or more RFCs, all other RFCs in the straddle were treated as terminated on the delivery date.[25]

Under these provisions, the following straddle situations may exist:

(1) A mixed straddle (whether or not identified under §1256(d)(4), *i.e.*, at least one, but not all, of the positions of which is an RFC). If the straddle is an identified (under §1092(a)(2)) straddle, the loss deferral rule will not apply, but the RFCs are marked to market and subject to the 60/40 rule. If an RFC marked to market is a loss position, the loss is not treated as sustained until all the straddle positions have been disposed of. None of the positions in the straddle are considered as offsetting positions outside the straddle. If any position of the straddle is disposed of before all positions are disposed of, the straddle is disqualified as an identified straddle and its positions are subject to the loss deferral rule.

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(2) Where the straddle is both a mixed straddle, identified under §1256(d)(4), and an identified straddle under §1092(a)(2), the taxpayer may choose whether to have §1256 apply to the RFCs. Where the taxpayer elects not to have §1256 apply, the straddle is treated for all purposes as a straddle made up entirely of positions other than RFCs. If no such election is made, the straddle is treated as a mixed straddle discussed in (1), above.

(3) Where all the straddle positions are RFCs, §1092 and §263(g) do not apply to any of the positions. All are subject to the mark-to-market and the 60/40 rules.[26]

Comment: Section 1256(a)(4) contains the following language (retained in the 1984 amendments except to replace the term "RFC" by "§1256 contract"): "If all the *offsetting* positions making up any straddle consist of RFCs to which this section applies (and such straddle is not part of a larger straddle), §§1092 and 263(g) shall not apply with respect to such straddle." (emphasis added). What is meant by the term "offsetting?" Why does the statute not read simply "If all of the positions...etc."? A straddle must, by definition, contain offsetting positions. If one position is a non-RFC and the other is an RFC, which is the "offsetting" position? Surely such a straddle is not exempt from §§1092 and 263(g). If it were, then §263(g) would not apply to cash and carry straddles, discussed above. In such a case, if §1092 did not apply, and the RFC was marked to market at a loss, the loss deferral rule would be defeated.

The "anti-straddle" rules take on special significance in view of the shortening of the long-term capital gain holding period to more than six months.[27]

To deal with the cash and carry straddle, ERTA added §263(g) requiring the capitalization of interest and carrying charges allocable to personal property which is part of a straddle (as defined by §1092(c)), where such amounts exceed the interest includible in gross income with respect to such property.

To deal with the characterization of payments made to be relieved from obligations under a forward sale or purchase contract (usually involving foreign currency), ERTA enacted §1234A, treating as capital gain or loss any gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined by §1092(d)(1)) which is, or on acquisition would be, a capital asset in the hands of a taxpayer, or an RFC which is a capital asset.

3. Hedging Transactions

None of the above rules (loss deferral under §1092, treatment of RFCs, capitalization of interest and carrying charges, etc.) applied to positions which were part of a hedging transaction.[28] A hedging transaction is a transaction: (a) entered into in the normal course of the taxpayer's business, and (b) the principal purpose of which is to reduce the risk of loss with respect to property or items of ordinary income where such property is to be used to generate ordinary income, or, is of a kind where the gain or loss from its sale or exchange would be ordinary gain or loss.[29] Short futures contracts entered into by commodity producers, for example, to protect against price drops, are hedges, as are foreign currency forward purchases and sales (or foreign currency RFCs) entered into in connection with the purchase of equipment or inventory or the sale of goods to foreign purchasers. Also qualifying are long positions entered into by a manufacturer using the commodity in its operations. Dealers in commodities, grain merchants, oil refiners, and the like and persons buying and selling such commodities may hedge risks entailed in their business operations.

The hedging exception presented one problem which was also dealt with in §1256. It was foreseeable that limited partnerships or S corporations would be formed to act as dealers in property, and that straddle positions qualifying as hedging transactions could generate ordinary losses which could be passed through to the investors. To prevent manipulation of the hedging exemption by tax shelter syndicators, the exemption was made inapplicable to syndicates. For this purpose a syndicate is defined as an entity (other than a corporation that is not an S corporation) if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs.[30]

C. Reasons for Additional Tax Straddle Provisions

The above provisions effectively ended most straddle-based tax avoidance. There continued to exist areas, however, in which straddles, loosely defined, could still achieve what Congress perceived as unjustifiable tax advantages. Some of these involved new investment products which either did not exist at the time of ERTA or had existed only briefly and posed no perceived pressing tax avoidance problems. Especially troublesome among these were commodity options, options and futures contracts providing for cash settlement,[31] and options and futures contracts based on stock indexes, interest yields of various marketed securities, and the like. Of concern, also, was the effect of the proposed shortening of the long-term gain holding period.

1. Stock Options

Stock options have always been a source of problems from the standpoint of taxation. The treatment of grantors and holders of options was, to a considerable degree, unsettled as late as the early 1970s. The wash sale and short sale rules applied to options only to an extremely limited extent. When ERTA was enacted, trading in options through organized exchanges had been authorized for a relatively short time (since 1975), and straddle stratagems employing options were not perceived to be a serious tax avoidance problem. Stock options differ from futures contracts in significant respects. First, the holder of an option has a property *right* but no *obligation* with respect to property. The holder's exposure to loss is limited to the premium paid whereas the possibility of gain is, at least theoretically, limitless (in the case of a call option). Second, the option privilege diminishes in value each day it is held where there is no change in the value of the property to which the option relates. The combination of a call option and a put option, while representing a long and short position respectively, does not, generally, present an opportunity for straddle manipulation as do offsetting positions in futures contracts.

Example: A purchases a nine-month option to acquire 100 shares of ABC at $100 per share for a premium of $1,000 when ABC is traded at $100. ABC will have to rise in value at least $10 for A to make a profit. A also

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purchases a put option with the same $100 strike price for a premium of $900. Now, ABC must either rise or decline in value by more than $19 for A to realize any profit from his position. If ABC rises in value to $112, A will have unrealized gain from the call option of about $200. If the put option is closed out, the amount of the loss will depend on the time remaining until the option expires. The put option is well out of the money. This, plus the fact that there is less time until the expiration date than when the option was acquired may result in the option having a value of, say, $300. The $600 loss sustained from closing out the put is three times the unrealized gain from the call. Replacing the closed out put with another will require another $300 investment. If the stock price remains stable, the value of the call option will gradually diminish to about $2 per share. The locked-in gain is eroded by the loss in value of the option right against which there is no effective protection. A may wind up losing another $1100 ($800 from the call and $300 from the put).

The position of the grantor of an option is somewhat anomalous. While, for some time, there was a question as to the proper tax treatment of gain or loss from the granting of an option, it was well settled at the time of enactment of §1234(b) that the writer or grantor (sometimes confusingly referred to as the "seller") of an option acquired no right or interest in property and, hence, when either (a) he became unconditionally entitled to retain the premium upon lapse of the option, or (b) he realized gain upon payment of an amount less than the premium received to terminate his obligation under the option or, had to pay a greater amount than the premium to effect a termination, the gain or loss was ordinary income or ordinary loss. These transactions, as explained above, were viewed as not involving the sale or exchange of a capital asset.[32] Legislation changed this result, but §1234(b) did not create in the grantor a property right. It merely decreed that, for tax purposes, the grantor's gain or loss would be treated as short-term capital in nature. The grantor of an option has no rights with respect to property. He has only an obligation to make delivery or purchase at a stated price upon demand by the optionee.

As can be seen, options differ from futures contracts in that rights only are acquired by one party to the option contract. The other party only assumes obligations. In a futures contract, each party acquires rights and assumes obligations.

Notwithstanding these differences, which make options unsuitable for straddle manipulation, it came to Congress' attention that straddle manipulation could be accomplished through options under certain circumstances.

Example: When ABC Corp. stock is selling for $100 per share, A purchases, in August, a call option expiring the following April with a strike price of $70. (It is a feature of stock options that the value of the option privilege, the "time value," ceases to be reflected in the option's price as the spread between the option's strike price and the price of the underlying stock increases. To cite an exaggerated example, a call option with a $1 strike price on stock selling for $200 is probably worth about $199 irrespective of the option's remaining life.) The premium paid by A for the option with the $70 strike price will, therefore, be close to $30. At the same time, A purchases a put option on the same stock with a strike price of $130. For the same reasons, the premium for this option will also be close to $30. Both options are "deep in the money," as that term is usually used (and without regard to the meaning given the term in the legislation to be discussed below). A now awaits a change in the ABC stock price. Assume the price declines to $60. The call option, depending on the time to expiration, is now worth, say, $2. A sells the option[33] and recognizes a capital loss of $28. He immediately replaces the option sold with another call option with approximately the same $70 strike price for a $3 premium. Meanwhile, the put option has increased in value to $70 ($130 − $60). If the stock price should then rise, there will be a roughly inverse change in the values of the two options. For each dollar the put declines, the call will increase, but not in exactly the same amount since the $3 price for the $70 call reflected the option's time value. For instance, if the ABC stock had declined to $90, and the call were sold for a $10 loss and then replaced, still being sufficiently in the money so that the time value was largely eclipsed by the strike price-stock price spread or intrinsic value, the situation would be more like an RFC spread. If these events occurred late in the year and the replacement call and original put are held until the following January, both can be closed out at a net gain more or less equal to the loss realized from the original call disposed of. The same straddle-like series of transactions can be effected by purchasing and granting in the money calls on the same stock.

This stratagem closely follows the old RFC straddle stratagem. In view of the post-TRA six-month long-term holding period, it may have the added advantages of deferral and of converting short-term to long-term gain (which was not possible under the pre-1984 TRA holding periods, since exchange-traded options have lives limited to nine months).

The grantor of a call assumes a short position with respect to the stock, and the writer of a put assumes a long position. Both, however, can profit only to the extent of the premium received. Granting options is, therefore, not usually an effective straddle device. The owner of stock who writes a call only partially protects his long position. Nevertheless, to the extent of the premium received, the grantor of a covered call holds offsetting positions with respect to property.[34] If the covered call is deep in the money, it may be used to effect a risk-free prolongation of the holding period for the stock. If stock having a basis of $70 has appreciated to $100 with another two months of holding period before it goes long-term, a call option with a $70 strike price can be written for a $30 premium. The optionee, while hoping that the stock will rise above $100 to yield a profit on the option, can nevertheless be counted on to exercise the option and recoup some portion of the premium if the stock does not fall below $70. If the stock does rise above $100, the grantor has forfeited the additional gain to the extent of the loss he will sustain in terminating his obligation under the option. The straddle, however, if it may be so termed, will usually be effective to lock in

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the unrealized appreciation on the stock for the time necessary to qualify for long-term capital gain treatment. Also, if the option is terminated in a closing transaction at a loss at the year's end and the stock is sold the following year, a deferral of tax can be effected. This may entail the writing of a new call to re-establish a balanced position when the old call is terminated. While this kind of straddle seems close enough to manipulation to justify a loss deferral rule and either a wash sale or short sale type of rule, Congress saw fit to distinguish a legitimate investment yield enhancement covered call where the strike price of the call granted is at or near the price of the stock. In this case, there is only slight appreciation lock-in, since the premium will reflect only the time value of the option privilege and will, therefore, not protect the grantor against any substantial decline in the price of the stock. If the option is terminated with a short-term loss at year's end and the stock is soon thereafter sold at a long-term gain during the next taxable year, however, the tax advantage is viewed by Congress to be unjustified.

2. Application of §1256(a) to Various Investment Products

Section 1256 applied only to RFCs, which were restricted to commodity futures contracts traded on regulated exchanges and to foreign currency contracts. In the 1980s, commodity options were introduced. A commodity option entitles the optionee, upon demand, to acquire from the grantor either (1) a long futures contract with a specified striking price (*i.e.*, futures price) or (2) a short futures contract. The first option is termed a long call, and the second a long put. The grantor of a long call must, upon exercise of the option, enter into a short futures position with the same specified striking price. This is termed a short call. Upon exercise of a long put, the grantor must enter into a long futures contract with the same striking price. This is termed a short put. It was unclear whether long option positions (long calls and puts) were subject to mark to market and the 60/40 rule. It was also unclear whether gains and losses of grantors of short options (short calls and puts) were subject to the rules of §1234(b). While long options appeared to be positions in actively-traded personal property where the futures contracts related to commodities, this was not clear where stock indexes were concerned. An option on a stock index, or a stock index futures contract, or an option on a stock index futures contract all involve interests in stock, and the definition of "personal property" set forth in §1092(d)(1) excludes interests in stock from the definition of personal property (with the exception of non-exchange traded stock options with a life of more than one year). These were all matters which had to be clarified by legislation.

3. Application of the Wash and Short Sale Rules to Straddles

Section 1092(b) authorized the Commissioner to prescribe regulations applicable to straddle positions similar to the rules of §1091(a) and (d) and §1233(b) and (d). The committee reports indicated that such regulations were to supersede the statute where applicable. They were, therefore, viewed as an integral part of the anti-straddle legislation. Yet, no such regulations had, at this writing, been issued. Further, if the statute was to be broadened to include exchange-traded stock options, future regulations would have to deal with these arrangements as well as with the new investment products described above. The wash sale and short sale rules alone cannot adequately deal with some transactions. Notable among these are the positions of option grantors whose gains and losses do not arise from the sale of property. The Commissioner would have to devise regulations embodying not only the wash and short sale rules, but other rules consistent with the purposes of the new straddle provisions to fill in any areas overlooked or bypassed by the statute, and to effectuate the functions envisioned by Congress when it enacted §1092(b) in ERTA. Further, it was decided to require such regulations to be issued within a reasonable time after enactment of the Act.

4. Options Dealers

Numerous tax shelters have been established in the form of limited partnerships purportedly engaged in the business of dealing in options. As explained above, an options dealer is not a merchant buying and selling property, but rather engages in market making, the purchasing and granting of options as registered specialist on an options exchange. Under §1234(b)(3), as interpreted by such dealers, gains and loss from such activities were treated as ordinary income and loss. By forming what, in effect, were straddle positions, and closing out loss positions, such dealers were able to pass through to limited partners or entrepreneurs ordinary losses. Not only did Congress view this as objectionable, it was seen as being inconsistent with the treatment accorded commodity dealers. Commodity dealers are usually brokers who trade in commodity futures on the floor of the exchange for customers and also for their own account. Such persons were not exempted from the §1256 rules (except insofar as they actually dealt in commodities and purchased or wrote futures contracts as bona fide hedging transactions). There seemed to be no reason to treat differently for tax purposes persons engaged in such options dealing and persons engaged in trading in commodity futures.

5. Mixed Straddles

The treatment of mixed straddles [35] presented some difficulties, especially in view of the changed long-term capital gain holding period. Losses on non-RFC positions were 100 percent allowable as short or long-term capital losses. Gains from the RFC positions, however, were entitled to 60/40 treatment. The reverse was also true, where a non-RFC had been held for the requisite time, all gain realized from its disposition qualified as long-term capital gain, but a loss from an RFC, regardless of the holding period, was accorded 60/40 treatment. This invited manipulation. Statutory rules could provide some remedy in this area. Congress, however, decided that a more effective approach would be to authorize regulations.

II. Overview

A. Introduction

The tax straddle provisions of the 1984 TRA (subtitle H of the Act) are contained in Act §§101 through 106. The following is an outline of these provisions.

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B. *Section 101: Repeal of Exception from Straddle Rules of Stock Options and Certain Stock*

1. *General*

Act §101 amends §1092. Act §101 gives effect to Congress' decision to extend the straddle rules to cases where the taxpayer holds stock or a stock option and has either granted or acquired an offsetting option with respect to the same stock (except for the grant of a covered call option with a strike price at or near the stock price). The straddle rules were also extended to certain cases where one of the positions is direct stock ownership, but the holding of other stock could not be considered a position offsetting such direct ownership. Certain special rules are also included in the amendments to §1092. One of these rules poses considerable interpretative difficulties, as will be explained.

2. *Repeal of Exception for Stock Options*

Section 1092(d)(2), defining "position" is amended to strike out the subparagraphs which made the definition inapplicable to exchange-traded stock options. In addition, §1092(d)(1), defining "personal property," is amended to strike out the parenthetical "(other than stock)." Thus, a "straddle," defined by §1092(c)(1) as "offsetting positions with respect to personal property" may, after the TRA, have as a position stock or an option on or with respect to stock. This provision is limited, however, by post-TRA §1092(d)(3), which excludes from the meaning of "personal property" any stock except stock described in §1092(d)(3)(A) and (B).

3. *Qualified Covered Call Options*

In connection with the inclusion of stock options in the meaning of "position" for purposes of the §1092(a) loss deferral rule, §1092(c), defining "straddle," is amended by adding a new §1092(c)(4). That paragraph excepts from the loss deferral rule straddles consisting of stock and a "qualified covered call option" granted with respect to such stock. *See* §1092(c)(4)(A).

"Qualified covered call option" (QCC) is defined in §1092(c)(4)(B) through (H). These rules are highly detailed and are intended to insure that only those options granted for non-tax motivated purposes (*i.e.*, protection of the grantor's investment gains and/or enhancement of investment yield) come within the exception. The covered call must have a strike price not lower than the stock price or the next highest "bench mark" at which options are available on the exchange (a QCC must be an exchange-traded option). Where the stock price is 67, for example, and options are traded at strike prices of 55, 60, 65, and 70, the QCC must have a strike price no lower than 65 (the highest available strike price which is less than the "applicable stock price." [36]

Where a QCC is closed during a taxable year and gain from the disposition of the covered stock is includible in income for a later year, and such stock was not held for at least 30 days after the QCC was granted, the QCC exception does not apply. *See* §1092(c)(4)(B).

4. *Straddle Positions Consisting of Directly Owned Stock*

The amendments made to §1092(d) redesignate paragraphs (3) through (5) as (4) through (6), and add a new (3)(A). Post-TRA §1092(d)(3)(A) states that, except as provided in §1092(D)(3)(B), "personal property" does not include stock. Subparagraph (B) provides that "personal property" includes stock which is part of a straddle, if at least one of its offsetting positions is:

> (i) an option with respect to the stock or substantially identical stock or securities, or
>
> (ii) under regulations, a position with respect to substantially similar or related property (other than stock).[37]
>
> (iii) "Personal property," under subparagraph (B) also includes any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.[38]

Note: Stock is not personal property and, therefore, cannot constitute a position of a straddle unless it is offset by an option or certain kinds of property other than stock, or the stock is stock of a corporation formed or availed of to avoid the straddle rules. Stock offset by a short sale of the same or substantially identical stock is not personal property, nor is stock offset by the stock of another corporation.

What is "substantially identical stock," and what is "substantially similar or related property"? "Substantially identical stock" is a term which has been interpreted most often in connection with the wash sale rules of §1091. It will almost never mean stock in another corporation unless the price of the two stocks is closely related by reason of a forthcoming stock-for-stock exchange pursuant to a reorganization.[39] For all practical purposes, then, the only stock "substantially identical" to given stock is stock issued by the same corporation. Common stock may be substantially identical to convertible preferred stock of the same corporation where their prices are related and move in unison, and where the holders have similar rights.[40]

"Substantially similar or related" property is not subject to such severe limitations. Nonetheless, such property must have characteristics in addition to those which would be sufficient to classify it as "offsetting," under §1092(c)(2). Only property described in regulations to be issued will qualify. The Conference Report sets forth some examples.[41]

Under what circumstances will a corporation be considered "formed or availed of" to take offsetting positions? This language has given rise to much litigation in the collapsible corporation area. Congress apparently decided not to attempt to lay down any objective criteria in this respect, leaving the matter to regulations and a case-by-case determination.

5. *Short Sale Principles Applied to QCCs*

Act §101(c) redesignates §1092(f) as (g), and adds new (f). Post-TRA §1092(f) provides that, where a QCC is granted with a strike price below the applicable stock price, if the stock was held long-term at the time the QCC was granted, any loss from the closing of the QCC is long-term (similar to the rule of §1233(d)). The holding period of the covered stock is suspended at the time a QCC is granted and does not commence to run again until the QCC is closed out.

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6. Special Rules for Identified Straddles

Act §101(d) provides rules relating to identified straddles containing "§1256 contracts." This term, introduced by Act §102, replaces the term "RFC" in §1256 and other Code sections which referred to RFCs. It has a broader meaning than RFC, and will be explained below. Section 1256 contracts include "non-equity options" purchased or granted by investors or dealers and, in the case of option dealers, includes "equity options" (*i.e.*, options purchased or granted, in the course of such dealers' activities as dealers, with respect to stock and stock indexes).

Section 1092(d)(5) (as redesignated) is entitled "Special Rule for Section 1256 Contracts." The general rule is set forth in paragraph (A): in case of straddle at least one (but not all) of the positions of which are §1256 contracts, §1092 applies to all §1256 contracts and any other position making up the straddle. This is identical to former §1092(d)(4) with "§1256 contracts" inserted in lieu of RFCs. Subparagraph (B), however, is new. It provides that "(f)or purposes of subsection (a)(2) (relating to identified straddles) subparagraph (A) and section 1256(a)(4) shall not apply to a straddle all of the offsetting positions of which consist of §1256 contracts."

7. Effective Dates

The effective dates for these provisions are set forth in Act §101(e).

Generally, they apply to positions established *after December 31, 1983* in taxable years ending after such date.

The rules set forth above including the definitions of personal property (for straddle purposes) and stock of a corporation formed or availed of to take positions offsetting those of its shareholders, apply to positions established on or after *May 23, 1983,* in taxable years ending after that date.

The amendments made to subsection (c) (defining "straddle" and containing the QCC exception) apply to positions established after *June 30, 1984* in taxable years ending after that date.

The special rule for §1256 contracts (§1092(d)(5)) provided by Act §101(d) applies to positions established after *July 18, 1984* in taxable years ending after that date.

C. Act §102: Amendments to §1256

1. "§1256 Contracts"

Under §1256, as in effect prior to the 1984 TRA, special rules were extended to RFC's. RFCs were defined as futures contracts traded on exchanges subject to CTFC regulations which require, *inter alia,* that the holder deposit a minimum amount of margin to secure performance and that, where this margin drops below a specific amount due to withdrawals by holders of offsetting positions in the futures, the deposit of additional maintenance margin.[42] The system of marking RFCs to market each day, permitting withdrawals of excess margin, and requiring additional margin deposits in the case of adverse price movements furnished the basis for taxation of RFCs.[43] Gain or loss from capital asset RFCs was to be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.[44] The 1982 Technical Corrections Act added to the definition of "RFC," a foreign currency contract meeting certain requirements.[45]

Section 102(a) of the 1984 TRA amends §1256 by striking out the term "RFC" and inserting in lieu thereof "§1256 contract." Post-TRA §1256(b), defining §1256 contract, provides that "§1256 contract" means: (1) Any regulated futures contract; (2) Any foreign currency contract; (3) Any nonequity option; and (4) Any dealer equity option.

The above-listed terms are defined in post-TRA §1256(g). The definitions of regulated futures contract and foreign currency contract are essentially the same as in pre-TRA §1256. The definition of "foreign currency contract" contains a technical addition. There is added after "delivery of" the words "or the settlement of which depends on the value of." This clarifies that a foreign currency contract which must, or can, be settled in cash is included. While the definition of RFC was amended by the 1982 TCA to make it applicable to cash settlement RFCs (eliminating all reference to the delivery of property), it was apparently unclear whether this also applied to cash settlement foreign currency contracts which are not RFCs (because they are not subject to the rules of a futures exchange).

2. "Nonequity" and "Equity" Options; "Dealer Equity Options"

"Nonequity options" are any options which are not an "equity option." §1256(g)(3).

A "dealer equity option" is any exchange-traded option which is an equity option, and is purchased or granted by an "options dealer" in the normal course of his activity in dealing in options, and is listed on the national securities exchange on which the dealer is registered.[46] "Options dealer" is defined as a person registered with an appropriate national securities exchange as a market maker or specialist in listed options. A listed option is any option (other than a right to acquire stock from the issuer) trade on (or subject to the rules of) a "qualified board of exchange."[47]

"Equity option," as defined in §1256(g)(6), means any option to (i) buy or sell stock, or (ii) the value of which is directly or indirectly determined by reference to any stock (or group of stocks) or stock index. It *excludes,* however, any option with respect to any group of stocks or stock index, if:

(1) There is in effect a designation by the CTFC of a contract market for a contract based on such group of stocks or index, or

(2) The Secretary determines that such option meets the requirements of law for such designation.[48]

Observation: An investor may purchase (or grant) a call or put option on a stock, on a stock index, or on a stock index futures contract. The SEC has regulatory jurisdiction over stock options and stock index options. The CTFC has such jurisdiction over index futures and options on such futures. Contracts subject to CFTC regulation are not considered "equity options."

Observation: The House bill included in the definition of "equity options" options on narrowly-based stock indexes or subindexes (giving as an example an index based on the

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stocks of nine corporations operating casinos) as to which trading is regulated by the SEC on exchanges, but which do not meet the CFTC requirements for futures trading on designated contract markets. The Act provides that all options on indexes are equity options until futures on such indexes are admitted to trading on a CFTC designated contract market or until the Secretary determines that such indexes would qualify for futures trading under CFTC rules. Such determination, the Conference Report makes clear, will have prospective effect only. Thus, some options will be considered §1256 contracts even though there is no futures trading in the underlying property. Other stock index options are §1256 contracts where there is futures trading in the index but such options need not be options on such futures. They need only to be based on a CFTC-qualified index.

Note: The term "dealer," while sometimes used to refer to persons purchasing, selling, or granting options and acquiring and closing out futures contracts, is inapposite. A "dealer" in stock and securities, usually a broker-dealer, is one who purchases stock and securities for resale to customers at a mark-up, like any dealer in personal property. His gains and losses from inventory are ordinary, as are gains and losses of a dealer in any other property. In the case of options, an individual (or entity) cannot act as a "dealer" in this sense. Options are not held for sale to customers. Some individuals, however, where registered as such on the exchange, do purchase, sell, and write options as market makers or specialists. They insure that options are available for purchase by other brokers or that options offered for sale can be sold at a reasonable price. They permit the market to operate smoothly and insure the liquidity of option positions. Section 1234(b)(1) contains the general rule that gains and losses of the grantor of an option from a closing transaction or lapse are short-term capital gains or losses. Section 1234(b)(3) exempts from this general rule gains and losses from options granted in the ordinary course of the taxpayer's trade or business of granting options. Market makers and specialists, therefore, claimed ordinary income or loss treatment of their gains and losses from such activity. Brokers trading in futures contracts for their own account, however, were held to realize capital gains and losses from such activity. Congress viewed as undesirable the disparity of treatment between options dealers and professional commodity broker-traders, both of whom were essentially trading for their own account. Under §1256, as amended, all options on *commodities* or *commodity futures* are §1256 contracts. Consequently, they are marked to market and are subject to the 60/40 capital gain/loss rule. This applies to casual investors, traders, and brokers. Options related to stock (stock options, and options on stock on non-CFTC-qualified indexes (so-called "equity options")) are also §1256 contracts where purchased, sold or granted by options dealers in the course of their activities as dealer (market making, etc.) As to all other persons, and as to dealers where the options are not purchased, sold or granted in the course of their activities as dealers, equity options are *not* §1256 contracts and are, therefore, not subject to marking to market or 60/40 treatment. Nonequity options are §1256 contracts as to both options dealers and other persons.

Where the Secretary determines that a board of trade, exchange, or other market has rules adequate to carry out the purposes of §1256, that section will apply to §1256 contracts entered into through such marketplace. The rules will also apply to persons performing functions on such qualified board or exchange similar to those performed by a registered market maker or specialist in options on an SEC or CFTC-regulated exchange. These persons will be considered options dealers where appropriate to carry out the intent of the statute.[49]

TRA §102(b) amends §1256(f) (special rules) by adding new paragraphs (4) and (5). Paragraph (4)(A) provides that gains and losses from trading in §1256 contracts are capital in nature. Subparagraph (B) excepts from this rule §1256 contracts held for hedging purposes if any loss from the property in the hands of the taxpayer would be ordinary loss. For purposes of this determination, the fact that the person is actively engaged in dealing in, or trading, §1256 contracts is not to be taken into account.

Post-TRA §1256(f)(5) sets forth special rules for dealer equity option gains or losses allocable to limited partners or limited entrepreneurs within the meaning of §1256(e)(3). As to such gains and losses, the 60/40 rule does not apply. They will all be treated as short-term capital gains or losses.

Query: Where does this leave §1234(b)(3)? As noted above, this paragraph excepts from the general rule that an option grantor's gains and losses are short-term capital gains and losses, the gains and losses of grantors with respect to options granted in the course of their business of granting options. Such options must be either non-equity options or dealer equity options. (There are no other kind of listed options). If so, they are §1256 contracts and subject to marking to market and the 60/40 rule. Section 1234(b)(3) would, therefore, appear to apply only to dealer options when the dealer has made an election under §1256(d)(1) to have §1256 not apply.

3. Self-Employment and Social Security Tax Provisions

Act §102(c) adds §1402(i). Section 1402 contains definitions of terms relating to self-employment tax. Post-TRA §1402(i) is entitled "Special rules for options and commodities dealers." Section 1402(i) includes in income subject to the self-employment tax gains and losses of options and commodities dealers in the normal course of the taxpayer's activity of dealing in or trading §1256 contracts. "Options dealer" has the meaning given by §1256(g)(8). A "commodities dealer" is defined as a person who is actively engaged in trading §1256 contracts and is registered with a domestic board of trade designated as a contract market by the CFTC.

Section 211 of the Social Security Act is also amended to include in net earnings from self-employment, gain or loss of any "options dealer or commodities dealer," in the normal course of the taxpayer's dealing in, or trading, §1256 contracts, from §1256 contracts and property related to such contracts without offset by the deduction allowed by §1202.

4. S Corporation Provisions

A tax is imposed by §1374 on S corporations' net capital gain exceeding $25,000 if it also exceeds 50 percent of its taxable income for the year, where the taxable income

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of the corporation exceeds $25,000. Act §102(d) amends §1374 to provide a new subsection (c)(4). Section 1374(c)(4) excludes from the net capital gain of any options or commodities dealer gain or loss from any §1256 contract (or related property) in the normal course of such dealer's activities as a dealer.

Options and commodities "dealers" are defined in the same manner as for purposes of the amendments to §1402 and the Social Security Act.

This same exclusion of dealers' gains and losses applies to §1362(d)(3) (defining "passive investment income" for S corporation taxation purposes).

Lastly, among the provisions relating to S corporations, Act §102(d)(3) provides that, notwithstanding §1362(b), a Subchapter S election may be validly made by an options or commodities dealer within 75 days of the Act's enactment date (July 18, 1984) effective for the taxable year including such enactment date.

5. Terminations of §1256 Contracts

Section 1256(c)(1) provided that §1256(a)(1)–(3) (mark to market and the 60/40 rule) apply to the termination or transfer of the taxpayer's obligation (or rights) with respect to a §1256 contract by offsetting, by taking or making delivery, or otherwise. Act §102(e), providing various "technical and conforming amendments" adds the words "by exercise or being exercised, by assignment or being assigned, by lapse.." Thus, if an option is a §1256 contract, its exercise or lapse triggers mark to market and 60/40 treatment. The same rule applies if a §1256 contract is assigned.[50] Where a nonequity option is exercised, the optionee will usually acquire an RFC, as will the grantor of the option. The above cited amendments will operate as follows.

Example: A purchases an option on February 1, 1985 on a long futures contract for commodity X. The option has a striking price of $3 per unit and calls for delivery in June 1986. B is the grantor. The exchange assumes the rights and obligations of both parties; there is no direct contractual relationship between them. In October 1985, the commodity price moves to $4 per unit. A exercises the option. B receives an exercise notice from the exchange. As to A, the option qualifies as a §1256 contract since it is a nonequity option. Upon its exercise, it is treated as if it had been sold for its fair market value (§1256(a)(1)). Assume that the fair market value of the option is $1 (not necessarily $1 per unit times the number of units since this does not take into account the option's time value). To the extent this exceeds A's basis in the option, it is subject to recognition under the 60/40 rule. A now has an RFC which also is subject to §1256. If the commodity price moves downward to $2 per unit, A will recognize a loss, if the RFC is held on the last business day of 1985. Section 1256(a)(2) provides that "proper adjustment shall be made in the amount of any gain or loss subsequently realized [*i.e.*, after marking to market] for gain or loss taken into account by reason of paragraph (1)." Presumably, then, the gain recognized upon the exercise of the option on the futures contract will be taken into account in determining the loss from marking the RFC to market at the end of 1985. As to B, the grantor, the termination of his obligation will result in the recognition of gain or loss subject to the 60/40 rule. Upon exercise of the option, B, who has written a short call, is obligated to enter into a short futures contract with a striking price of $3. His loss on the exercise of the option is, presumably, $1 per unit times the number of units covered by the contract, offset by the amount of the premium he received for granting the option. When the option is exercised, B will be required to post maintenance margin upon assuming the obligation under the futures contract. This will measure his loss before offset by the premium. If B liquidates the contract on the same day he acquires it, the loss will be the amount payable by him to the exchange in closing out the contract minus the premium received. If he does not liquidate the contract, but holds it to the end of the year, the loss previously recognized will, presumably, be taken into account in determining any gain or loss from marking the RFC to market at year's end.

Note that these provisions apply whether or not the §1256 contract is part of a straddle.

6. Termination of a Straddle Position

The special rule of §1256(c)(2) is amended to provide that all §1256 contract positions of a straddle are considered terminated where a straddle contains two or more §1256 contract positions and the taxpayer takes delivery under such contracts or (as added by the amendment) *exercises* any such contracts. Thus, for example, where a straddle consists of an RFC and an option on an RFC, and the option is exercised, gain or loss must be recognized with respect to *both* positions of the straddle.

Query: Suppose the straddle is made up of a long RFC and a short call granted by the taxpayer. The short call is exercised. Does this trigger §1256(c)(2)? In such a case, it is not the taxpayer who exercises the option, but the optionee.

7. Other Technical and Conforming Amendments

(1) The term "§1256 contracts" is inserted into §1212(c) (relating to the carryback of losses from RFCs) to replace references to RFCs. After the TRA, these carryback rules apply to net §1256 contract losses.[51]

(2) Section 263(g) (requiring the capitalization of interest and carrying charges with respect to straddle positions) is amended. Under the amendment, the amounts disallowed are those charges in excess of the sum, as under prior law, of the interest (including OID) includible in gross income with respect to personal property which is part of a straddle, *and* (added by the TRA):

(a) Amounts treated as ordinary income under §1271(a)(3)(A) (ratable share of acquisition discount where a T-bill is sold or exchanged), §1278 (the current inclusion in income of market discount where the holder so elects), and §1281(a) (current inclusion in income of discount with respect to short-term obligations by accrual basis and certain other holders), plus

(b) The excess of any dividends included with respect to such property (straddle positions) over the deductions allowable under §§243-245 (dividends received deduction).

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(3) The TRA added to §263(g)(2) a sentence providing that "interest" includes any amount incurred or paid in connection with a short sale.[52]

(4) The TRA further amended §263 by adding a new §263(g)(4). Section 263(g)(4) provides that, in the case of a short sale, §263(g) is to be applied after §263(h) (requiring the capitalization of certain short sale expenses). Section 263(g)(4) also provides that, in the case of any obligation to which §§1277 or 1282 applies, §263(g) is to be applied after those sections.[53]

(5) Section 1234A is amended to clarify that, where a debt instrument is considered personal property for purposes of §1092, or is a §1256 contract, gain or loss from the termination of the taxpayer's right or obligation with respect thereto is not capital in nature where the termination results from the retirement of the debt instrument (whether or not through a trust or other participating arrangement).

8. *Effective Dates*

(1) The provisions of Act §102 are, generally, effective as to positions established after *July 18, 1984,* but these provisions will apply to options on RFCs established after *October 31, 1983.* Except as provided in Act §102(g)(2), the amendments relating to self employment tax apply to taxable years beginning after *July 18, 1984.*

(2) The amendments made to §1256(c) (relating to terminations) apply as if included in the relevant ERTA provisions as amended by the Technical Corrections Act of 1982.

(3) A taxpayer may elect under §102(g) to have the amendments made by Act §102 apply to all §1256 contracts held on July 18, 1984, effective after such date in taxable years ending after such date. Or, in lieu of such election, an election can be made to have Act §102 apply to all §1256 contracts held at any time during the taxable year which includes July 18, 1984. In the event this latter option is elected, §102(h) of the Act provides for the payment of any additional tax in installments over a period of two or more (but not exceeding five) years. A number of rules are provided for taxpayers making this election and electing to pay the tax in installments.

Note: The provisions of Act §101(a) repealing the exemption from the §1092 straddle rules for stock options and certain stock, apply to positions established after December 31, 1983. Options dealers holding stock and option positions in such stock will, therefore, not be subject to loss deferral on positions established before that date. Also, the October 31 effective date for the application of §1256 to options applies only to options on RFCs, not to dealer equity options. Options dealers with mixed straddle positions composed of stock and options will, thus, not be subject to either loss deferral under §1092 or mark to market and 60/40 with respect to any positions on hand on December 31, 1983, as a general rule. If an election is made under Act §102(g)(2), however, mark to market and 60/40 will apply to options dealers' equity options held during 1983 where the dealer's fiscal year includes both a period prior to 1984, and July 18, 1984.

D. Regulations Under §1092(b)

Section 1092(b), as enacted by ERTA, authorized the Secretary to prescribe by regulations, rules with respect to any gain or loss from any position of a straddle. These rules were to be similar to the rules of §1091(a) and (d) (the wash sale rules) and to §1233(b) and (d) (the short sale rules), and consistent with the purposes of §1092. These regulations have not, at this writing, been issued. It is not altogether clear what rules Congress had in mind. The committee reports mentioned a rule disallowing any loss from the disposition of one leg of a straddle where, within 30 days, the leg disposed of was replaced (or acquired prior to disposition of the loss leg) by a position effectively locking in the unrealized gain from the leg retained. It was intended that such wash sale rule be applied before the loss deferral rule. The wash sale rules of §1091, applicable only to stock and securities, did not apply to RFCs, options (excepting options to acquire stock or securities when acquired in connection with the sale of stock or securities) or other positions in personal property subject to the straddle rules. Section 1233 principles would, presumably, prevent holding period manipulation. Here, Congress seems clearly to have had in mind the broadening of the meaning of "substantially identical property" where an offsetting position effects a significant diminution of risk of loss from a position held short-term. It was thus intended that §1233(b) principles be extended to suspend the holding period of an RFC held short-term where an offsetting RFC was acquired, even though the latter called for delivery in a month different from that of the first position and, therefore, was not considered substantially identical property for purposes of §1233(b). Similarly, the loss from the disposition of an offsetting position would be long-term where it was acquired at a time when the taxpayer had held a position in substantially identical property long-term. The Joint Committee Report to ERTA states that the rules to be developed in these regulations "will supplement and have broader application than the original statutory rules in the two sections." The report further provides that the concept of offsetting positions is to replace that of "substantially identical property." The regulatory rules were intended to suspersede the statute where both apply.[54]

Act §103 amends §1092(b). The subsection, after amendment, has two paragraphs. Under paragraph (1) the Secretary is directed to prescribe regulations with respect to gain or loss on straddle positions appropriate to carry out the provisions of §§1092 and 263(g). Section 1233 and §1091 principles are to be applied, as under the former §1092(b) regulatory authority, consistent with the purposes of §§1092 and 263(g).

Post-TRA §1092(b) is somewhat differently worded than the former §1092(b). Section 103(b) of the Act directs the Secretary to prescribe initial §1092(b) regulations (including regulations relating to mixed straddles) not later than six months after the Act's date of enactment (July 18, 1984). The intent that such regulations supersede the statute where both are applicable may be presumed to continue. Also, amended §1092(b) does not limit the Secretary to wash and short sale principles. The regulations are to be adopted *in addition to* whatever rules are formulated to carry out the purposes of §§1092 and 263(g), consistent with such purposes.

Section 1092(b)(2) adds to the scope of the regulations to be issued under (b)(1). These regulations are to provide that the taxpayer may offset gains and losses from mixed

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straddle positions either by (1) straddle-by-straddle identification, or (2) the formation of a mixed straddle account with respect to a class of activities. Gains and losses from the positions in this account are to be recognized and offset periodically. Offsetting under alternative (2) is to occur before application of §1256, and §1256(a)(3) (the 60/40 rule) will only apply to net gain or net loss attributable to §1256 contracts. Further, the principles of §1233(d) are not to apply with respect to any straddle identified under the first election (straddle-by-straddle), or to any straddle that is part of an account established under the second election. In no event is more than 50 percent of the gain from a mixed straddle account to be treated as long-term, nor may more than 40 percent of the net loss be treated as short-term.

The regulations under §1092(b) may treat as a mixed straddle positions not described in §1256(d)(4).

Observation: The provisions mandating regulations permitting taxpayers to set up mixed straddle accounts nowhere refer to the definition of "mixed straddle" in §1256(d)(4). This definition is for purposes of §1256(d) only. Nor do these provisions mention what a "mixed straddle" is. Presumably, it is a straddle having at least one position (but not all) which is a §1256 contract. The regulations may treat as a mixed straddle "positions not described in §1256(d)(4)."

These so-called mixed straddle regulations are not to apply to mixed straddles all of the positions of which were established prior to January 1, 1984.

E. Limitation of Hedging Position Losses

Section 1256(e) provides that subsection (1) (mark to market, 60/40) does not apply to hedging transactions. Similarly, §1092(e) exempts such transactions from the §1092 rules. The definition of "hedging transaction" provided by 1256(e)(2) was not amended by the Act. Paragraph (3) of §1256(e) provides special rules limiting the pass-through of hedging losses by "syndicates" to limited partners or limited entrepreneurs. To these provisions, Act §104(a) adds a new paragraph (5), "Limitation of losses from hedging transactions." Under this paragraph, any hedging loss allocable to a limited participant of a syndicate is allowable only to the extent of the taxable income of such limited partner or entrepreneur for the taxable year attributable to the trade or business in which the hedging transactions were entered into. Taxable income, for this purpose, is to be determined without taking into account the hedging items.

Note: This limit applies in addition to the limitations provided by paragraph (3). It applies, in the case of hedges relating to property other than stock or securities, only to a taxpayer described in §465(a)(1) (*i.e.*, one to whom the at-risk rules apply).[55]

Comment: These provisions should not be confused with those of §1256(f)(5) relating to gain or loss with respect to dealer equity options allocable to limited partners or limited entrepreneurs (within the meaning of §1256(e)(3)). Such gain or loss is not subject to the 60/40 rule of §1256(a)(3) (but the mark to market rule continues to apply to such options), and all such gains or losses are treated as short-term capital gains or losses.

The paragraph (5) limit does not apply to any hedging loss exceeding the unrecognized gains from hedging transactions as of the end of the year attributable to the trade or business in which the hedging transactions were entered into.

Any loss disallowed under §1256(e)(5) is carried over and treated as a deduction attributable to hedging loss in the next taxable year. A "hedging loss" is defined by §1256(e)(5)(D) as the excess of the deductions allowable with respect to hedging transactions (without regard to the above limitations) over income received or accrued during the taxable year from such transactions.

Section 1256(e)(5) applies to taxable years beginning after December 31, 1984.[56]

F. Wash Sale Rule Amended to Apply to Losses from Certain Short Sales; Traders No Longer Exempt

This provision was a Senate amendment to the House bill. It was perceived as being necessary to prevent undesirable tax consequences in certain circumstances. Where a short sale was closed at a loss, the pre-TRA wash sale rules did not disallow the loss, even though it occurred within 30 days of closing the short sale, if the taxpayer acquired stock or securities substantially identical to the property sold short, or, within this 30 day period (before and after the closing of the short sale at a loss) another short sale of substantially identical property was entered into. Act §106(a) adds a new §1091(e) to extend the wash sale rule to the situations described.[57]

Act §106(b) further amends 1091(a) to eliminate the provision which limited the disallowance of a wash sale loss in the case of an individual to losses which would otherwise be allowable under §165(c)(2). Under pre-TRA law, the wash sale rules did not apply to noncorporate taxpayers in the trade or business of trading in stocks or securities. Under the amendment, the wash sale rule applies to noncorporate taxpayers unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business. The same rule applies to corporations, as it did under former law.

The amendments made by Act §106(a) apply to short sales after July 18, 1984. Those made by Act §106(b) apply to sales after December 31, 1984 in taxable years ending after such date.

G. More Stringent Identification Rules

ERTA tightened the requirements for the identification of stock and securities under §1236 by a dealer for purposes of having such property considered as held for investment or for sale to customers. Identification was required before the close of the day on which the stock was acquired. Similarly, identification of the positions of an "identified straddle" for purposes of §1092(a)(2) had to be made before the close of the day on which such positions were acquired. Before-the-close-of-the-day identification was also required for the positions of a "mixed straddle" under §1256(d)(4) and the positions of a hedging transaction for purposes of 1256(e)(2). Act §107(a) amends all of these identification rules to allow the Secretary to require more prompt identification if appropriate. The amendments apply to positions entered into after July 18, 1984 in taxable years ending after that date.

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H. Pre-ERTA Straddles

The Commissioner successfully challenged straddle losses claimed for years to which §§1092 and 1256 do not apply. The decisions [58] have based the disallowance on the taxpayer's failure to bring the straddle transactions within the provisions of §165(c)(2). Section 165(c)(2) requires, as a condition for the allowance of any loss to an individual not incurred in a trade or business, (which, admittedly, is not the case with abusive straddles), that the transaction giving rise to the loss have been entered into for profit. While the Commissioner prevailed in these cases on this ground, the Service's primary ground, that the loss from the closing out of a leg of a straddle which is immediately replaced by another position locking in unrealized gain from the retained leg is not a closed transaction,[59] has been rejected by the Tax Court.[60] This position was not, however, abandoned by the IRS. While the position may be of little significance in determining deficiencies against taxpayers utilizing straddles to defer taxes in years not subject to the ERTA changes (since §165(c)(2) would appear to be adequate) it might be crucial in cases involving dealers and traders.

The Conference Committee decided to put an end to litigation based on the closed transaction theory. Act §108(a) provides that losses from the disposition of straddle positions sustained in taxable years to which the ERTA amendments do not apply are to be allowed where "such disposition is part of a transaction entered into for profit." Thus, any disallowance must be based on §165(c)(2) if it is to prevail.

Act §108(b) provides, further, that for purposes of Act §108(a), any position held by a commodities dealer or any person regularly engaged in investing in RFCs shall be rebuttably presumed to be part of a position entered into for profit. This presumption does not apply, however, to a "syndicate" as defined by §1256(e)(3)(B).

Where a straddle loss occurring in a year not subject to ERTA is disallowed under §165(c)(2), it is unclear whether, and to what extent, any adjustment is required to the year in which the straddle is closed out, *i.e.*, where all straddle positions including the locked in gain leg and the replacement leg are closed out at a net gain approximating the loss on the replaced position closed out. If the closed transaction theory is held to be invalid, but the loss is disallowed under §165(c)(2), the taxpayer is left with what, in effect, amounts to a double inclusion of an item of gross income. To afford relief in such a situation (and, one must assume, to induce the settlement of the substantial backlog of pending pre-ERTA straddle cases) Act §108(c) provides that the disallowed loss will be allowed as an offset to the net gain resulting from the closing out of the straddle positions in the following year.

Except as otherwise provided by Act §108(a) and (c), and in §§1233 and 1234, the determination with respect to a position of whether gain or loss is recognized, the amount and timing of such gain or loss, and whether it is short or long-term in nature is to be made without regard to whether the position is part of a straddle.

Note: In other words, the closed transaction theory is not to be applied to disallow losses from straddle positions.

For purposes of Act §108, "straddle" has the same meaning as under §1092(c) as in effect on the day after ERTA's enactment date, and is to include a straddle made up entirely of RFCs.[61] Also, "commodities dealer" has the meaning given that term by §1402(i)(2)(B) (relating to the self employment tax).[62]

Finally, an "RFC" has the meaning given such term by §1256(b), as in effect prior to the enactment of the 1984 TRA.[63]

III. Detailed Analysis

A. Summary of Basic Changes and Their Implications

The tax straddle provisions of the 1984 TRA (subtitle H; Act §§101-108) were viewed as necessary to close the loopholes in the comprehensive straddle rules enacted by ERTA and the Technical Amendments Act of 1982. Although Treasury and the Congress may have overreacted to some of the perceived tax abuses based on straddle techniques and related transactions, the introduction of many new investment products coupled with the ingenuity of tax advisors made a tightening and refinement of the straddle provisions necessary.

1. Stock and Interests in Stock

The loss deferral rule of §1092(a)(1) applies only to losses sustained from a position in personal property. A position in personal property means any interest in actively traded property. This means that, if the interest is not publicly traded on an exchange (or of a type publicly traded on an exchange), §1092 does not apply.

Any exchange traded option is always a §1092 position, whether it relates to stock, a stock index, financial instruments, a commodity, or to a commodity futures contract. Such a position may also be a §1256 contract, but, with one exception, this has no bearing on the applicability of the loss deferral rule. The exception is that the loss deferral rule does not apply to a straddle made up entirely of §1256 contracts.[64]

For the loss deferral rule to apply, there must be a straddle. A straddle is two or more offsetting positions.[65] One position offsets another where holding one diminishes the risk of loss from holding the other.[66] "Offsetting" is a broad term. A position in one kind of property can offset a position in another type of property.[67]

The direct ownership of stock is not a position in personal property unless [68] it is part of a straddle the other offsetting position of which is an option on the same stock.[69] For this purpose, the grantor of a call option with respect to stock is considered to hold a position offsetting the direct ownership of the same stock. Whether the grantor of a put option will be considered to hold a position offsetting a short sale of the stock seems debatable, but the IRS may so hold since the short position is offset by the long position (granting a put option).

Direct ownership of stock may also be considered a position in personal property where it is part of a straddle the other position of which is a position in "substantially similar or related property (other than stock)." [70] What constitutes "substantially similar or related property" is to

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be prescribed by regulations. These regulations will be effective as to positions established on or after March 1, 1984 as to examples contained in the Conference Report.[71] Such examples are:

(i) stock offset by a debenture convertible into shares of the same stock where the price movements of the two positions are related;

Note: Of course, for the debenture to offset the ownership of stock, one of the two positions must be a short position — a factor seemingly overlooked in the report.

(ii) stock offset by a short position in a stock index RFC (or, alternatively an option on such RFC or an option on the stock index) where the directly-held stock is stock of an investment company the price changes of which mimic the price changes of the index, index option, or index futures contract (or alternatively, a portfolio of stocks included in the stock index).

Apart from these examples, the regulations are to have prospective effect only.[72]

Finally, aimed principally at offshore commodity funds, is the provision that direct ownership of stock is a position in personal property, without qualification as to the type of offsetting position, where such stock is of a corporation "formed or availed of" to take positions in property offsetting those of a shareholder.

2. Effective Dates

The extension of the §1092 rules to exchange-traded stock options and direct positions in stock is effective as to positions established after December 31, 1983 in taxable years ending after that date.[73] An effective date for positions established on or after May 23, 1983, however, is set for stock in a corporation formed or availed of to take positions offsetting those of a shareholder.[74]

B. Grantors of Options

As previously indicated, direct stock ownership coupled with the granting of an option on the stock is a straddle; both interests are positions under §1092(d)(3)(B)(i)(I). A special rule is provided, however, for a "qualified covered call option." [75] Generally, a qualified covered call must not be "deep-in-the-money" and must have a life of at least 30 days and a strike price no lower than the highest "bench mark" which is lower than the stock's applicable price.[76] A call not meeting these qualifications is, for purposes of §1092, "deep-in-the-money." [77]

In interpreting these provisions, the statute provides a cluster of special rules. A strike price one bench mark lower is allowed for options having a life of at least 90 days where the strike price is more than $50.[78] Where the stock sells for $25 or less, the strike price must be at least 85 percent of the stock price, irrespective of the next lowest bench mark.[79] Where the stock price is $150 or less, the option's strike price may not be more than $10 lower than such stock price.[80] Where a qualified covered call option is closed at year end, and the stock is disposed of the next year without having been held at least 30 days after the option was closed out, the qualified covered call rules do not apply.[81]

Where the owner of stock grants a call option with a strike price less than the applicable stock price, a rule similar to the rule of §1233(d) is applied. If the stock was held long-term at the time the option was granted, then any loss from closing out the option is long-term loss. Also, the writing of such an option suspends the holding period of the stock.[82] This rule applies only to qualified covered call options with a strike price lower than the applicable stock price. The Conference Report states that it is anticipated that rules relating to stock option loss characterization and the holding period of stock will also be provided by regulations applying short sale principles (*see* §1092(b)(1)) to straddles consisting of stock and stock options. Since qualified covered calls are not subject to the straddle rules, however, they will be subject only to the statutory rules, *i.e.*, §1092(c)(4)(E) (special year end rule) and §1092(f) (the §1233(d) principles discussed above). The §1092(f) rule was adopted for this purpose in lieu of rules proposed in the House bill and Senate amendments which would have converted long-term gain from the sale of the stock to short-term gain to the extent of short-term losses on the option position. The §1092(f) rule is easier to administer and involves less record keeping. It is effective as to positions established after June 30, 1984.[83]

Observation: To avoid running afoul of this rule, attention must be paid to the applicable stock price and option strike price. If the strike price is even $1 less than the stock price, the stock's holding period is suspended; not a trivial matter in view of the TRA's six-month capital gain holding period rules.

As already pointed out, the grantor of a stock option holds a "position" for §1092 purposes but, unless the option is a "dealer equity option," he is not considered as holding a §1256 contract. The grantor of an option on any type of futures contract, however, does hold a §1256 contract (provided, of course, the option is listed). While the grantor of a stock index option holds a position for §1092 purposes, it is possible that he may hold what is considered an offsetting position, *i.e.*, one where the price moves inversely to that of the index. This will presumably occur, however, only where he holds stock in an investment company and where the option is so deep in the money that its price changes mimic those of the investment company stock.

Note: The qualified covered call provisions do not apply to options granted by an options dealer (as defined by §1256(g)(8)) in connection with his activities of dealing in options.[84]

Where a limited partnership or S corporation is an options dealer, the 60/40 rule does not apply to gains and losses passed through to the limited participants if they are attributable to dealer equity options. Such gains and losses are treated as short term capital gains and losses.[85]

Note: Section 1256(e) was also amended to restrict hedging losses passed through to such limited participants even though such losses may qualify for pass-through under the syndicate provisions of pre-TRA law.

C. Regulations Under §1092(b)

1. General

Perhaps one of the most difficult to interpret passages of the 1984 amendments are the amendments to §1092(b) made by Act §103. As indicated above, under prior law, the Secretary was authorized to prescribe by regulations rules

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similar to the wash sale and short sale rules to straddle positions. These rules were largely to supersede the statutory rules. No regulations were published, however, as of the TRA's enactment date. Under amended §1092(b)(1), regulations are mandated, to be issued within six months from the enactment of the Act (July 18, 1984), prescribing the tax treatment of gain or loss from positions which are part of a straddle appropriate to carry out the provisions of §1092 and §263(g). Rules similar to the wash and short sale rule are to be prescribed "to the extent consistent with such purposes."

In addition, §1092(b)(2) provides for regulations "relating to mixed straddles." The regulations to be issued under paragraph (1) are to provide "elective provisions in lieu of §1233(d) principles." Specifically, the statute provides:

> "(i) the taxpayer may offset gains and losses from positions which are mixed straddles —
>
> (I) by straddle-by-straddle identification, or
>
> (II) by the establishment (with respect to any class of activities) of a mixed straddle account for which gains and losses would be recognized (and offset) on a periodic basis.
>
> (ii) such offsetting will occur before the application of §1256, and §1256(a)(3) will apply to net gain or net loss attributable to §1256 contracts, and
>
> (iii) the principles of §1233(d) shall not apply with respect to any straddle identified under clause (i)(I) or part of a straddle account established under clause (i)(II)" [86]

Under the regulations to be prescribed under §1092(b)(1), the authority is extended to mixed straddles, including positions which are not described as such under §1256(d)(4)[87] (*i.e.*, where all positions of the straddle are not identified before close of the day on which the first §1256 contract was acquired). Thus, mixed straddles of all kinds are covered, including straddles consisting of a §1256 contract entered into on one date and a position not qualifying as a §1256 contract acquired on some later date.

In addition, where a mixed straddle account is established under (i)(II), *supra:*

> (i) in no event shall more than 50 percent of the net gain from the account in any taxable year be treated as long-term capital gains, and
>
> (ii) in no event shall more than 40 percent of the net loss from such account be treated as short-term capital loss.[88]

2. The §1092(b)(2) Mixed Straddle Accounts

a. In General

The intent and purposes of §1092(b)(2), providing taxpayers an election to set up mixed straddle accounts, are not evident from a reading of the statute. This election, the statute states, is offered to taxpayers who wish to avoid the application of "§1233(d) principles" to mixed straddles. Section 1233(d) was enacted to prevent the consequences similar to those illustrated in the following example.

Example: Taxpayer A holds 100 shares of ABC with a basis of $80 a share and a value of $100 a share. A has held the stock for more than the short-term capital gain holding period. A executes a short sale against the box, (*i.e.*, where the seller holds stock identical to the stock which is held short) at the $100 price. If the stock price declines, A can close the short sale with the stock held for a long-term capital gain of $20 a share. Should the stock price advance, to, say, $120, without 1233(d), A could close the short sale with stock purchased for this purpose, realizing a $20 short-term loss on each share. This loss could be applied to offset unrelated short-term gain. At the same time, A could sell his stock, recouping the short-term loss, and the gain would be long-term. Section 1233(d) provides that, in this situation, any loss from the closing of the short sale is long-term loss.

Thus, under §1233(d) where a taxpayer holds a position in property where the gain or loss from its disposition is characterized in a certain manner and also holds a position offsetting the first position, gain or loss from the disposition of the offsetting position will have the same character as that which arose from the disposition of the first. Under §1233(d), once long-term capital gain has been locked in by a short sale, the character of that gain is carried over to this short position. Applying this principle to a mixed straddle, where stock is held and a covered call option is granted with respect to that same stock (the §1256 contract position where it is a dealer option) gain or loss from the two offsetting positions are viewed as a unit. At the time one of the positions is disposed of, whatever gain or loss is realized from such disposition will be reflected in an offsetting unrealized gain or loss from the offsetting position. This latter gain or loss if netted against the gain or loss from the position disposed of will yield a net gain or loss. In applying this principle to mixed straddles remember that this discussion involves two types of mixed straddles. These are: (1) an identified straddle (per §1256(d)(4)): and (2) other mixed straddles. For the straddle to be an identified straddle, all of its positions must be identified no later than the day on which the first §1256 contract position was acquired. Thus, where a non-§1256 contract is first acquired, a mixed straddle including a §1256 contract entered into on a subsequent day must be identified as such before the close of that day. Where the §1256 contract position of the straddle is first acquired and the offsetting non-§1256 contract is acquired on a subsequent day, this can never be an identified mixed straddle. Only in the case of a type (1) identified mixed straddle can an election under §1256(d) be made, exempting the §1256 contract positions from §1256. This can be referred to as a type (1)(d) straddle, signifying that the election has been made.

The Conference Report contemplates that the application of §1233(d) principles "will result in recharacterizing short-term losses realized from mixed straddle positions not subject to §1256 as 60/40 losses" in type (2) straddles as to which no election under §1092(B)(2) have been made. Thus if any position of a type (2) straddle is disposed of at a loss, it will be characterized as 60 percent long-term and 40 percent short-term loss. If an options dealer writes a covered call option (as a dealer), loss from the sale of the stock will be treated as a 60/40 loss, irrespective of the holding period.

Comment: This is a decided disadvantage. Where the stock position of such a straddle is sold at a gain, it may (depending on the holding period when the straddle was

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established) be characterized under pre-1984 TRA law as short-term capital gain. The loss from disposing of the §1256 contract, however, will receive 60/40 treatment (where the straddle is not a type (1)(d) straddle). In such a situation, where the taxpayer has unrelated long-term capital gain, this must be offset by the 60 percent of long-term loss from the §1256 contract position. This effectively converts such unrelated long-term gain to short-term gain. This result can be avoided by making a §1256(d) election with respect to the straddle.

The Conference Report states that the §1092(b)(2) regulations "will permit taxpayers to avoid the loss recharacterization rule that results from applying §1233(d) principles while retaining favorable treatment for mixed straddle net gains derived from §1256 contracts." This avoids characterizing the loss from the non-§1256 type (2) contract position as 60/40 loss, while retaining the advantage of 60/40 treatment of net gain from a type (2) mixed straddle where the gain is attributable to the §1256 contract position.

Example: Dealer D holds ABC stock with a basis of $95 and a value of $100. He grants a covered call option. This is a type (2) mixed straddle. The stock price declines to $85. It is sold. The $10 loss will be treated under the §1092(b)(1) regulations as 60/40 loss. The gain from the option (or loss, if the option is not closed out and the stock price subsequently rises) is also treated as 60/40 gain (or loss). If the stock price had, instead, risen to $110, and the stock was sold at a gain, it would (unless the stock has been held long-term at the time the call was granted) be treated as 100 percent short-term gain. The loss on the option, presuming it is closed out at the same time, is 60/40 loss. If stock is acquired and a covered call granted on the same day, however, and the mixed straddle was identified under §1256(d)(4), the taxpayer could make a §1256(d) election. In this event, all of the loss from closing out the option would be short-term.

The mixed straddle accounts provided by §1092(b)(2) are intended to relieve taxpayers (primarily, if not solely options dealers), from the adverse effects of the application of §1233(d) principles, as described above, to mixed straddles.

Comment: The complexity added by the §1092(b)(2) regulations is evident from the Conference Report. The first cause of complexity is, of course, the extension of the straddle rules to stock/stock option positions. The second arises from considering the grantor of an option as holding an "interest in property." The third is the treatment of the obligation assumed by the grantor of an option as a §1256 contract where the option is granted by a dealer. To this are added the rules for identified straddles under §1092(a)(2), identified mixed straddles under §1256(d)(4) and the §1256(d) election. To these involved rules there is further added the regulatory authority under §1092(b)(1) to apply to straddle positions principles similar to those of §§1091 and 1233. (The Commissioner apparently found the task of drafting these regulations either too difficult to manage or not worth the trouble to exert his authority in the three years which elapsed since ERTA). Capping this byzantine pattern of legislation and regulations is the mixed straddle election under §1092(b)(2) regulations. The Conference Report contains a statement as to what the conferees intend these regulations to provide. The rules involved would appear to have been too complex for legislative formulation in the limited time the Conference Committee had to agree on tax legislation. All of these various provisions would seem to have been targeted on the options dealer who figured in numerous, ingeniously-structured tax shelter schemes devised to avoid the ERTA tax straddle provisions. It is unlikely that the matters discussed above will have any significance to investors generally. Legislative rules drafted by representatives of special interests, further amended in committee, are often extremely complex. This piece of work would, perhaps, have been better accomplished by a separate Options Dealers Relief Bill with committee reports spelling out in detail the tax benefits granted and the justification therefor.

b. Single Straddle Account

Where the taxpayer (options market maker in the examples given) establishes, at his election, a single straddle account, the following rules apply. Where the covered stock in a covered call is sold at a gain or loss, the regulations will provide for the offsetting of such gain or loss by unrealized gain or loss from the option. The net gain or loss will be characterized as short-term. Such net loss will not be subject to §1092 deferral. This offset will be taken into account in determining gain or loss from closing out the option. An example given in the committee report is as follows: The option in a covered call is closed out at a $12 gain (the option lapses or is repurchased at a gain). There is unrealized loss on the covered stock of $10. Of the $12 gain from closing out the option, $10 is characterized as short-term (under short sale principles) and the remaining $2 is subject to 60/40 treatment. If the stock were sold for a $12 gain, and there was an unrealized $10 loss from the option position (marked to market) the gain would be short-term to the extent of $2 (netting the gain and the unrealized loss). Any gain or loss from the option position (if marked to market at year end, for example) will be adjusted to reflect the $10 offset. Thus, assume an options dealer received a $1,000 premium for writing a call on ABC stock with a $100 strike price, and the call is covered (whether at the time the option was granted or after the purchase of stock). If the stock price rises to $125 and 1,000 shares are sold at a gain of, say, $3,000, this gain is first offset by any unrealized loss from the call. Assume that it will cost $2,500 to repurchase the call (in a closing purchase transaction) and there is unrealized loss of $1,600. This is set off against the $3,000 gain on the stock for a net gain of $1,400. This gain is short-term gain.[89] If the option is still open at year end, and the stock price has fallen to $95, and could be closed out for a net gain (taking the $1,000 premium into account) of, say, $990, no gain is recognized at that time. The option is marked to market at the $2,600 closing purchase transaction price. Assume that the option lapses the next year. The taxpayer will recognize a gain of $3,600 subject to 60/40.

The holding period of positions other than §1256 contracts included in a mixed straddle will not commence until the straddle is terminated, according to the Conference Report. This application of §1233(b) principles would apparently apply only to non-§1256 positions acquired at the time of or subsequent to the acquiring of the §1256 posi-

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tions, *i.e.*, the holding period is *suspended*. Thus, if stock was held long-term at the time a covered call is granted by the options dealer (as a dealer) gain from the sale of the stock, as offset by any unrealized loss from the open option, would be long-term, or so it is hazarded. Regulations may call for a different result. Further, since, upon the termination of any straddle position (or all of them) a net gain or loss computation is made at that time, the amount of gain or loss from, and the holding period for, any positions of a straddle disposed of after the straddle is terminated (all offsetting positions disposed of) is determined without regard to any gain or loss attributable to the straddle period.

If all the positions of a mixed straddle remain open at year end, the §1256 positions are marked to market. Losses from such positions will be deferred to the extent of unrealized gains from non-§1256 positions. Such losses will be treated as all short-term under the §1091(b)(2) regulations. Any excess will be subject to 60/40 treatment. If marking the §1256 positions to market results in gain, to the extent of unrealized losses from non-§1256 positions, the gain will be all short-term under the §1091(b)(1) regulations.

c. Multi-Straddle Accounts

To escape from this complex web of rules, the options market maker (and those relatively few other taxpayers who may acquire mixed straddle positions in sufficient volume to make it worth while) is afforded relief under the §1092(b)(2) regulations. These regulations will allow the setting up of multi-straddle accounts. In the case of non-market makers, each multi-straddle account will relate to the same stock. The market maker holding long and short positions in ABC stock who grants and purchases options in the same stock will set up a multi-straddle account for these positions, and another account for similar positions in XYZ stock. Regulations will govern the details. Each account will have a period, (*e.g.*, one day, one week, one month, etc.) appropriate to record keeping and other factors. At the end of each period, gains and losses from non-§1256 positions are netted, and gains and losses from §1256 positions are netted separately. The two nets are then offset. If the result is net non-§1256 gain or loss, it is afforded 60/40 treatment. The total of the net gains or losses for each period is made for the taxable year. If the aggregate net gain for all periods so totaled is more than 50 percent long-term, the excess over such 50 percent is converted to short-term gain. If the aggregate loss for all periods is more than 40 percent short-term, the excess of 40 percent will be converted to long-term loss.

D. Options on §1256 Contracts

As stated above, §1256(c) requires that gain or loss is recognized upon the exercise of an option on a §1256 contract. If such option is excluded from mark to market and 60/40 treatment due to a §1256(d) election, any gain or loss will be governed by §1234(a) or (b).[90] The Conference Report makes it clear that, in such a case, gain or loss will not be accorded 60/40 treatment to either holders or grantors of the options. Thus, if the optionee, who has excluded an option on an RFC from §1256 by a §1256(d) election, exercises the option, or permits it to lapse, the grantor's gain or loss on the option will not be accorded 60/40 treatment. This is so even though the option is a §1256 contract as to the grantor and the grantor has made no §1256(d) election with respect to such contract.[91] The conferees thus rejected the notion that the "character" of the property underlying an option which is a §1256 contract includes the 60/40 rule.

E. The "Special Rule" for §1256 Contracts

One feature of the TRA's straddle provisions that is difficult to understand is the amendment to the special rule relating to mixed (not necessarily in the §1256(d) sense) straddles. Pre-TRA §1092(d)(4) provided that, in the case of a mixed straddle, §1092 applied to all RFCs and all other positions therein. This same rule, with "§1256 contracts" inserted in lieu of "RFCs" is contained in post-TRA §1092(d)(5)(A). A second special rule is provided here, however. Section 1092(d)(5)(B) provides that, "for purposes of subsection (a)(2) (relating to identified straddles), subparagraph (A) [the rule just cited] and §1256(a)(4) shall not apply to a straddle all of the offsetting positions of which consist of §1256 contracts."

Section 1256(a)(4) carries over from prior law the rule that, if all the "offsetting positions" of a straddle consist of §1256 contracts, §§1092 and 263(g) shall not apply to such straddle.

If this latter rule means that neither §1092 nor §263(g) applies to any straddle made up *in part* of §1256 positions, *i.e.*, the "offsetting positions," it seems incomprehensible. Does "offsetting positions" mean "short positions," or positions offsetting non-§1256 contract positions? If it means *all* positions, (which it seems unquestionably to do) then the rule makes sense. Note, however, that the statute could have, but did not, use this language. The Joint Committee report on ERTA states flatly that "If a straddle is composed partially of [RFCs] and partially of other positions . . . losses from positions that are part of the straddle will be subject to the loss deferral rule or to the rule relating to identified straddles." In other words, such losses will be subject to §1092(a), without qualification as to whether the RFC positions are or are not "offsetting."[92]

Returning to the rule provided by new §1092 (d)(5)(B), the provision states that the following do not apply to a straddle composed entirely of §1256 contracts: (i) the identified straddle rule; (ii) the rule making §1092 applicable to all the positions of a mixed straddle; and (iii) the rule making §1092 *inapplicable* to (it is submitted) a straddle composed completely of §1256 contracts, are not to apply to a straddle composed entirely of §1256 contracts. In other words, where all the offsetting positions of a straddle are §1256 contracts, §1092(a)(2) both applies and does not apply. In an apparent reference to §1092(d)(5)(B), this somewhat cryptic statement appears in the Conference Report:

> "The conference agreement extends the identified straddle rules of §1092(a)(2) to straddles consisting entirely of §1256 contracts. Thus, such a straddle which satisfies the definition of an identified straddle under §1092 as amended by the bill will not cause §263(g) or §1092 to apply to any position by treatment of part or all of such straddle as also including positions not part of the identified straddle."

What the conferees may have had in mind is a straddle which is part of a larger straddle, but which is made up entirely of RFC positions. For example, consider the follow-

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ing positions straddle: (1): (A) cash silver — (B) short silver RFC; Straddle (2): (C) long silver RFC — (D) short silver RFC. The (C) — (D) straddle is an all-RFC straddle. The holder identifies position (A) and position (D) as an identified straddle. Perhaps Congress intended that the loss deferral rule of §1092(a)(1) and §263(g) will not apply to either position. Since the (A) — (D) straddle is part of a larger straddle, however, it would not qualify for identification. *See* §1092(a)(2)(B)(iii). The purposes of this rule are, to say the least, unclear. The Conference Report, further, does little to enlighten.

F. Amendments to §1256

1. General

The replacement of "regulated futures contract" by "§1256 contract" is described in the Overview. The statute makes it clear that any option with respect to a commodity which is an exchange-traded option, and any listed option on a commodity futures contract, is a §1256 contract and subject to the mark to market and 60/40 rules. This applies to the grantors of options as well as option holders, and to dealers as well as other persons.

2. Terminations of Rights and Obligations with Respect to Options

In the case of an option holder, where the option is held at the end of the year, marking to market will entail, presumably, reference to the price of such option if sold on the last business day. Options are not subject to deposit and withdrawal as are RFCs. Once the premium is paid, the option holder has no further obligations and his rights are limited to the exercise or non-exercise of the option. He can sell the option in a closing sale transaction, terminating his rights. Until the option is actually exercised, however, he has no direct interest in the underlying property.

Post-TRA §1256(c)(1) provides that the rules of paragraphs (1) through (3) of subsection (a) (mark to market, 60/40) apply to the termination during the taxable year of the taxpayer's "obligation (or rights) with respect to a §1256 contract, by offsetting, by taking or making delivery [up to this point, the statute follows prior law] *by exercise or being exercised, by assignment or being assigned, by lapse,* or otherwise." The italicized words are new.

"Assignment or being assigned" refers, probably, to foreign currency contracts which are often closed out in this manner.

"Exercise or being exercised" and "lapse" all refer to options. The following examples illustrate the application of these rules.

Example: On November 1, 1985, when the October 1986 futures price of commodity is $5 per unit, A grants a short call option to B at the $5 striking price for a premium of $1,000. On December 27, when the October futures price has risen to $7 per unit, B exercises the option. He acquires a long futures contract with a $5 per unit price. A enters into a short futures contract with the same price, posting maintenance margin of $2 per unit. The exercise of the option is treated as the termination of a §1256 contract both as to A and B. B must mark the option to market, recognizing gain, subject to 60/40 treatment, equal to the option's fair market value less the $1,000 premium paid. This would be $2 times the number of units covered by the futures contract plus the time value of the option, if any. A, apparently, must recognize a loss of $2 per unit less the premium received. These gains and losses are taken into account under §1256(a)(2) in determining any future gains and losses with respect to these futures contracts. If the price of the commodity remains relatively steady, and B allows the option to expire, each party must recognize gain or loss from this termination. B's loss is the amount of the premium paid. A's gain is the same amount.

Note: While equity options are not generally subject to the §1256 rules, they do constitute §1256 contracts when purchased or granted by an options dealer.[93] A "dealer equity option" is: (i) any listed option to buy or sell stock; or (ii) the value of which is determined directly or indirectly by reference to any stock (or group of stocks) or stock index.[94] An option on a stock index future which is authorized (or is determined by the Commissioner to qualify) for trading on a CFTC-designated contract market is not considered an "equity option."[95] It is, therefore, a non-equity option and a §1256 contract without regard to whether the option is held or granted by a dealer or other person.[96]

Section §1256(c) overlays §1234A, which treats as gain or loss any gain or loss attributable to the cancellation, lapse, expiration, or termination of a right or obligation with respect to personal property (as defined in §1092(d)(1)) including any §1256 contract which is a capital asset in the hands of the taxpayer. This rule was amended by Act §102(e)(4) to provide that it will not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement). The Conference Report cites as an example a mortgage pass-through certificate.[97]

3. Options Dealers

A broker-dealer in stocks and securities may also purchase, sell, and grant options. Some of these transactions may constitute hedging transactions with respect to stock or securities held as inventory. Some may be for investment (speculation on the market) only. Such a dealer may, for example, grant a call option covered by inventory stock or covered by stock held for investment. In either case, the dealer will hold positions of a straddle (long stock position offset by short option position). If the option transaction is a bona fide §1256(e) hedge, and is properly identified as required by §1256(e)(2)(C), §1092 does not apply,[98] and gain or loss will be ordinary. In no event will such an option be a §1256 contract where these transactions do not constitute "dealer equity options." Dealer equity options are options purchased or granted by an options dealer in the course of his activities of making a market. The broker-dealer may also be registered with an options exchange as a market maker or specialist. In that case, in addition to the options described above, the broker-dealer may grant or acquire "dealer equity options" qualifying as §1256 contracts. These will undoubtedly have to be identified in some manner. Regs. §1.1234-3(c) provides that, for purposes of §1234(b)(3), options granted by a broker-dealer in the course of his business of granting options (which would seem to refer to "dealer equity options" under the statute) must be identified as such under rules similar to those of

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§1236. Under the regulations authorized under Act §107(b), identification of such options may have to be made almost immediately upon their being granted. Failure to identify such options as dealer options will not, however, prevent the IRS from so characterizing them.

G. Observations and Suggestions

1. Stock — Stock Option Straddles

a. Ownership of Stock/Stock Option Positions

Investors holding stock in various corporations should be aware that, if they intend to grant and purchase options in the same stock, they may run afoul of the TRA straddle rules. This will occur only where the options granted or purchased are "offsetting positions," however. Where a person holds stock, there are only two offsetting option positions: the purchase of a put and the writing of a call. Investors have long been aware that, where stock is held short-term, the purchase of a put suspends the holding period, and that use of the stock to exercise the put will result in short-term gain.[99] While the statute is not clear on this point, it is probable that any gain from the sale of such a put will also be characterized as short-term no matter how long the option has been held. Under the TRA rules, in addition to these more familiar tax consequences, where a taxpayer during the year holds a stock — put option straddle, and either position is disposed of at a loss (this includes the expiration of the option unexercised), the loss is deductible only to the extent it does not exceed the unrealized gain from the stock at the end of the year.

Example: On October 15, 1984 (the amendments to §1092 are generally applicable to positions established after December 31, 1983) A, holding 100 shares of ABC stock, purchases a put option with a strike price of $100 for a premium of $8 per share. The stock, which has been held long-term, has a basis of $75 and a price, at the time of the put, of $100. A believes the stock may decline in value. A's purpose in purchasing the put is to protect himself against any loss so that he may take his profit on the stock in 1985. On December 15, the price of the ABC stock is still $100. A now believes that the expected decline in the stock will not take place and that it may safely be held until January 1, 1985 without a hedge. The put option, which has declined in value due to the loss of its time value, is sold (a closing sale transaction) for a loss of $2 per share. This loss is not deductible since it does not exceed the unrecognized $2,500 gain on the stock. It can be deducted only in 1985 when the ABC stock has been sold. Since §1233(d) does not affect put options, the loss on the option is short-term. While there seems to be no good reason why §1233(d) principles should be applied to characterize the loss from the put as long-term, the regulations to be issued under §1092(b)(1) may possibly take this position.

Where the offsetting position is the granting of a call option, the investor should be aware of the special rules relating to qualified covered calls. These will override the §1092(b)(1) regulations. If the call option does not qualify under the QCC provisions, and the taxpayer realizes gain by reason of the option's lapse, the gain is short-term by reason of §1234(b)(1) regardless of how long the option was held open. On the other hand, the granting of the option does not, as does acquisition of a put option, affect the stock's holding period under §1233(b). This is so even though it constitutes a "short" position. This, too, however, may be changed by the §1092(b)(1) regulations.

Example: In November 1984, A acquires 100 shares of ABC stock for $100. The price rises to $110. A grants, for a premium of $24 per share, an April $90 option on December 20. This is not a qualified covered call. If this option is terminated on the last business day of 1984, any loss will be deferred under §1092(a)(1) until the following year. Under pre-1984 TRA law, the granting of the call act to suspend the holding period for the ABC stock. Whether this will continue to be true is unclear.

Where the call is a qualified covered call, the §1092(b)(1) regulations will not apply since, under §1092(c)(4)(A), it is not regarded as a position of a straddle for purposes of §1092 (or for purposes of §263(g)). The two special rules of §1092(c)(4)(E) and §1092(f) will apply, however. Under §1092(c)(4)(E), if the call option is closed out and the covered stock is sold for a gain less than 30 days after the option was closed out, and if such gain is includible in a taxable year after the taxable year in which the option was closed, the option is disqualified and §§1092 and 263(g) will apply to both positions of the straddle (the covered stock and the call option). In measuring the 30-day period: (1) the day the stock is disposed of, but not the day it was acquired, is counted;[100] (2) §1223 does not apply (relating to the holding period of property received in an exchange); and (3) there is not counted any day on which the taxpayer held a short position diminishing any risk of loss on the stock — this includes the period during which the call option was open.[101]

Note: Due to §263(g), interest with respect to stock purchased on margin is not allowed as a deduction where the stock is part of a straddle (*i.e.*, any period during which the stock position is offset by an option other than a qualified covered call); it must be added to the basis of the stock. This would apply both to a non-qualified call and a put option.

The second special rule relating to qualified covered calls is similar to §1233(d). Where the option strike price is less than the applicable stock price (generally, the closing price on the day prior to the day the option was granted), any loss with respect to the option is long-term capital loss where, at the time the loss is sustained, any gain from the covered stock would be long-term. In addition, the stock's holding period is suspended while the option is open.

Query: May it be inferred from this special rule that this is not ordinarily the case where a covered call option is granted?

b. Other Straddle Involving Direct Ownership of Stock

As indicated *supra*, "substantially similar or related" is a technical concept new to the Code. It is used in §246(c) (and is incorporated by reference in §1059) to refer not only to property other than stock (as in §1092(d)(3)(B)(i)(II)) but to all kinds of property. It also appears in §263(h). Its meaning, in all cases, is to be supplied by regulations. This term falls midway between

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"substantially identical" and "offsetting."[102] It is incorporated into the special year-end rule of §1092(c)(4)(E) with reference to the holding period of the stock offset by a qualified covered call. As restricted to property other than stock, it is used in describing property which will be considered to offset direct ownership of stock in one of the three exceptions to the rule that stock is not considered "personal property" for §1092 purposes.

The third exception to the last-stated rule is stock in a corporation formed or availed of to take positions offsetting positions of any shareholder. This exception was enacted principally to deal with foreign commodity trading corporations. Interpretation of this provisions will almost certainly lead to disputes.[103]

2. Section 1256 Amendments

Effective as to positions established after October 31, 1983, options on regulated futures contracts are to be treated as RFCs for purposes of §1256.

Commodity options play an important non-tax motivated role in commodity trading. An investor may be convinced that the price of a certain commodity is due to rise due to various factors. There is often a considerable time lag between the perception of these factors and their impact on the commodity prices. Taking a long futures position may entail risks the trader is unwilling to take, since the price may fluctuate considerably during the lag period, compelling the investor to post thousands of dollars in margin maintenance during market downswings. A long call fixes the amount at risk. Downside market fluctuations will not require the risking of additional funds. Also, where a futures contract held by an investor has generated unrealized gain, options may be played against such contract. For example, where the futures contract is a short position and the price has moved downward, a long call can be acquired to lock in the unrealized gain. If the price falls further, additional gain from the short position is forfeited to the extent of the premium paid for the option. If the price moves upward, however, for every dollar of unrealized gain wiped out, the long call will gain one dollar in value. In some situations, where the price moves upward dramatically, the gain ultimately realized from the long call will exceed the unrealized gain from the short futures contract wiped out. There are, of course, many intermediate positions. In the short RFC-long call case, where the commodity price moves upward sufficiently, additional margin on the short position may be called for. The holder might decide to close the position out and protect the unrealized gain from the long call by acquiring another short contract. Similar stratagems may involve the granting of options. Instead of purchasing a long call, the holder of the appreciated short futures position could grant a short put. Here, gain from the short position is locked in only to the extent of the premium received. If the price moves further downward, margin will have to be posted to secure the grantor's obligation under the short put, or the option may be closed out at a loss.

The amendments to §1256(d) ("Terminations, etc.") provide that the rules of §1256(a)(1) through (3) are to apply to the termination of the taxpayer's rights or obligations with respect to a §1256 contract "by exercise or being exercised" or by "lapse." Where a commodity option is acquired, it is (a) exercised, (b) closed out in a closing sale transaction, or (c) allowed to expire unexercised. Upon the happening of any one of these events, the option must be marked to market and any gain or loss is afforded 60/40 treatment. Thus, if a long call is exercised, and the taxpayer thereby acquires a long RFC position, the excess of the option's fair market value at the time it was exercised over the amount of the premium paid is gain which must be recognized. It is treated as 60/40 gain. Then, under §1256(a)(2), such recognized gain is to be taken into account in determining the amount of any gain or loss from the RFC.

Note: While it seems unlikely that such an option would be part of a mixed straddle, this is possible. For instance, a straddle could be made up of stock in a diversified investment company and an option on a stock index futures contract, or of direct ownership of a commodity and an option on a futures contract relating to the same or similar property. If §1256(d)(4) is satisfied, an election may be made under §1256(d) not to have §1256 apply to the option position. In such a case, although the taxpayer avoids §1256(c)(1), 60/40 treatment of any gain or loss is also forfeited.

The above comments also apply to the grantor of an option on an RFC. The holder of a long option position on an RFC where a §1256(d) election has been made, may, if the position is held for more than six months, realize long-term capital gain. The grantor of an option elected out of §1256, however, will realize short-term gain due to §1234(b)(1) no matter how long the position has been held open.

Section 1234(c), added by Act §105, provides that gain or loss shall, be recognized on the exercise of an option on a §1256 contract.[104] This, presumably, applies to all §1256 contracts, including those as to which a §1256(d) election has been made. A cash settlement option is to be treated as an option to buy or sell property.[105] An option on a Treasury bill futures contract is a cash settlement option since it is one which, on exercise, settles in (or could be settled in) cash or property other than the underlying property.[106] Where such an option is granted, whether by an investor or an options dealer, it would seem clearly to be subject to the §1256(c)(1) termination provisions unless a §1256(d) election has been made. If a §1256(d) election is made, §1234(c) and, by reason of the latter subsection, §1234(b) will characterize any gain or loss as short-term. The latter provisions would also seem to apply where the granting of the option is a hedging transaction (by a dealer in Treasury obligations, for example) and hence, by reason of §1256(e), is not subject to §1256.

The amendments made to §1234 apply to options purchased or granted after October 31, 1983 in taxable years ending after that date.

3. Effective Dates of Act §102

Act §102(f)(1) sets the effective dates for the amendments to §1256 and to §263(g) (Act §102(e)(7) and (8)). The general effective date is that Act §102 is to apply to positions established after the TRA's enactiment date (July 18, 1984) in taxable years ending after such date.

The amended §1256 rules apply to options on RFCs, however, acquired or granted after October 31, 1983.[107]

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The self-employment tax amendments (which apply to options dealers and commodities dealers (as defined in §1402(I)(2)(B)) apply to taxable years beginning after July 18, 1984.

Act §102(f)(4), entitled "Gains or Losses from Certain Terminations," provides that the "(t)he amendment made by subsection (d)(9) shall apply as if included in the amendment made by §505(a) of (ERTA) as amended by §105(e) of the Technical Corrections Act of 1982."

Comment: This seems to be a technical error. The reference seems clearly to be to Act §102(e)(9) amending §1234A (which was amended by ERTA §507(a) and TCA of 1982 §105(e)) relating to certain terminations by providing that it is not to apply to the retirement of debt instruments.

Two elections are provided under Act §102(g). Under the first, the amendments made by Act §102 apply to all §1256 contracts held on the TRA's enactment date. Under the second, the amendments apply to all §1256 contracts held at any time during the taxable year which includes July 18, 1984 (date of enactment).[108]

If the second (§102(g)(2)) election is made, the taxpayer may also elect to pay all or part of the tax for the taxable year including the date of enactment in two or more (but not more than five) equal installments. The maximum amount of tax which can be thus paid is the excess of the tax liability resulting from taking the §102(g)(2) election into account and treating all stock option §1256 contracts (*i.e.*, dealer equity options), and any stock which such options offset, as having been acquired for a price equal to their fair market value as of the end of the preceding year.

Observation: A stock option which offsets a direct ownership of stock position must be a granted call. The grantor of such an option could not "acquire" such an option. What is probably intended is the fair market value of a call option which, if acquired in a closing purchase transaction, would offset the option granted.

The §102(g)(2) installment payment election must be made no later than the due date for the return for the taxable year including July 18, 1984 in accordance with regulations to be issued.

4. Hedging Loss Limitation

Act §104 adds §1256(e)(5). That paragraph restricts the amount of any losses from hedging transactions which can be passed through to limited partners or entrepreneurs. This amendment appears to be aimed primarily at option market maker tax shelter schemes, but will have a somewhat broader application. It is limited, as to hedging transactions involving other than stock and securities, to the persons described in §465(a)(1), the at-risk rules, *i.e.*, individuals and personal holding company qualified corporations. The loss pass-through is limited to the taxable income of the limited participant for the taxable year attributable to the trade or business to which the hedging transactions relate (such taxable income to be computed not taking into account the hedging transaction items).[109] The disallowed loss is carried over and treated as a hedging transaction loss in the following year.[110] Where the hedging losses exceed the aggregate of unrecognized gains from the hedging transactions as of the close of the year attributable to the business to which the hedging transactions relate, such excess may be passed through.[111] This limit is added to the already existing restrictions of §1256(e) relating to syndicates. This amendment may have an impact on farming operations operated as limited partnerships or S corporations, and to certain similar business entities dealing in commodities as producers or processors.

The amendments to §1256(e) apply to taxable years ending after December 31, 1984.

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[1] Economic Recovery Tax Act of 1981; P.L. 97-34.
[2] *See Reinach v. Comr.*, T.C. Memo 1965-288, aff'd 373 F. 2d 900 (2nd Cir. 1967), cert. denied, 389 U.S. 841.
[3] General Explanation of the Tax Reform Act of 1976, Joint Committee on Taxation at 675.
[4] *See* §1236 and Regs. §1.1234-3(c).
[5] §1233(c)(2)(B). Long and short futures positions in the same commodity on the same exchange are automatically offset where held by the same person.
[6] *I.e.*, a contract of the sale of a given quantity of a given commodity to be delivered on a specified future date.
[7] *I.e.*, a contract of the purchase of a given quantity of a given commodity to be delivered at a specified future time.
[8] *Smith* was not appealable since the government prevailed, albeit on different grounds than those relied on in its primary position. The author has confirmed in conversations with IRS officials, however, that the "lack of closed transaction" theory is still considered valid in its area. *See Fox v. Comr.*, 82 T.C. 25 (1984), following *Smith*, for another decision based on §165(c)(2). The Commissioner has been effectively prohibited from relying on the "lack of a closed transaction" theory in any future litigation. *See* Act §108(d), discussed *infra*.
[9] §1092(a)(1).
[10] §1092(d)(2)(A).
[11] §1092(d)(1).
[12] §1092(d)(2)(B).
[13] §1092(a)(3).
[14] §1092(e).
[15] §1092(a)(1)(B).
[16] §1092(c)(3).
[17] §1092(a)(2)(A)(ii).
[18] §1092(a)(2)(B).
[19] §1092(c)(2)(C).
[20] §1092(d)(4).
[21] §1256(b).
[22] *Id.*
[23] §1256(g).
[24] §1256(c)(1).
[25] §1256(c)(2).
[26] §1256(a)(9).
[27] §1222, as amended by §1001(a) of the Act.
[28] §1256(e)(1); §1092(e).
[29] §1256(e)(2).
[30] §1256(e)(3).
[31] The 1982 TCA amendments to §1256 brought cash settlement RFCs within the meaning of "RFC."
[32] When the grantor closes out his position, this is termed a "closing purchase transaction." He purchases an option offsetting the option granted by him, thereby terminating his obligation.
[33] Where the holder of an option closes out his position, this is termed a "closing sale transaction."
[34] It is submitted, however, that the grantor of an option does not hold a "position" in personal property as defined by §1092(d) as "an interest in"

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property. Congress appears to have decided otherwise, however, and it may be futile to contest its somewhat cavalier semantics in this respect.

[35] Meaning any straddle consisting of both non-RFCs and RFCs, whether or not identified under §1256(d)(4) or qualifying for such identification.

[36] For this purpose, "applicable stock price" means the closing pice for the stock on the day the option is granted or the day's opening price if such opening price exceeds 110 percent of the previous day's closing price.

[37] §1092(d)(3)(B)(i).

[38] §1092(d)(3)(B)(ii).

[39] *See Hanlin v. Comr.*, 108 F. 2d 429 (3rd Cir. 1939), one of the few cases to deal with this question.

[40] Rev. Rul. 77-201, 1977-1 C.B. 250.

[41] H.R. Rep. No. 861, 98th Cong., 2d Sess. at 908.

[42] §1256(b).

[43] §1256(a)(1).

[44] §1256(a)(3).

[45] §105(a)(5)(B) of P.L. 97-448.

[46] §1256(g)(4).

[47] *I.e.*, registered with the SEC or designated by the CFTC as a contract market, or any other market which the Secretary determines has rules that are adequate to carry out the statute's purposes.

[48] The Conference Report, H.R. Rep. No. 861, 98th Cong. 2d Sess, at 909 urges the Secretary to make such determinations in view of the number of stock index options currently being traded for which there is no designation by the CFTC for futures trading in the same index.

[49] §1256(g)(8)

[50] This was probably intended to apply to non-RFC foreign currency contracts. An RFC cannot, under CFTC regulations, be assigned.

[51] Act §102(e)(3)

[52] *See* discussion in chapter 10 of 1984 TRA provisions relating to short sale expenses

[53] Sections 1277 and 1282 disallow and defer to later periods the deduction of interest expense incurred or continued to purchase or carry market discount bonds or short-term discount obligations.

[54] Joint Committee on Taxation, General Explanation of ERTA, at 286-287.

[55] §1256(e)(5)(C).

[56] Act §104(b)

[57] *See* Regs. §1.1091-1(c)-(g) which adopts a similar rule albeit without any statutory authority. The amendment belatedly renders the regulations legitimate.

[58] *E.g.*, *Smith v. Comr.*, 78 T.C. 350 (1982)

[59] *See* Rev. Rul. 77-185, 1977-1 C.B. 48.

[60] *See Smith, supra*, footnote 58.

[61] Act §108(e).

[62] Act §108(f).

[63] Act §108(g).

[64] §1256(a)(4).

[65] §1092(c)(1).

[66] §1092(c)(1) and (2).

[67] §1092(c)(2)(A).

[68] §1092(d)(3)(A).

[69] §1092(d)(3)(B)(i)(I).

[70] §1092(d)(3)(B)(i)(II).

[71] Conference Report at 908.

[72] *Id.* The concept "substantially similar and related property," new to the Code, is also included in the provisions of other 1984 TRA amendments. See §263(h)(4)(B) and 246(c)(4)(C) (which is incorporated by reference in §1059(d)(3)). *See also* discussion in S. Rep. No. 169, 98th Cong., 2d Sess., at 173-4 which points out that, in ascending order of strictness of application, are: "offsetting," "substantially similar or related," and "substantially identical."

[73] Act §101(e).

[74] Act §101(e)(2).

[75] §1092(c)(4).

[76] §1092(c)(4)(B), (D). The applicable price, for this purpose, is the price at which the stock closed on the last preceding trading day or, if more than 110 percent of such closing price, the price at which the stock opened on the day the option was granted.

[77] §1092(c)(4)(C).

[78] §1092(c)(4)(D)(ii).

[79] §1092(c)(4)(D)(iii).

[80] §1092(c)(4)(D)(iv).

[81] §1092(c)(4)(E).

[82] §1092(f).

[83] Act §101(e)(3).

[84] §1092(c)(4)(B)(iv).

[85] §1256(f)(5)(B).

[86] §1092(b)(2)(A).

[87] Section 1092(b)(2)(C). Conference Report at 911.

[88] §1092(b)(2)(B).

[89] Presumably the stock was held short-term at the time the option was granted. If the stock had been held long-term, does the same result apply? Section 1233(b) principles would not seem to call for such a result — but the regulations will make this clear.

[90] Conference Report at 915. This would appear to be the only case where §1234(b)(3) still applies.

[91] Conference Report at 915.

[92] *See* Joint Committee on Taxation, General Explanation of ERTA at 285.

[93] §1256(b)(4); §1256(g)(4).

[94] §1256(g)(6)(A).

[95] §1256(g)(6)(B).

[96] §1256(b)(3).

[97] Conference Report at 911.

[98] §1092(e).

[99] §1233(b).

[100] §246(c)(3)(A).

[101] §246(c)(4). These §246(c) provisions are made applicable by §1092(c)(4)E).

[102] *See* S. Rep. No. 169, 98th Cong., 2d Sess., at 173-4.

[103] This provision was originally proposed in H.R. 3096. *See* explanation in *BNA Daily Tax Report* No. 184 (9/21/83) at J-5-6. The Treasury proposal, reprinted in *BNA Daily Tax Report* No. 123 (6/24/83) at J-5-6, suggests that, rather than the relatively vague "formed or availed of" standard, some objective criteria might be used, such as asset ownership, *etc.* This seems to have been abandoned, but may be incorporated in regulations.

[104] §1234(c)(1).

[105] §1234(c)(2).

[106] §1234(c)(2)(B).

[107] Act §102(f)(2).

[108] Act §102(g)(1) and (2).

[109] §1256(e)(5)(A).

[110] §1256(e)(5)(A)(ii).

[111] §1256(e)(5)(B).

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CHAPTER 28

PROVISIONS AFFECTING CAPITAL GAINS AND LOSSES

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I. Introduction

Under subchapter P of the Code [1] gain or loss from the sale of "capital assets" is taxed specially, generally resulting in the imposition of a lower rate of tax than that imposed on ordinary income.[2] The term "capital asset" generally includes all property other than (1) stock in trade or inventory of the taxpayer or property held for sale by the taxpayer primarily to customers in the ordinary course of a trade or business; (2) depreciable property used in the trade or business; (3) certain literary, musical or artistic property held by its creator or a donee of such property; (4) accounts receivable arising out of a trade or business or from the sale of inventory; and (5) certain U.S. government publications.[3] The special capital gains rate is applied to the "net capital gain" which is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.[4] The holding period for determining whether a capital gain or loss is "long-term" or "short-term" has varied over the years since 1921, and, immediately prior to the Act was one year.[5]

Section 1211 provides limits the extent to which capital losses may be deducted. Corporate taxpayers thus are allowed to deduct capital losses only to the extent of capital gains. Other taxpayers may offset capital losses against ordinary income to the extent of $3,000 per year. Long-term capital losses of individuals, however, are reduced by 50 percent when offset against ordinary income, except that any such losses incurred prior to 1970 and carried over to later years are deductible dollar per dollar under a special transition rule in §1212(b)(3).

Certain types of property excluded from the definition of "capital asset" in §1221 have been accorded capital gains treatment under other sections of the Code. In §1231, for example, gains from property used in the trade or business and gains from the compulsory or involuntary conversion of property used in the trade or business and capital assets held for more than one year (whether business or personal) are considered to be capital gains, although the losses from such property are ordinary losses. Similarly, royalties received on the disposition of coal and iron ore will, under certain circumstances, receive capital gains treatment under §631(c). In the case of iron ore, however, (but not coal) capital gain treatment will be denied where there is a disposal of iron ore to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the taxpayer.

The Code also limits the availability of capital gains treatment in certain cases. Thus, under §1239, the direct or indirect sale or exchange of depreciable property between specified related persons (including husband and wife and certain 80 percent controlled entities of the taxpayer) is denied capital gains treatment. Under §1251 (enacted in 1969) taxpayers are prevented from using foreign losses to shelter non-farm income while later obtaining capital gains on the disposition of farm property. Under §1251 the excess losses from the farming activities would be recaptured as ordinary income at the time of sale. The Tax Reform Act of 1976 limited the application of this recapture provision to those farm losses incurred prior to 1976.

II. Overview

The Tax Reform Act of 1984 makes numerous changes in the capital gains and losses provisions. First, the holding period for long-term capital gain treatment is reduced from one year to six months.[6] The Act also repeals the transitional rule for pre-1970 capital losses, which may no longer be offset in full against ordinary income.[7] Capital gains treatment accorded under §1231 to property used in the trade or business and capital assets involuntarily converted is limited by the Act, which taxes as gain from ordinary income the "non-recaptured net §1231 losses" of the previous five years. The Act also limits the application of §1231 to gains or losses from involuntary conversions of business property arising from fire, storm, shipwreck or other casualty or from theft. Personal casualty losses and gains will be taken into account under §165. The Act also eliminates the availability of capital gain treatment for any disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interests as the taxpayer.

The Act also amends those sections of the Code discussed above which limit the availability of capital gains treatment in certain circumstances. First, the Act amends §1239 to provide that patent applications shall be treated as depreciable property and thus subject to the limitations of that section on sales to related persons.[8] Next, the Act redefines the term "related persons" to include a taxpayer and any trust of which he is a beneficiary (unless his interest therein is remote and contingent),[9] and to include an employer and a related welfare benefit fund controlled directly or indirectly by the employer or a related person.[10] The term "related person" no longer will include, however, a husband and wife, in accordance with new rules governing the transfer of property incident to a divorce.[11] The limitation on capital gains treatment required by §1251 provisions on recapture of farm losses have been repealed as deadwood.[12]

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III. Detailed Analysis

A. Holding Period For Long-Term Capital Gain Treatment Reduced to Six Months [Act §1001]

1. Statutory Change

The Act amends §1222 (which defines the terms relating to capital gains and losses) to decrease the holding period for long-term capital gains and losses from one year to six months. This amendment restores the holding period that was in effect prior to the Tax Reform Act of 1976. The reduction in the holding period was justified by the Treasury, which testified in its support, as an incentive to save and to hold corporate stock and improve the efficiency of capital markets by removing artificial barriers to stock transactions.[13] The tax reduction from converting short-term gains to long-term gains is expected to outweigh the tax increase on individuals from converting short-term losses to long-term losses on assets held between six and 12 months.[14]

2. Effective Date

This amendment is effective with respect to property acquired after June 22, 1984 and before January 1, 1988, and thus may be said to be experimental in nature.

B. Section 1239 Exception To Capital Gain Treatment Expanded [Act §§175, 557, 421(b)(6)]

1. Statutory Changes

Section 1239 was enacted to deny capital gains treatment to sales and exchanges of depreciable property between husband and wife or between an individual and a corporation controlled by him. In the case of such sales between related parties the immediate capital gains tax paid by the related purchaser was in most cases more than offset by the opportunity to write off against future ordinary income the depreciation resulting from the increase in the adjusted basis arising from the sale.[15] The Act amends and strengthens provisions of current §1239 in several ways. First, it provides that patent applications are to be treated as depreciable property for purposes of §1239.[16] The Act also changes the definition of "related person" contained in Code §1239(b) which, prior to the Act, included (1) a husband and wife, and (2) a person and all entities which were 80 percent controlled (directly or indirectly) by that person. The constructive ownership principles of §318 are applied to determine the extent of control of a related entity under §1239(c).[17] Under the Act, husband and wife no longer are considered to be related persons.[18] The reason given for this change by the House Ways and Means Committee was its belief that, in general, it is "inappropriate" to tax transfers between spouses whether during marriage or incident to a divorce.[19] In addition to removing husband and wife from the categories of related persons, the Act adds to that category a person and a trust in which the person has a beneficial interest (other than a remote or contingent interest).[20] Also included within the definition of "related person" are an employer (and any person related to the employer) and a welfare benefit fund to which the employer contributes, whether or not the fund is exempt from tax.[21] This amendment was intended to prevent employers from assigning inappropriate values to property contributed to such funds.[22]

2. Effective Dates

The amendment with respect to patent applications is effective with respect to sales and exchanges made after March 1, 1984 in taxable years ending after that date.

The amendments to the definition of "related person" are effective as follows:

(a) The amendment which eliminates husband and wife from the category of related persons is effective with respect to transfers after the date of enactment (July 18, 1984). Both spouses may, however, elect to have the amendment apply to all transfers made after December 31, 1983. In the absence of this election the amendment shall not apply to any transfer made under any instrument (such as a divorce decree) in effect on or before the date of enactment. The manner of making these elections is to be prescribed by the Secretary[23];

(b) The amendment which adds employers and the employee benefit funds to which they contribute to the category of "related person" is effective with respect to all sales or exchanges after the date of enactment (July 18, 1984) in taxable years ending after such date;[24] and

(c) The amendment which adds to the category of related persons beneficiaries of trusts in which they have a noncontingent interest is effective with respect to sales or exchanges after March 1, 1984 in taxable years ending after such date.[25]

C. New Rules Recapturing §1231 Gain As Ordinary Income And Coordinating Casualty Losses With §1231 [Act §§176 and 711(c)]

1. Statutory Changes

a. Recapture of §1231 Gain [Act §176]

As noted above, §1231 provides an exception which accords capital asset treatment to gains on sales or exchanges of property used in the trade or business and gains from the compulsory or involuntary conversion of long-term capital assets into other property or money. Net losses from sales or exchanges of such property are, however, not considered to be losses from sales or exchanges of capital assets. The Act[26] amends §1231 to provide that the net §1231 gain for any taxable year shall be treated as ordinary income, rather than capital gain, to the extent of the "non-recaptured net §1231 losses" for the five most recent preceding taxable years beginning after December 31, 1981. Thus, taxpayers who have deducted net §1231 losses against ordinary income in taxable years beginning after December 31, 1981 will have to recapture as ordinary income a portion of any net §1231 gains for taxable years beginning after December 31, 1984.

b. Casualty Losses

Prior to the Act, §1231 applied to gains and losses from the compulsory or involuntary conversion of all capital assets held for more than one year whether or not such assets were personal or business assets. The Act has amended §165(h) (Treatment of Casualty Gains and Losses), however, to remove gains and losses from personal casual-

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ties from the scope of Code §1231. Gains from personal casualties are those arising from the involuntary conversion of property which is not used in a trade or business or in a transaction entered into for profit and which arise from fire, storm, shipwreck, theft, or other casualty. Gains and losses from the compulsory or involuntary conversion of property used in the trade or business and long-term capital assets held in connection with a trade or business or in connection with a transaction entered into for profit will continue to be netted under §1231. The excess of recognized gains over recognized losses on such property will continue to be taxed as capital gain, while the excess of recognized losses over recognized gains will continue to be deductible against ordinary income.

The Act also provides an amendment to coordinate the ten percent of adjusted gross income limitation in §165 with §1231. Under the formula prescribed by §165 for determining the amount of the 10 percent limitation, the taxpayer's net recognized gains from involuntary conversions and casualty losses must be taken into account before the deduction for capital gain (and thus adjusted gross income) can be computed. This interrelationship of §1231 with the adjusted gross income computation makes the computation of the casualty loss deduction indeterminable. The Ways and Means Committee explains that the 10 percent limitation thus is to be determined without regard to the application of §1231 to gain or loss from involuntary conversions arising from casualty or theft.[27]

2. Effective Dates

The amendment adding the recapture provisions to §1231 is applicable to net §1231 gains for taxable years beginning after December 31, 1984.

The amendments which coordinate §1231 with §165 (casualty gains and losses) are effective with respect to taxable years beginning after December 31, 1983. The rule with respect to the computation of adjusted gross income under §165(h) (which shall be determined without regard to the application of §1231 of the Code) is a transitional rule, applicable to those years beginning before January 1, 1984.

D. Repeal Of Farm Loss Recapture Rules [Act §492]

Section 1251 (relating to recapture of gain from disposition of property used in farming where farm losses offset non-farm income) is repealed by TRA §492 of the Act, effective for taxable years beginning after December 31, 1983. Technical and conforming amendments are made to other sections of the Code.[28] Since the Tax Reform Act of 1976 had made the farm loss recapture rules inapplicable to losses incurred after 1975, the need for this provision had been eliminated and its repeal was enacted as part of the "deadwood" provisions.[29]

E. Denial Of §631(c) Capital Gain Treatment For Certain Dispositions Of Coal [Act §178]

1. Statutory Changes

The Act amends §631(c) to provide that capital gain treatment for certain royalties on coal will be denied where there is a disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interest which own or control the taxpayer. The amendment is intended to conform the treatment of royalties on coal to that of royalties on iron ore, and to reduce the avoidance of the overall tax on coal mining operations which arises when a separate land holding company acquires and leases coal reserves to a related company which actually conducts the mining operation. Under this arrangement the royalties are deductible by the operating company and are taxable as capital gains to the leasing company, thus reducing the overall tax burden on the related group.[30]

2. Effective Date

The amendment is generally effective with respect to dispositions of coal after September 30, 1985. The Conference added a special rule, however, for certain "qualified fixed contracts." Under this exception, dispositions of coal to related persons will not be denied capital gains treatment where the coal is sold under a fixed contract in effect on June 15, 1984 and at all times thereafter where the price for such coal cannot be adjusted to reflect the changed income tax liabilities of the seller. This exception for fixed contracts terminates on January 1, 1990. If during any taxable year there is a disposition which is not specifically allocable to a qualified fixed contract or to a contract which is not a qualified fixed contract, then the disposition is treated as first allocable to the qualified fixed contract.[31]

F. Repeal of Transitional Rules For Pre-1970 Capital Losses [Act §1002]

The Act repeals the rule of §1212(b)(3) that pre-1969 long-term capital losses need not be reduced by 50 percent when offset against ordinary income. The repeal was enacted in the interest of tax simplification, since taxpayers now have had 14 years to use the pre-1970 losses, and the special rules applicable to them have added considerable complexity to individual tax forms.[32] The repeal is effective for taxable years beginning after December 31, 1986.[33]

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[1] §1201 et seq.

[2] The highest effective rate of tax generally applicable to capital gains under the current Code is 20 percent for individual taxpayers and 28 percent for corporate taxpayers. §1201.

[3] §1221.

[4] §1222(11).

[5] *See* §1222 and Jt. Comm. Tax Print, "Taxation of Capital Gains and Losses" (JCS 52-83) (Nov. 1, 1983).

[6] Act §1001.

[7] Act §1002.

[8] Act §175.

[9] *Id.*

[10] Act §557.

[11] Act §421(b)(6).

[12] Act §492.

[13] Statement of the Honorable John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury before the Committee on Ways and Means, U.S. House of Rep., 98th Cong., 1st Sess., (Nov. 2, 1983).

[14] *Id.*

[15] H. Rep. No. 586, 82nd Cong., 1st Sess. (1951), 1951-2 C.B. 357, 376.

[16] Act §175 adding §1239(e).

[17] §1239(c).

[18] Act §421(b)(6) amending §1239(b).

[19] H. Rep. No. 98-432 (Part 2), 98th Cong. 2d Sess., pp. 1491-1492 (1984).

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[20] Act §175(b). Whether or not a beneficiary's interest in a trust is a remote contingent interest shall be determined within the meaning of §318(a)(3)(B)(i).
[21] Act §557.
[22] H. Rep. No. 98-432, *supra*, p. 1293.
[23] Act §421(d).
[24] Act §557(b).
[25] Act §175(c).
[26] Act §176
[27] *See* H. Rep. No. 98-432 (Part 2), supra, ¶1612 and Act §711(c)(2).
[28] §§170, 341, 353(b), 751, and 1252.
[29] *See* Conf. Rep. No. 98-861, 98th Cong., 2d Sess, p. 1130 (1984).
[30] *See* Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., "Deficit Reduction Act of 1984" (Comm. Print 98-169).
[31] *See* Act §178(b)(2) and Conf. Rep. No. 98-861, 98th Cong., 2d Sess., p. 1035-1036 (1984).
[32] *See* S. Rep. No. 98-300, 98th Cong., 1st Sess., p. 84 (1983).
[33] Act §1002(b).

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CHAPTER 29

NEW RECHARACTERIZATION ON LIKE-KIND EXCHANGES

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I. Exchange of Partnership Interests Disqualified from §1031 Treatment

A. Background

Section 1031(a) provides that no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be similarly held. Specifically excluded from like-kind treatment are stocks, bonds, notes, choses in action, certificates or trust or beneficial interest, or other securities or evidences of indebtedness, or interest.

The Internal Revenue Service has contended that partnership interests, although not expressly excluded in the Code, do not qualify for like-kind treatment. In Rev. Rul. 78-135, 1978-1 C.B. 256, the Service justified its position by arguing that the parenthetical exclusion in §1031 "in part encompasses all types of equity interests in financial enterprises other than by direct ownership of the underlying property. Because a partnership interest represents such an equity interest, it comes within the ambit of the [exclusion]." [1] The Service has regularly lost in litigation on this issue where the underlying assets are of like kind and where the partnership interests are of similar type (*i.e.*, general for general, limited for limited, but not general for limited).[2]

The Conference Report expresses the concern that the partnership interest exchanges are being used to avoid gain with respect to "burned out" partnerships (*i.e.*, partnerships where loss deductions have substantially diminished the basis in partnership interests which were largely attributable to unpaid, nonrecourse liabilities).[3] The solution adopted by TRA of 1984 is to eliminate all partnership like-kind exchanges.

B. Detailed Analysis

Section 1031 is amended to provide that interests in a partnership do not qualify for like-kind exchange treatment. Accordingly, any such exchange will give rise to recognition of gain.

C. Effective Date

The disqualification provision applies to exchanges after July 18, 1984, except where the transfer is pursuant to a binding contract in effect on March 1, 1984, and at all times thereafter.[4]

II. Period for Completing Deferred Like-Kind Exchange Restricted [Act §77]

A. Background

Code §1031 provides an exception from the general rule requiring the current recognition of gain or loss realized upon the sale or exchange of property. Under §1031(a), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind which will also be so held. As with most other nonrecognition provisions of the Code, §1031(d) provides that the basis of property transferred carries over to the property received, and is increased by any gain recognized (or decreased by any loss recognized or boot surrendered), and reduced by the amount of money or the fair market value of other property received. The realized gain is deferred until the "exchange property" is disposed of in a subsequent taxable transaction.

The legislative history underlying §1031 suggests that the original justification for nonrecognition of gain or loss on such exchanges was two-fold: (i) Congress' desire not to impose a tax on a theoretical gain where a taxpayer continued his investment in like-kind property; and (ii) a recognition of the administrative burden required to detect and evaluate thousands of barters and horse trades consummated each year.

Prior to 1921, exchanges of property for other property generally were taxable. The Revenue Act of 1921 expressly exempted all exchanges of property for other property, whether of a like-kind, or not, if the property received did not have a "definite and readily realizable market value." [5] This nonrecognition rule was intended to eliminate the then-common administrative problem of determining values. The 1921 Act went even further for exchanges of like-kind property, which became exempt from taxation even if the property received did have a "definite and readily realizable value."

Nonrecognition of gain or loss on exchanges of non – like-kind property lasted for only three years. In the Revenue Act of 1924, such exchanges were again made taxable because it was felt that the "readily realizable market value" concept of the 1921 Act was so indefinite that it could not, and, in fact, was not being applied consistently.[6] However, the nonrecognition rule for like-kind exchanges

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was retained. The Revenue Act of 1924 represents the last major revision in language of current §1031.

In 19[illegible] like-kind exchange provisions were reconsidered and [illegible]ained. Congress reiterated that difficulties of evaluation and protection of the revenues remained primary reasons for rejecting elimination of the provision, but also acknowledged that in a like-kind exchange, the taxpayer continues his investment in the same kind of property, and, therefore, only realizes a "theoretical" profit or loss which should not equitably be recognized.[7] Since 1934, this continuity of investment rationale has become accepted as the primary purpose underlying §1031.[8]

In recent years, the principle of continuity of investment has been at the heart of determinations as to whether so-called "delayed" or "nonsimultaneous" exchanges qualify for nonrecognition under §1031. The characteristics of such transactions are fairly straightforward. Suppose, for example, that B wants to acquire A's property immediately for cash, but is willing to cooperate in an exchange. However, either because of financing considerations or other business exigencies, B cannot wait until A finds suitable property which he is willing to accept in exchange. A refuses to sell for cash, but does not want to lose the price which B has offered to pay. To solve the problem, A and B enter into an agreement pursuant to which A agrees to transfer his property to B immediately and B agrees to create a credit balance on its books equal to the value of A's property. The balance is to be used to acquire and convey like-kind property designated by A within the next 5 years. The credit balance will be reduced by the amount of B's purchases and increased by an annual percentage growth factor applied to the outstanding credit balance at the end of each month. If, at the end of the five years, the balance is not reduced to zero, B will have the option to pay the remaining amount in cash.

This example parallels the facts in *Starker v. U.S.*,[9] the first Court of Appeals decision which directly considered the question of delayed exchanges in the context of §1031. The Government argued that the transaction outlined above did not qualify under §1031 because the transfers were not simultaneous and, alternatively, that A had received a contract right which was not like-kind to the real property which he had transferred. The Ninth Circuit held that simultaneity is not required in a §1031 exchange and, in response to the Government's "like-kind" argument, stated:

> A contractual right to assume the rights of ownership should not, we believe, be treated as any different than the ownership rights themselves. Even if the contract right includes the possibility of a taxpayer receiving something other than ownership of like-kind property, we hold that it is still of a like kind with ownership for tax purposes when the taxpayer prefers property to cash before and through the executory period, and only like-kind property is ultimately received.[10]

The *Starker* decision has resulted in widespread speculation and comment on the use of delayed exchanges. Without any clear expression as to the necessity of the simultaneous exchange in §1031 itself, the underlying regulations, or the legislative history, questions have focused upon whether the accepted purpose of the statute — to defer taxation if the taxpayer continues his investment in like-kind property — implies a need for simultaneity. If the exchange property to be received is identified at the time the taxpayer delivers his property, and delay is caused because the property is not yet in existence, or because of practical difficulties in accomplishing transfer, it is easier to conclude that the taxpayer has continued his investment in like-kind property. In this regard, a taxpayer may be considered for tax purposes to have made an investment in property, since he bears the risk of loss and opportunity for gain associated with such property.[11]

Acceptance of nonsimultaneity under such circumstances finds some support in the Tax Court's decision in *Rutherford v. Comr.*,[12] where the court held that §1031 applied to a taxpayer who received twelve half-blood heifers in exchange for his agreement to have such heifers artificially inseminated by the sperm of a registered bull and deliver the first twelve three-quarter-blood heifers born to the heifers received. With respect to the delayed nature of the exchange, the Court simply stated:

> "At least under the circumstances of this case, we do not consider the fact that the three-quarter blood heifers to be delivered by ... [taxpayer] were not in existence at the time of the transfer of the half blood heifers ... precludes the applicability of Section 1031(a)."

Each of the parties bore the risks of ownership of the particular heifers received or to be received.[13]

The *Starker* case, however, involved a very different situation. Upon the transfer of A's property to B, A's investment risks were totally unrelated to real estate. Prior to his receipt of his exchange properties, A not only did not bear the benefits and burdens of investment in any particular piece of real estate, he was out of the real estate market altogether. The significance of this aspect of the transaction is demonstrated by the fact that since A had a right to receive real estate of a fixed value, if real estate values went up in the interim, A was worse off, and if they went down, he profited. This is the exact opposite of the effect which market swings would have on an investor in real estate. The only risk A bore during this period was the credit risk of his purchaser, B.

Under this analysis, therefore, *Starker* is contrary to the purpose of §1031 since it permits a taxpayer to "get out of the market" (*i.e.*, discontinue his investment) for a period of time, without paying tax. The Ninth Circuit, in ignoring the accepted purpose of the statute, never asked these questions. It simply concluded, without reason, that §1031 applied as long as a property was ultimately received.

It bears noting, however, that the taxpayer in *Starker* did not have a contractual right to demand cash at the end of the five year period; the cash option was solely in the hands of the purchaser. In that sense, *Starker* was a strong case for the taxpayer and thus can be distinguished from cases in which a taxpayer actually has such a right. In such cases, a taxpayer may combine the installment sale rules and the like-kind exchange provisions to defer taxation on dispositions of property for indefinite periods of time.[14]

For example, if a taxpayer transfers property to B in

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exchange for a promise by B to either transfer suitable property to the taxpayer within the next five years, or, at the end of such period, to pay a certain cash consideration, and if, at the end of the five year period, the full cash consideration is paid, the installment sale provisions would apply to defer the gain until the year of receipt of the cash.[15]

In addition to such problems, the *Starker* case also presents many other difficult administrative and substantive issues:

(a) If, in a nonsimultaneous exchange transaction, a taxpayer has the right to demand cash at any time, should the fact that he does not exercise the right make a difference?

(b) If the transferee puts cash or an irrevocable letter of credit into escrow as security, will such a security device be regarded as the equivalent of constructive payment? [16]

(c) Is the assumption of a seller's mortgage by the buyer taxable to the seller immediately, or must the transaction remain open to see what, if any, mortgage is assumed by the seller when the exchange property is received? [17]

(d) Section 1031(d) provides that the property acquired takes the basis of the property transferred increased by gain recognized and decreased by the amount of cash and fair value of other boot received. If multiple properties are to be received, presumably the basis should be allocated based on the relative fair market values of the properties received to the total value to be received. However, if cash is received for the remaining balance, unallocated basis will remain. Should it be allocated to properties previously received? What if some or all of the properties received have since been disposed of? Such problems become even more complex under the Ninth Circuit's holding in *Starker* that boot received in later years is to be treated and received in the year that the taxpayer transferred his property so as to cause gain recognized to the extent of the boot to be reported in the first year. This holding violates the annual accounting concept and in the case of cash-basis taxpayers, the concept of cash-basis accounting.[18]

The answers to all of these questions remain unclear, since the Ninth Circuit in *Starker* either ignored them or did not give them adequate attention.

B. Overview

1. Requirement that Property be Identified and that Exchange Be Completed Not More Than 180 Days After Transfer of Exchanged Property

Section 77 of the Act amends Code §1031(a) and, *inter alia*, permits nonsimultaneous exchanges under certain circumstances. New §1031(a)(3) provides that any property received by a taxpayer will not be treated as like-kind property for purposes of deferral if (1) such property is not "identified" as property to be received in the exchange "before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange," or (2) such property is received after the earlier of (i) "the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange," or (ii) "the due date (determined with regard to extension) for the transferor's return ... for the taxable year in which the transfer in the relinquished property occurred."

2. Effective Dates

Section 77(b)(3)(A) provides that the nonsimultaneous exchange requirement of new §1031(a)(3) will apply to transfers after July 18, 1984 (the date of enactment). With regard to transfers on or before such date, §77(b)(3)(B) provides that the exchange property will be considered to be like-kind property for purposes of deferral only if it is received before January 1, 1987. In such cases, the period for assessing any deficiency of tax resulting from the property not being considered like-kind will not expire before January 1, 1988. However, §77(b)(4) provides that if the exchange property is identified in a binding contract in effect on June 13, 1984, and at all times thereafter before the transfer, it will be considered like-kind property if received before January 1, 1989. With respect to such transfers, the period for assessing any deficiency of tax will not expire before January 1, 1990.

C. Detailed Analysis

1. Requirement that Property be Identified

The requirement in new §1031(a)(3)(A), that the exchange property be identified "before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange," underscores that the continuity of investment rationale underlies §1031. As noted above, for tax purposes, a taxpayer is considered to have made an investment in property if he bears the risk of loss and opportunity for gain associated with such property. New §1031(a)(3)(A) ensures that taxpayers will bear the benefits and burdens of property investment by means of the identification requirement.

To be sure, the identification requirement, as enacted, permits a taxpayer to "get out of the market" altogether for 45 days, without paying tax.[19] However, the length of the designation period appears to have been designed purely to give parties sufficient time to locate suitable exchange property and, in any event, is a far cry from the *Starker* case where the taxpayer was not required to designate any property over a 5-year period.[20]

The identification requirement gives rise to several questions, not the least of which concerns the length of the identification period. New §1031(a)(3)(A) provides that exchange property is not like-kind property if such property is not identified as "property to be received in the exchange before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange." Since such day is the 44th day, the identification period would appear to be 44 days. The Joint Explanatory Statement of the Committee of Conference (the "Joint Explanatory Statement") provides, however, that "transferors are permitted 45 days after the transfer to designate the property to be received." [21] It appears, therefore, that it was the intent of the Conferees to establish a 45 day identification period, and that a technical amendment to new §1031(a)(3)(A) will be necessary to carry out their intent.

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Until such time, taxpayers should proceed on the basis that the [illegible]e permitted only 44 days after the initial transfer in a nonsimultaneous exchange transaction to designate the prop[illegible]:o be received.

Another question raised by the identification requirement is how the designation must be made. Although the Senate Finance Committee Print is silent on that point, the Joint Explanatory Statement states that "the designation requirement in the conference agreement may be met by designating the property to be received in the contract between the parties." [22] While designation within a contract clearly is not mandatory, it certainly appears the most convenient way in which to comply with the statute. A more cumbersome means of identification would be to complete and file an as-yet-to-be-devised Internal Revenue Service form.

The identification requirement also raises the question whether multiple designations of property may be made so as to give taxpayers a choice as to the property that ultimately may be received. Allowing such multiple designations, however, would appear to contradict the continuity of investment rationale underlying §1031, because it would leave taxpayers less exposed to the fluctuations in property values. The greater and more diverse the number of designations, the lower would be the investment risk to the taxpayer.

The Senate Finance Committee and Ways and Means Committee Conferees may well have been guided by such reasoning, because they limited the circumstances under which multiple designations may be made. The Joint Explanatory Statement provides that "[i]t is anticipated that the designation requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer Property 1 to A if zoning changes are approved and Property 2 if they are not, the exchange would qualify for like-kind treatment." [23]

Thus, multiple designations will be permitted only if stated as alternatives "determined by contingencies beyond the control of both parties." However, except for the requirement that such contingencies be "beyond the control of both parties," the Joint Explanatory Statement does not attempt to define their scope. Thus, if A transferred real estate in exchange for a promise by B to transfer Property 1 to A if the fair market value of Property 1 was of a specified dollar amount and Property 2 if Property 1 was below such amount, it is possible that the exchange would qualify for like-kind exchange treatment, because, presumably, fluctuations in the fair market value of the property would be beyond the control of both parties. On the other hand, multiple designations employing such contingencies would appear contrary to the continuity of investment rationale because they would greatly reduce the taxpayer's investment risks. It is arguable, therefore, that multiple designations employing contingencies based on property value fluctuations may not qualify under the statute.

A further question raised by the identification requirement is whether cash may be listed as one alternative in a multiple designation of alternative properties. For example, if A transferred real estate in exchange for a promise by B to transfer Property 1 to A if zoning changes are approved, or Property 2 if such zoning changes are not approved and if improvements to Property 2 are made, or cash if zoning changes are not approved and such improvements to Property 2 are not made, would the exchange qualify for like-kind treatment? Since designations of exchange property — albeit in the alternative—would have been made, the identification requirement in new §1031(a)(3)(A) presumably would have been met, regardless of the cash alternative. On the other hand, the identification requirement arguably contemplates that *all* property identified, regardless whether designated in the alternative, must otherwise qualify as like-kind property. Accordingly, if it is conceivable that cash may be received, instead of like-kind property, then the nonsimultaneous exchange might not qualify for nonrecognition.

A related question is whether property identified in a contract will be considered like-kind property when under the terms of the contract a taxpayer retains the right to elect cash (in lieu of such property) at any time during the exchange period. In other words, if exchange property is identified in a contract, but the taxpayer has the right to demand cash at any time, should the fact that the taxpayer does not exercise the right make a difference? New §1031(a)(3)(A) requires the identification of property "to be received in the exchange." It does not require the identification of property that "might be received." The statutory language clearly contemplates that property so identified will, in fact, be exchanged. Accordingly, if there is any possibility that designated property might not be exchanged (*i.e.*, if the taxpayer exercises his right to demand cash), then even if such property ultimately is exchanged, it may not qualify as like-kind property, even though the right to demand cash remained unexercised.[24]

2. *The Requirement that the Exchange Be Completed Not More Than 180 Days After the Transfer of the Exchanged Property*

In addition to the identification requirement set forth in new §1031(a)(3)(A), new §1031(a)(3)(B) requires that the exchange property be received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (including extensions) for the transferor's return for the taxable year in which the transfer of the relinquished property occurs. This requirement forecloses taxpayers from combining the installment sale rules and the like-kind exchange provisions to defer taxation on dispositions of property for an indefinite period of time. In other words, taxpayers will no longer be able to wait for several years after the initial transfer to decide whether to receive cash instead of property and, nevertheless, achieve deferral under the installment sale provisions if they ultimately elect to receive cash. In tandem with the identification requirement, the exchange completion requirements force taxpayers to determine shortly after (and within the taxable year of) the initial transfer whether to receive property (and rely on the like-kind exchange provisions) or to receive cash (and rely on the installment sale rules).

The exchange completion requirements also rid the Internal Revenue Service of the above-noted administrative

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problems regarding the allocation of liabilities and basis among different properties by ensuring that the tax consequences of deferred exchanges will be determined in the year of the initial transfer. For example, the tax consequences of the assumption of a seller's mortgage by a buyer with respect to the initial transfer of the relinquished property in a nonsimultaneous exchange will now be reflected on the transferor's return for the taxable year of such transaction, because it will be apparent prior to the due date of such return what, if any, mortgages were assumed by the seller when the exchange property is received.

Moreover, basis allocation problems which formerly arose when multiple properties were received at various times over an exchange period lasting several years will no longer arise because exchanges of such properties will have to take place prior to the date of the taxpayer's return for the year of the initial transfer. For example, under old §1031, where cash (representing the difference between the value of the property initially transferred and the value of the multiple exchange properties) ultimately was received, unallocated basis remained and questions arose as to whether such unallocated basis should be allocated to properties previously received. Such basis allocation problems became even more complex when some or all of the properties received had been disposed of. The new identification and exchange completion requirements, however, will force parties at a very early stage of a nonsimultaneous exchange transaction to indicate whether or not cash, in addition to multiple properties, will be received for the relinquished property. Accordingly, basis allocation should be a relatively simple matter.

3. Additional Observations

It is a common practice in nonsimultaneous exchange transactions for the transferee to put cash or an irrevocable letter of credit into escrow as security for the purchase of the exchange property. Cash is not transferred directly to the transferor of the initially relinquished property out of concern that the transaction might be treated as a sale of property for cash followed by a purchase of the transferee's property.[25]

When during the course of the legislative process it became apparent that the new nonsimultaneous exchange provisions would include both an identification requirement and a requirement that the exchange be completed within a particular period of time, the question arose whether the satisfaction of such requirements would enable parties to a nonsimultaneous exchange transaction to forego using the cash or irrevocable letter of credit escrow and permit the transferor to receive the cash and purchase the identified property while still claiming like-kind exchange treatment. The question was posed to the staff of the Joint Committee on Taxation, and a sentence was added to the Joint Explanatory Statement which provides that the new nonsimultaneous exchange provisions "would not permit a taxpayer who receives cash and later purchases the designated property to claim like-kind exchange treatment." [26] Thus, prudent practitioners should still use the escrow mechanism.

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[1] 1978-1 C.B. at 257.

[2] *Est. of Meyer v. Comr.*, 58 T.C. 311 (1979), aff'd, 503 F.2d 556 (9th Cir. 1974), nonacq., 1975-2 C.B. 3; *Long v. Comr.*, 77 T.C. 1045 (1981); *Pappas v. Comr.*, 78 T.C. 1078 (1982); *Gulfstream Land & Development v. Comr.*, 71 T.C. 587 (1979).

[3] H.R. Rep. 432 (Part 2), 98th Cong., 2d Sess. 1233 (March 5, 1984); S. Rep. 169 (Vol. I), 98th Cong., 2d Sess. 243 (April 2, 1984).

[4] TRA of 1984 §77(b)(1), (2).

[5] Revenue Act of 1921, Ch. 136 §202(c).

[6] H. Rep. No. 179, 68th Cong., 1st Sess., p. 179 (1924).

[7] H. Rep. No. 704, 73rd Cong., 2d Sess., p. 13. (1934).

[8] Treas. Regs. §1.1002-1(c); *Leslie v. Comr.*, 539 F.2d 943 (3rd Cir. 1976); *Gordan Marsh Company v. Comr.*, 269 F.2d 453 (2nd Cir. 1959); *but see Century Electric Co. v. Comr.*, 92 F. 2d 155 (8th Cir.), cert. denied, 342 U.S. 954 (1952).

[9] 602 F.2d 1341 (9th Cir. 1979).

[10] *Query*: If the Court reasoned that the contract right which A acquired was property of like-kind, why did it conclude (or even raise the issue) that the transfers do not have to be simultaneous?

[11] The risk of loss is generally viewed as the touchtone of an investment for depreciation purposes. *See, e.g., Mayerson, v. Comr.*, 47 T.C. 340, 350 (1966).

[12] 37 T.C.M. 1851–77 (1977).

[13] Although the case deals with the applicability of §1031 to the transferor of the property to be delivered in the future rather than the transferee, it supports the notion that §1031 can apply to a delayed exchange involving designated property.

[14] An installment sale is defined as a disposition of property in which at least one payment is received after the close of the taxable year in which the disposition occurs. For this purpose, payment includes property permitted to be received without the recognition of gain (§453(f)(6)).

[15] It is unclear, however, whether a taxpayer, who initially claims the benefit of §1031, will be deemed to have "elected-out" of §453 so that IRS permission would be required to utilize the installment sale method.

[16] The Installment Sales Revision Act of 1980 added §453(f)(3) to provide that a third party guarantee, including a standby letter of credit, is not to be taken into account in determining whether payment has been received by the seller. The reasoning of the statute could be applied to §1031 by analogy.

[17] Treas. Regs. §§1031(b)-1(c) and 1.1031(d)-2 provide that if the liabilities assumed by the buyer exceed any liabilities assumed by the seller, the net difference constitutes taxable boot to the seller.

[18] Generally, tax consequences are determined on an annual basis under the annual accounting convention.

[19] The original House passed version contained no designation requirement and, therefore, would have permitted a taxpayer to "get out of the market" up to the time the exchange property would have to be transferred (*i.e.*, the earlier of the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date (determined with regard to extensions) for the transferor's return for the taxable year in which the transfer of the relinquished property occurs). See H. Rep. No. 98-432 (Part 2), 98th Cong., 2d Sess., 165-168 (1984). The Senate version, on the other hand, required the exchange property to be designated on the date the transferred property was relinquished. S. Rep. No. 169 (Vol 2), 98th Cong., 2d Sess., 198-201 (1984).

[20] That new §1031(a)(3)(A) gives taxpayers a statutory time period during which designations of exchange property may be made is particularly significant because it undercuts the rationale that like-kind exchanges merit special treatment because of the administrative difficulty of valuing property which is exchanged solely or primarily for similar property. Both the Senate Finance Committee Print and the Ways and

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Means Committee Report accompanying earlier versions of the nonsimultaneous exchange provisions stated that "[t]his rationale may also be less applicable to deferred like-kind exchanges, in particular exchanges which are 'left open' until the taxpayer has selected a suitable exchange property." S. Rep. No. 169 (Part 1), 98th Cong., 2d Sess., 242 (1984); H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1232 (1984). The Senate Finance Committee Print and the House Ways and Means Committee Report explained further that "[i]n such cases, the transfer of property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future. Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer." S. Rep. No. 169 (Vol 1), 98th Cong., 2d Sess., p. 243 (1984); H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1233 (1984).

New §1031(a)(3)(A), however, leaves nonsimultaneous exchanges open for a defined statutory period (*i.e.*, the period between the date of the initial transfer and "the day which is 45 days after" the transfer). Accordingly, a taxpayer's gain can be measured "with reasonable accuracy" at the time of the original transfer, because the transferred property must be valued at a specific or near-specific dollar amount at the end of the statutory designation period in order to determine the aggregate value of the properties that the taxpayer may receive. By making provision for such a designation period and, therefore, by undercutting the "administrative difficulty of valuing property" rationale for the special treatment of like-kind exchanges, Congress clarified as never before that the continuity of investment rationale is the only valid rationale for §1031.

[21] H. Rep. 861, 98th Cong., 2d Sess., p. 866 (1984).

[22] Conf. Rep. No. 861, 98th Cong., 2d Sess., 242 (1984).

[23] Conf. Rep. No. 861, 98th Cong., 2d Sess., 866 (1984).

[24] *Cf., Carlton v. United States*, 385 F. 2d 238 (5th Cir. 1967), and *Rogers v. Comr.*, 377 F. 2d 534 (9th Cir. 1967). In both cases, the taxpayer's contractual right to demand cash at any time was considered the constructive receipt of cash and, therefore, was subject to tax.

[25] Practitioners in such transactions have assumed that the proported security devise does not constitute constructive payment.

[26] Conf. Rep. No. 861, 98th Cong., 2d Sess., p. 867 (1984).

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CHAPTER 30

MISCELLANEOUS CHANGES AFFECTING NONRECOGNITION PROVISIONS

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I. Nonrecognition of Gain or Loss on Transfers Between Spouses or Incident to Divorce

Act §421 adds a new §1041 to the Code. The new section provides that property transfers between spouses or, if incident to divorce, between former spouses, will not result in the recognition of gain or loss. The transferee will hold the property at the transferor's basis. Also, investment tax credits will not be recaptured.

Section 1041 is generally effective for transfers after July 18, 1984. Taxpayers are permitted to elect §1041 treatment for transfers occurring after 1983 and on or before the general effective date.

Section 1041 is analyzed in depth in Chapter 13 of this portfolio.

II. Nonrecognition of Gain on Certain Stock Sales to ESOPs

Section 1042 of the Code, added by Act §541, permits a tax-free rollover of the proceeds from a sale of qualified securities to an ESOP or to certain worker-owned cooperatives, provided (1) the proceeds are reinvested in the securities of another business and (2) immediately after the sale, the ESOP or cooperative owns at least 30 percent of the value of employer securities.

Section 1042 is analyzed in depth in Chapter 48 of this Portfolio.

III. Nonrecognition of Gain Resulting From Net Gifts Made Before March 4, 1981 [Act §1026]

A. Introduction

A "net gift" arises when a donor makes a gift on the condition that the donee pay the gift tax imposed on the transfer. In *Diedrich v. Comr.*,[1] the U.S. Supreme Court affirmed an Eighth Circuit case which held that net gifts result in gain to the donor to the extent that the gift tax exceeds the donor's adjusted basis in the transferred property. The Eighth Circuit case was decided on March 4, 1981.

Section 1026 of the Act provides that no income will be recognied to donors who made net gifts before March 4, 1981. This is a non-Code provision. For a more complete discussion of this change, see Chapter 58.

IV. Liberalization of Residence Replacement Rules for Armed Forces Members Stationed Overseas [Act §1053]

A. Introduction

Section 1034 of the Code defers the recognition of gain realized on the sale of a personal residence. Gain on such sale is recognized only to the extent that the amount of the "adjusted sales price"[2] of the old residence exceeds the amount reinvested by the taxpayer in a new residence within a certain time, generally beginning two years before the date of the sale and ending two years after the date of sale.[3]

Section 1034(h) of the Code provides an exception, suspending the running of the two-year period following the sale of the old residence set forth in §1034(a) during any time the taxpayer (or spouse if both old and new residences are used by both as the principal residence) serves on "extended active duty"[4] with the United States Armed Forces. Prior to the Deficit Reduction Act of 1984, the additional period allotted under this rule was limited to four years after the date of the sale of the old residence. The suspension occurs only when the military service began prior to the termination of the normal two-year replacement period as set forth in §1034(a).

B. Overview

1. Summary of Amendment

Section 1053 of the Tax Reform Act of 1984 provides that, in the case of a member of the Armed Forces who is stationed outside the United States or who is required to reside in government quarters at a remote site, the normal replacement period will not expire until the end of four years after the sale of the old principal residence, or until the taxpayer is no longer stationed outside the United States or no longer required to reside in such government quarters, whichever is later. This additional extension is not to exceed eight years.

2. Effective Date

The provision applies to sales of principal residences made after July 18, 1984.

C. Detailed Analysis

Subsection (h) of Code §1034 is amended to provide to certain members of the Armed Forces a liberalized period

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after the sale of the principal residence within which time the acquisition of a new residence may result in the nonrecognition of gain.

New §1034(h)(1) restates prior law verbatim, continuing the suspension of the running of the general, two-year replacement period provided in subsection (a), for members of the Armed Forces serving on extended active duty. As under prior law, replacement of the old residence must occur, in any event, within four years after the date of sale of the old residence.

New §1034(h)(2) provides that for members of the Armed Forces that qualify for the suspension of the running of the two-year period, such suspension will not terminate during the period that such taxpayers (1) are stationed outside the United States,[5] or (2) upon return from outside the United States are required to reside in government quarters.[6] In any event, for the nonrecognition provisions to apply, a new residence must be obtained no later than eight years after the date of sale of the old residence.

Note: The Conference report is in conflict with the statute, indicating that the normal nonrecognition period will not expire until the end of four years after the sale of the principal residence *or one year after* the member is no longer stationed outside the United States or no longer required to reside in government quarters.[7]

This explanation is consistent with the language of the provision as added to the Senate version of H.R. 4170, pursuant to a floor amendment offered by Senator Tower (R-Tex.) on April 12, 1984.[8] As agreed to, the Tower amendment would have altered section 1034(h). New section 1034(h)(2) read as follows:

> "(2) MEMBERS STATIONED OUTSIDE THE UNITED STATES OR REQUIRED TO RESIDE IN GOVERNMENT QUARTERS. In the case of any taxpayer who, during any period of time the running of which is suspended by paragraph (1) —
>
> (A) is stationed outside of the United States, or
>
> (B) after returning from a tour of duty outside of the United States and pursuant to a determination of the Department of Defense that adequate off-base housing is not available at a remote base site, is required to reside in on-base Government quarters
>
> any such period of time as so suspended shall not expire before the later of the date provided for in paragraph (1) *or the date 1 year after the date on which the taxpayer is no longer stationed outside the United States or is no longer required to reside in such on-base quarters*, described in subparagraph (B) as the case may be in either case (which period of time, as so suspended, shall not exceed 8 years).

It would apppear reasonable to allow the one year period in view of the practicalities of purchasing a residence, and no logic for altering the Tower amendment language in conference can be adduced from the legislative history. Despite this, taxpayers are advised to rely on the statutory language until the discrepancy, if unintended, can be addressed by technical corrections legislation.

Example: Sergeant York is overseas on extended active duty from January 1, 1984 until June 1, 1988. He sells his residence on January 15, 1985. Under prior law, and also under the Deficit Reduction Act, the latest date on which he can replace his old residence is January 15, 1989, four years after the sale of the old residence. However, suppose York, on his return to the United States, is required to reside in on-base barracks at a remote facilitiy in Alaska for a period of one-year. In this case, the latest date on which he can replace his old residence is June 1, 1989, the last day of the period during which he was required to live in on-base, government quarters.

Applicability of the liberalized replacement period on the basis of active duty overseas apparently requires mere documentation of such fact by the individual taxpayer. However, for members of the Armed Forces returning from overseas active duty, the Secretary of Defense must determine that adequate, off-base housing is unavailable at the "remote base site" to which they have been stationed for the more liberal replacement period to apply.

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[1] 457 U.S. 191 (1982).
[2] §1034(b).
[3] §1034(a). For a detailed analysis of the operation of §1034, *see*, 179 T.M., *Sale or Exchange of Residence*.
[4] Extended active duty, for purposes of this section, means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. §1034(h); Regs. §1.1034-1(g)(5).
[5] §1034(h)(2)(A).
[6] §1034(h)(2)(B).
[7] H. Rep. 861, 98th Cong., 2d Sess. 1269 (June 23, 1984).
[8] 48 Cong. Rec. S4536-37, (Part II), April 12, 1984.

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Chapter 31

NEW OR MODIFIED RULES APPLICABLE TO CORPORATE DISTRIBUTIONS

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I. Nonliquidating Distributions of Appreciated Property

A. Introduction

1. Prior Rules Concerning Distributing Corporation Gain

Since the Supreme Court in 1935 tacitly accepted the rule that a corporation distributing appreciated property to its shareholders did not recognize gain on the distribution,[1] there has been a steady erosion of that rule. The rule never applied to corporate distributions of appreciated property in satisfaction of a previously declared obligation to pay cash dividends.[2]

In 1954, the rule was codified by §311 of the Code, relating to dividend and redemption distributions, and by §336 of the Code, relating to liquidation distributions. However, the 1954 Code also added exceptions to the general nonrecognition rule of §311(a). These exceptions occurred where the distributing corporation distributed LIFO inventory assets to the extent that those assets would have been carried at a greater amount under FIFO rules[3] and where the distributing corporation distributed assets subject to liabilities (or where the distributee shareholder assumed liabilities in connection with a distribution) in excess of the basis of the properties distributed.[4] Since the enactment of the depreciation recapture rules, distributions of property that are subject to recapture have generated gain to the distributing corporation.[5] Distributions of installment obligations[6] and distributions of the stock of certain 10 percent-or-more owned foreign corporations[7] have also been established as exceptions to the rule of nonrecognition.

In 1969, §311(d)(1) was added providing that a corporation distributing in redemption property having a fair market value greater than its adjusted basis recognizes gain to the extent of the excess. This rule, when originally enacted, had several exceptions to it codified in §311(d)(2). For example, distributions pursuant to redemptions terminating the interests of more-than-10 percent shareholders and certain distributions of the stock of more-than-50 percent owned subsidiaries did not trigger recognition of gain under §311(d). In 1982, the Tax Equity and Fiscal Responsibility Act eliminated the first, and significantly narrowed the second, of the two exceptions to §311(d)(1) described in the preceding sentence. TEFRA, however, added, among other new exceptions, a provision that distributions of appreciated property in redemption of the shares of U.S. corporate shareholders did not cause the distributing corporation to recognize gain if the distribution was treated under §302(d) as a §301 distribution.

Until the TRA 1984, actual distributions under §301 — those in which no stock is surrendered in exchange for the property distributed, as opposed to distributions in redemption treated as §301 distributions — have not been subject to the general rule that distributions of appreciated property generate gain to the distributing corporation. Such distributions have been, however, fully subject to the rules relating to LIFO reserves, liabilities in excess of basis and the other exceptions to §311(a) nonrecognition treatment.

2. Prior Rules Concerning Distributees' Holding Period

Prior to the enactment of the TRA 1984, an individual shareholder to whom property was distributed as a dividend or in redemption of stock generally began his holding period in such property on the date of distribution. On the other hand, the holding period that a corporate shareholder took in property that was distributed to it as a dividend or in redemption of stock depended upon whether the fair market value of the property was greater than or less than the distributing corporation's adjusted basis in the property (plus gain recognized by the distributing corporation on the distribution).

If the property so distributed had a fair market value less than its adjusted basis (plus any gain recognized by the distributing corporation), the corporate shareholder took the lower fair market value basis and thus began its holding period with respect to the property distributed on the date of distribution.[8] However, if the property so distributed at a fair market value greater than its adjusted basis (plus gain recognized by the distributing corporation) — in general, had appreciated in value, or if depreciation deductions had been taken, the corporate shareholder took the distributing corporation's adjusted basis in the property (plus any gain recognized by the distributing corporation on the distribu-

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tion) and could tack on the distributing corporation's holding period.[9]

Thus, where a corporation purchased the stock of a second corporation which caused the second corporation to distribute to the first corporation property that had appreciated in value and that the acquired corporation had held for more than one year, the purchasing corporation could resell the property and take long term capital gain on the built-in gain. This would be true even if the sale occurred less than one year after the corporation had received the property or had made the stock acquisition. This permitted U.S. corporations to purchase stock in corporations about to declare dividends of appreciated property, such as oil royalty trusts, receive the property as a dividend subject to the maximum 6.9 percent effective rate of tax on intercorporate dividends, sell the stock at a short term capital loss and either sell the property dividend for a long term capital gain or contribute such property to charity and take a charitable deduction equal to the fair market value of the property.[10]

B. Overview

TRA 1984 modified the rules relating to the taxation of gain to corporations making nonliquidating distributions of appreciated property. Corporations distributing appreciated property in §301(a) distributions are now generally taxed on such gain unless these distributions are to certain 10 percent individual shareholders and consist of either "qualified dividends" or more than 50 percent of the value of certain corporations engaged in active trades or business. Corporations distributing appreciated property to corporate shareholders in redemptions treated as §301(a) distributions are now subject to tax on the gain realized. Gain recognized under §311(b) or (c) now takes priority over gain recognized under §311(d).

TRA 1984 also limited the holding period of corporate shareholders in appreciated property distributed in distributions governed by §301(a). Where a distributing corporation recognizes gain on such a distribution under §311(d)(1), a corporate distributeee now begins its holding period on the date of the distribution. Where a distributing corporation does not recognize such gain under §311(d)(1), a corporate distributee now begins its holding period on the date it acquired the stock on which the distribution was made.

C. Detailed Analysis

1. Gain of Distributing Corporation

a. Legislative History

The House and Senate bills [11] expanding the recognition of gain to distributing corporations on non-liquidating distributions of appreciated property were substantially identical. The committee reports accompanying the bills explain that, in a system in which corporate earnings are taxed twice, a corporation that distributes appreciated property should be treated the same as one that sells the property and distributes the proceeds to its shareholders.[12]

(i) Dividend Distributions

Both bills would have required corporations distributing as a dividend property having a fair market value in excess of its adjusted basis in general to recognize the excess as gain from the sale or exchange of the distributed property. One exception to this rule in both bills would have been for dividend distributions to U.S. corporate shareholders who owned at least 80 percent of the voting stock and of the non-voting stock of the distributing corporation.

A second exception contained in the bills to the rule of income recognition would have been for "qualified dividends," *i.e.*, (i) dividend distributions (ii) to noncorporate shareholders holding at least 10 percent of the corporation's stock for at least five years (or throughout a less-than five year old corporation's existence) (iii) of property used by the distributing corporation in the conduct of a business carried on for last five years prior to the distribution. Under this exception, inventory (property held for sale in the ordinary course of the distributing corporation's business) and accounts receivable with respect to the performance of services or the sale of inventory or property held for sale to customers would be excluded from the type of property that could be distributed without tax to the distributing corporation even if such property were used in that corporation's business.

A third exception contained in both bills would have been for distributions of appreciated stock in a corporation more-than-50 percent owned by the distributing corporation before the distribution if the corporation whose stock was distributed had been engaged in the active conduct of a trade or business for the last five years prior to the distribution.

(ii) Redemption Distributions

Both the House and Senate bills would have retained most of the pre-TRA 1984 rules in §311(d) respecting distributions of appreciated property in redemptions. Those rules exempted distributing corporations from gain recognition on §302(d) redemption distributions of appreciated property to any corporate shareholder.[13] However, both bills would have substantially limited this exception and taxed the distributing corporation on any gain realized on a redemption distribution to a corporate shareholder unless such shareholder owned at least 80 percent of the voting shares and 80 percent of the non-voting shares of the distributing corporation.

(iii) Priority of Section 311(d)

Where §311(d) applied, under both the House and Senate bills, it would have applied only after the application of §311(b), which imposes a tax on a corporation distributing inventory which had been accounted for on a LIFO basis to the extent of the LIFO reserve amount on such property, and §311(c), which imposes a tax on a corporation distributing property subject to a liability to the extent that the liability assumed or to which the property was subject exceeded the adjusted basis of the property. The committee reports accompanying the House and Senate bills provide an example of the application of this new priority rule indicating that its effect would be to impose a tax on the maximum amount of gain recognized under subsections 311(b) through (d).[14] Under pre-TRA 1984 law, application of §311(d) was to the exclusion of §311(b) and (c).

(iv) Effective Dates and Transition Rules

The House and Senate bills differed on effective dates and transition rules. Section 54(d) of H.R. 4170, which

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passed the House, would have made the new rules effective for distributions declared after the date of enactment. The House bill contained one exception, for pre-February 1986 distributions of interests in a royalty trust by a corporation whose stock was owned on February 1, 1984 at least 10 percent by a group of shareholders that acquired between February 1983 and February 1984 at least 10 percent of the stock of a corporation control of which the distributing corporation acquired during the same period.

Section 36(b) of the Senate amendment to H.R. 4170 would have made its new rules expanding the taxation of gain on distributions of appreciated property effective for distributions declared after March 15, 1984. The Senate amendment would have expanded the House exceptions for royalty trust distributions to include distributions of any property following a proposal to distribute royalty trust interests. The Senate amendment would also have exempted pre-February 1986 distributions of interests in certain publicly traded partnerships and certain distributions declared prior to enactment of the bill of no more than 51 percent of the stock of corporations controlled by the distributing corporation where the distribution was considered before February 15, 1982.[15]

b. Enacted Provision

(i) Conference Committee Changes

Section 54 of the TRA 1984 adopts the substance of the House and Senate bills expanding the scope of §311(d)(1) of the Code, with one major exception. Unlike the bills passed by the two chambers, the TRA 1984 does not exempt distributing corporations from tax on dividends or redemptions of appreciated property to corporate shareholders owning at least 80 percent of the voting and nonvoting stock of the distributing corporation. The conference report explained that such an exception would have continued to permit the shifting from subsidiary to parent corporations of the gain on such distributed property and the transformation of that gain from ordinary to capital. Moreover, the report noted that, under the House and Senate exception, corporations that acquired at least 80 percent of the stock of another corporation could continue to defer income recognition by having the acquired corporation distribute to it appreciated assets while recognizing losses — either directly by selling the stock of the acquired corporation (the value of which would be reduced by the value of the distributed assets),[16] or indirectly, by having the acquired corporation sell the assets which had adjusted bases greater than their fair market value.[17] The report also noted that the conferees anticipated that the IRS would consider what, if any, amendments to the consolidated return regulations would be necessary to take into account the rule that dividend distributions of appreciated property from 80 percent controlled subsidiaries were generally taxable to such subsidiaries.[18]

Thus, in the aftermath of TRA 1984, the "general rule" is that nonliquidating distributions, whether or not in exchange for the surrender of stock, of appreciated property are taxable to distributing corporations as if those corporations had sold or exchanged the property prior to the distribution.

(ii) Dividend Distributions

Under the new rules, distributions of appreciated property as dividends will now subject the distributing corporation to tax with two exceptions. First, "qualified dividends" — distributions of property used by the distributing corporation in the active conduct of a trade or business carried on for more than five years by it (or by one from whom it acquired the business other than by purchase) to a noncorporate shareholder who has held at least 10 percent of the distributing corporation's stock for at least five years, (or throughout the existence of a less-than five-year old corporation) — do not subject the distributing corporation to tax under §311(d)(1).[19] However, they could subject it to tax under §311(b) or (c). Distributions of inventory, property held for sale to customers in the ordinary course of business and accounts receivable for such property or for services rendered — even if used in the distributing corporation's trade or business — do not qualify for this exception.

> *Example:* Corp. D has been engaged in the real estate rental business continuously since 1978. In 1985, it distributes as a dividend a rental building not held for sale to customers that has a fair market value of $2 million, an adjusted basis of $1 million and is subject to $1.5 million of debt. The recipient is R, an individual shareholder who has held 50 percent of the stock of Corp. D since 1978. Even though the fair market value of the building exceeds Corp. D's adjusted basis in it by $1 million, Corp. D is not subject to tax under §311(d), because the distribution is a "qualified dividend." However, Corp. D would be subject to tax under §311(c) on the $500,000 by which the amount of debt to which the building is subject exceeds Corp. D's adjusted basis in the building. Moreover, had R not been an individual but an S corporation (or a C corporation), Corp. D would have been subject to tax under §311(d) as well as under §311(c).

The second exception to the general rule of recognition of gain applies to distributions to noncorporate shareholders who have owned at least 10 percent of the value of the distributing corporation's stock for at least five years (or throughout the existence of less-than five-year old corporations) of stock or obligations of corporations that, prior to the distribution, were owned more than 50 percent by the distributing corporation. This exception does not apply, however, unless (1) substantially all of the controlled corporation's assets are used in an active trade or business and (2) no substantial part of such controlled corporation's assets were acquired from the distributing corporation in a §351 exchange or as a capital contribution within five years.[20] This exception is simply an adaptation to dividend distributions of a pre-TRA 1984 exception to recognition of gain on redemption distributions.

Note: If the distributee shareholder sells or exchanges the distributed property shortly after the distribution, the IRS could assert that the sale or exchange should be attributed to the distributing corporation under the *Court Holding* doctrine,[21] in which case the above exception would not apply.

Because §311(d)(1) does not apply to distributions of appreciated property in liquidation, it may create additional incentives for liquidation-reincorporation transactions in

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which appreciated property not wanted or needed in a corporation's business is distributed to its shareholders along with assets needed in the business, where these latter assets are subsequently transferred to one or more new corporations. Needless to say, the Service would be quick to recharacterize such transactions as reorganizations under §368(a)(1)(D) or (F), with the property not transferred to a new corporation taxable to the distributee shareholder under §356.[22]

However, it is at least arguable that §356 distributions do not come within the purview of §311(d), which by its terms applies only to distributions under sections 301-307. Indeed, the Service has taken the position that, based on the legislative history of §311(d) when originally enacted in 1969, the provision does not apply to distributions under §§354-56.[23] On the other hand, Regs. §1.311-2(a)(2) — while providing that generally §311(d) does not apply to distributions under sections 355 and 356 — states "if the distribution is in substance a redemption, §311(d) will apply." Moreover, the Service has also taken the position that §301 — not §356 — applies in liquidation-reincorporation situations.[24] If §301 were the operative provision, §311(d) would by its terms apply.

Finally, section 356 distributions may subject the distributing corporation to gain recognition under section 1001, as the Service held in Rev. Rul. 72-327, 1972-2 C.B. 197.

The interaction of the §311(d)(1) rules and TRA 1984 amendments to §338 result in a deemed §338 election where a purchase of at least 80 percent of the stock of a target corporation in a "qualified stock purchase" is followed less than one year later by a dividend distribution of appreciated property from the target corporation. Prior law permitted such a distribution without triggering a deemed election but the acquiring corporation took as its basis in the distributed property the distributing corporation's adjusted basis.

Revised §311(d)(1), by imposing a tax on corporations distributing as dividends appreciated property, causes corporate distributees of such property to take as their basis therein the distributing corporation's adjusted basis plus gain recognized on the distribution.[25] Section 338(e)(2)(B), as revised by TRA 1984 §712(k)(3)(A), provides in effect that a distribution to an acquiring corporation or its affiliate from a target corporation that was the subject of a "qualified stock purchase" triggers a deemed §338 election, unless the distributee's basis in the distributed property is the same as the distributing corporation's adjusted basis. However, there is language in the conference report concerning the changes to §338(e)(2). This language suggests that regulations could provide that a dividend distribution from a target corporation within the one-year post-acquisition date consistency period would not trigger a deemed election if the acquiring corporation agreed to take the target corporation's adjusted basis in the distributed property.[26] However, the distributing corporation would presumably still have to recognize gain under §311(d)(1) on such a distribution.

It would appear that the §311(d) rules, along with the new rules enacted by TRA 1984 §54(b) governing the holding period for appreciated property received in nonliquidating distributions by corporate shareholders, narrow the scope of the nonrecognition rule of §1248(f)(2) with respect to §311 distributions by U.S. corporations of at least 10 percent of the stock in foreign corporations to U.S. corporate shareholders. The new rules may also cause gain recognition to such distributing corporations in the absence of earnings and profits.

Section 1248(f)(1) states the general rule that, notwithstanding any other provision in the income tax laws, the excess of the fair market value over the adjusted basis of stock in a foreign corporation owned at least 10 percent by a U.S. corporation distributed in a §311 distribution is taxed as a dividend to the U.S. distributing corporation to the extent of the foreign corporation's earnings and profits while owned by the distributing corporation. Section 1248(f)(2) provides that §1248(f)(1) "does not apply" to distributions to U.S. corporate shareholders which take a tacked on holding period in such stock and which, after the distribution, own at least 10 percent of the stock of the foreign corporation.

Although where §311(d)(1) gain is not recognized on a dividend distribution (or a distribution treated as a dividend by virtue of §302(d)) of appreciated stock in a 10 percent-or-more foreign subsidiary, the U.S. corporate distributee tacks on the distributing corporation's holding period, new §301(e)(1) requires a holding period where §311(d)(1) applies to the distribution. It should be noted, however, that in many cases §311(d)(1) will not apply because the exception in §311(d)(2)(B) for distributions of stock of 50 percent owned subsidiaries engaged in 5-year businesses will take precedence.

(iii) Redemption Distributions

In the aftermath of the TRA 1984, distributions of appreciated property in redemption of stock subject the distributing corporation to tax, with six exceptions — five of which were part of pre-TRA 1984 law.[27]

Thus, one major change wrought by the TRA 1984 in this area is the elimination of the prior law exception to gain recognition for distributions in redemption of corporate shareholders if such redemptions are taxed to the corporate shareholders under sections 302(d) and 301. Application of the new rule that such distributions subject the distributing corporation to tax apparently affect not only direct redemptions but also §304 acquisitions of stock of commonly controlled corporations in exchange for appreciated property. Although one could argue that a §304 acquisition is not an actual redemption and thus that §311 does not apply, the Service in regulations has stated otherwise.[28] Of course, if §311(a) did not apply, the acquiring corporation's gain would be recognized under §1001 in any event.

A second change was introduced by §54(a)(2)(A) of TRA 1984. That section adds as §311(d)(2)(A)(ii) a new exception to gain recognition for "qualified dividends" distributed to noncorporate shareholders. This exception applies not only to actual dividends but also to certain redemption distributions treated as dividends by §302(d).[29] For a redemption distribution to a noncorporate shareholder that is taxed to the shareholder as a dividend to be considered a "qualified dividend": (1) the distributee shareholder must have held at least 10 percent of the value of the

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distributing corporation's stock for the lesser of five years or the existence of the corporation and (2) the property must be property — other than inventory, property held for sale to customers in the ordinary course of business or certain receivables the collection of which would yield ordinary income — used by the distributing corporation in the active conduct of a trade or business that has been carried on for at least five years and was not acquired by purchase within five years before the distribution.

Example: Corp. D has been engaged in the active conduct of a business since 1978 and has current and accumulated earnings and profits totalling $200. Corp. D has 100 shares of common stock outstanding, which have been held since 1978 by the following unrelated shareholders: 50 shares have been held by individual T and 10 shares each have been held by individuals V, W, X, Y, and Corp. Z. On July 1, 1985, Corp. D redeems 10 shares of stock from each of T and V, distributing to each property that is not inventory, held for sale to customers or receivables having a $100 fair market value and a $70 adjusted basis in Corp. D's hands, and redeems three shares of Corp. Z's stock, distributing to it similar property having a $30 fair market value and a $21 basis. Corp. D does not qualify for the "qualified dividend" exception to gain recognition with respect to the distribution to V because the distribution to V is not a dividend to him but a §302(b)(3) redemption. The distribution might qualify for the exception to gain recognition for distributions in partial liquidation, however, depending on whether the distribution is attributable to Corp. D's ceasing to conduct a trade or business it had conducted for the previous five years. Corp. D does not qualify for the "qualified dividend" exception with respect to the distribution to Corp. Z, even though the distribution is probably treated as a dividend under §302(d), because Corp. Z is not a noncorporate shareholder. Corp. D would qualify for the "qualified dividend" exception with respect to the distribution to T because such distribution would be taxed to T under §§302(d) and 301 and T is an individual.

Note: In order for the "qualified dividend" exception to apply, not only must the distribution be taxable to the distributee shareholder under §302(d), but the distributing corporation must have current or accumulated earnings and profits so that the distribution is taxed as a dividend. Absent the TRA 1984 amendment adding §312(n)(4), it would have been impossible in certain cases to determine whether a distribution was a "qualified dividend" because that determination can be dependent on whether the distributing corporation will generate earnings and profits as a result of the distribution. Section 312(n)(4) provides that a distributing corporation's earnings and profits are increased by the amount of gain that would have been recognized under §311(d) but for the application of §311(d)(2). Where an otherwise "qualified dividend" is taxed to the distributee shareholder in part as dividend and in part as a return of capital or a capital gain distribution, it would appear that the portion of the gain realized on the distribution that would not be recognized under the exception would be the same portion of the distribution that would be treated as a dividend.

Example: Assume the same facts as in the previous example, except that Corp. D has $100 in earnings and profits and distributes pro rata to each of its shareholders property that is not §1221(1) or §1221(4) property having an aggregate fair market value of $200 and an aggregate adjusted basis of $140. As a result of the distributions, Corp. D's earnings and profits are increased by $60 to $160 under §312(n)(4). Because 80 percent of the distributions to T, V, W, X and Y are "qualified dividends," it would appear that 80 percent of the gain realized by Corp. D on such distributions would escape tax.

(iv) Priority of Section 311(d)

The conference committee retained the rule in the House and Senate bills that §311(d) is applied after the application of §311(b) and (c). Thus, if the amount of LIFO reserves or the excess of liabilities over basis of properties distributed as a dividend or in redemption exceeds the gain on those properties, the amount of such reserves or excess will be taxed to the distributing corporation.

(v) Effective Date and Transition Rules

The conference committee made the new rules expanding the types of nonliquidating distributions of appreciated property that are subject to tax under §311(d)(1) effective for distributions declared on or after June 14, 1984, with four exceptions.[30] Two of those exceptions were the two exceptions contained in the Senate amendments for certain pre-February 1986 distributions following a proposal to distribute interests in a royalty trust [31] or of partnership interests that were publicly traded on a national securities exchange.[32] A third exception, added in the conference, would exempt from §311(d)(1) treatment pre-September 1986 distributions of stock of a corporation that, on June 15, 1984, was affiliated with the distributing corporation if a tender offer for the stock of the distributing corporation was begun on May 23, 1984 and amended the next day.[33]

A more general exception to the effective date for the new §311(d)(1) rules was enacted for pre-1985 distributions of appreciated property to a U.S. corporate shareholder that owns at least 80 percent of the voting shares and at least 80 percent of all nonvoting shares of the distributing corporation if the distribution is, or is a redemption treated as, a §301(a) distribution.[34] This exception somewhat eases the burden of the deletion from the final bill of the exception from §311(d)(1) treatment for distributions to 80 percent corporate shareholders.

2. Distributees' Holding Period

a. Legislative History

Section 54(b) of H.R. 4170, passed by the House of Representatives, and §35(c) of the Senate amendment thereto both would have added a new §301(e) to provide that U.S. corporate shareholders whose basis in distributed property is measured by the distributing corporation's adjusted basis in such property (plus gain recognized to the distributing corporation on the distribution) would not be treated as holding that property prior to the date that they held the stock on which the dividend was paid. The committee reports accompanying the bills cited the anomaly of a corporation purchasing stock in another corporation that owned appreciated property, having the acquired corporation distribute the appreciated property — which could

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then be sold for a long-term capital gain or be contributed to charity — and selling the stock for a short term capital loss. The reports thus concluded that such transactions should be treated as two transactions: (1) the purchase of the stock and (2) the purchase of the property that was distributed as a dividend.[35]

b. Enacted Provision

(i) Substantive Changes

The formulation used in the House bill and the Senate amendment arguably would not have operated to restrict the holding period of corporate distributees in appreciated property on which the distributing corporation recognized gain. The basis of a corporate distributee in distributed property received in a §301(a) distribution is the lesser of the fair market value of the property or the distributing corporation's adjusted basis in such property plus any gain recognized to the distributing corporation on the distribution.[36] Where the distributing corporation recognized gain on a distribution under §311(d)(1), as modified by the TRA 1984, the fair market value of the property and the sum of the distributing corporation's adjusted basis plus gain recognized on the distribution would be the same.

As a result of this possible ambiguity, the conference committee modified the House and Senate versions of §301(e) to provide that, where property on which a distributing corporation recognizes gain under §311(d)(1) is distributed to a corporate shareholder, the distributee corporation's holding period begins on the date of the distribution. Where gain is not recognized under §311(d)(1) and the corporate shareholder takes as its basis in the property the distributing corporation's adjusted basis, then — except for purposes of §1248 — the distributee corporation's holding period in the property cannot begin before the date it acquired the stock on which the distribution was made.[37]

Example: Corp. X purchases the stock of Corp. D on January 1, 1985. On February 1, 1985, Corp. D distributes to Corp. X as a dividend property that is not stock or an obligation of a subsidiary and that has a fair market value of $100 and an adjusted basis in Corp. X's hands of $50. Because Corp. D recognizes gain under §311(d)(1) on the distribution, Corp. X's holding period with respect to the distributed property would begin February 1, 1985. If Corp. D had made a distribution that, under §311(d)(2)(B) avoided tax, Corp. X's holding period would have begun January 1, 1985.

Note: The impact of the new rules relating to a corporate distributee's holding period in appreciated property distributed to it is somewhat lessened by the TRA 1984 rule reducing the minimum holding period for long-term capital gain treatment from one year to six months.

One possible ambiguity in the new §301(e) rules concerns their application when a distributing corporation realizes gain that is potentially taxable under §311(d) as well as either §311(b) or (c). As §311(d)(1) is worded, where the amount realized under §311(d)(1) is the same as the amount realized under §311(b) or (c), §311(b) or (c) — whichever is applicable — would be the provision governing recognition. It would thus appear that §301(e)(2), which provides for a holding period in distributed property no greater than the holding period in the stock on which the distribution was made, and not §301(e)(1), the property acquisition date holding period rule, would govern.

However, it is arguable that neither §301(e)(1) nor §301(e)(2) applies where the result of the application of §311(b) or (c) is to give the corporate distributee a basis in the distributed property equal to its fair market value; *i.e.*, where the FIFO value of the distributed property or the liability to which such property is subject is the fair market value of that property. If §301(e) did not apply in such a case, the distributee corporation could tack on the distributing corporation's holding period. Although a similar possibility that corporate distributees of §311(d)(1) distributions would argue that the holding period limitations would not have applied led the conference committee to provide explicit holding period rules where §311(d) applies, that argument may not have much weight. To argue that §301(e)(2) does not apply, a corporate distributee of a §311(b) or (c) distribution would have to take the position that its basis was not in part a carryover basis but was instead a §301(d)(2)(A) fair market value basis. But, if so, the corporate distributee would not get the protection of the §1223(2) tacked-on holding period and would fall under the general rule that its holding period began on the date of the distribution.

(ii) Effective Date

The changes limiting a corporate distributee's holding period in appreciated property received in a §301(a) distribution apply to property distributed after July 18, 1984, the date that the TRA 1984 was enacted.[38]

II. New Rules for Computing Earnings and Profits

A. Introduction

1. Background

Under §§301 and 316 of the Code, a distribution by a corporation to its shareholders is treated as a dividend — and, thus, is taxable to the shareholders at ordinary income rates — only to the extent the distribution is out of current or accumulated earnings and profits. Distributions in excess of earnings and profits are treated as a return of capital and reduce the shareholder's basis in his or her share of stock.[39] Distributions in excess of basis are treated as gain from the sale or exchange of the stock.[40]

In general, a corporation's earnings and profits are intended to be a measure of the economic income of the corporation available for distribution to its shareholders. In calculating earnings and profits, the corporation's taxable income is the usual starting point. To derive earnings and profits from taxable income, the latter is adjusted to eliminate items of income and deduction which are based solely upon decisions of tax policy rather than upon their actual economic or financial impact. In addition to eliminating taxable income items of this nature, certain other items are added to the computation of earnings and profits even though they are excluded from or are not involved in the computation of taxable income.

Because many of the rules applicable in determining taxable income are applicable to some extent in determin-

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ing earnings and profits, a corporation's earnings and profits may be less than its "true," or economic, income. Prior to TRA 1984, the disparity between earnings and profits and economic income could be substantial. For example, under prior law, an oil and gas corporation could reduce its earnings and profits each year by the amount of intangible drilling costs it deducted from taxable income even if such costs led to the creation of an asset that would last several years. Because the corporation was not required to capitalize the costs of the asset, it was possible that it would have economic earnings available for distribution to the shareholders but no earnings and profits for tax purposes.

Another example of the possible disparity between earnings and profits and economic income under prior law involved corporate sales of appreciated assets. If the selling corporation reported the gain on the installment method, it was required to increase its earnings and profits in the year of sale and in subsequent years only by an amount equal to the portion of the realized gain that was recognized in each year. In this situation, a distribution by the corporation to its shareholders could be treated as a dividend under state law although, for federal income tax purposes, it might be treated as a return of capital.

The Code does not contain a comprehensive definition of earnings and profits. Section 312 of the Code, however, prescribes certain adjustments to the earnings and profits determination. One adjustment is set forth in §312(e), which deals with the effect on earnings and profits of a distribution in redemption of stock. Section 312(e) provides that the part of the distribution that is "properly chargeable" to the capital account of the distributing corporation does not reduce earnings and profits. Some cases have held, and the IRS has ruled, that a corporation's capital account is an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus, and that this amount is reduced in proportion to the amount of the corporation's stock that is redeemed. Under this approach (which is changed by TRA 1984), earnings and profits are reduced by an amount equal to the amount of the distribution over the amount charged against capital account.[41]

This approach may result in an excessive reduction of earnings and profits. Assume, for example, that X corporation has 1,000 shares of $10 par value stock outstanding, and that A and B each acquired 500 of the shares upon their issuance at a price of $20 per share. Assume further that X corporation, which has operated a profitable services business since its inception, holds net assets worth $100,000 consisting of cash ($50,000) and appreciated improved real property ($50,000), and has current and accumulated earnings and profits of $50,000. If X corporation distributes $50,000 in cash to A in complete redemption of A's shares in X corporation, the distribution, under the approach in question, would be charged first against X corporation's capital account, reducing it by $10,000. The remaining $40,000 would reduce earnings and profits. After the transaction, X corporation would have $10,000 of earnings and profits. A would generally have no dividend income from the redemption. Thus, although A has no dividend income and although he received only half of the corporation's net assets, its earnings and profits are reduced by 80 percent.

2. Reasons for Change

Congress believed that a disparity between a corporation's earnings and profits and its economic income resulted in an "unintended tax benefit" being passed through to the shareholders of the corporation. Additionally, Congress was concerned that a distribution in redemption of stock "can offset more than a proportionate share of the earnings and profits of the distributing corporation." This lack of proportionality was especially disturbing to Congress since redemptions can be taxable to the shareholder as capital gain.

The general goals of Congress in enacting the legislation discussed below were "to ensure that a corporation's earnings and profits more closely conform to its economic income" and to provide that, in the case of a redemption of stock, the distributing corporation's earnings and profits are generally reduced in proportion to the outstanding stock redeemed.

B. Overview

Act §61 amends §312 of the Code by adding a new subsection (n) thereto. The new subsection prescribes a number of adjustments to the earnings and profits determination. As stated above, the purpose of the adjustments is to make earnings and profits conform more closely to true or economic income of the corporation. The adjustments required under new §312(n) change the effect on earnings and profits of the following items and transactions: construction period carrying charges; intangible drilling costs and mineral exploration and development costs; the amortization provisions of §§173, 177 and 248; certain untaxed appreciation of distributed property; LIFO inventory adjustments; installment sales; completed contract method of accounting; and redemptions.

Act §61 amends §312(k)(3)(A) to adjust the effect on earnings and profits of ACRS deductions for real property. Act §61 also amends §312(a)(2) to adjust the effect on earnings and profits of distributions of obligations having original issue discount. In connection with this latter adjustment, Act §61 modifies new §1275 (added to the Code in Act §41) to provide that discount obligations issued and distributed by a corporation with respect to its stock are to be subject to the original issue discount rules.

Finally, Act §61 adds a new subsection (f) to §301. The new subsection prescribes special rules for determining stock basis and taxable income in the case of certain distributions received by 20-percent corporate shareholders with respect to their stock. With exceptions, the new provisions are effective after September 30, 1984.

C. Detailed Analysis

1. Section 312(n): Adjustments to Earnings and Profits to More Accurately Reflect Economic Gain and Loss

Section 312(n), added to the Code in Act §61, prescribes eight adjustments to the earnings and profits determination. The adjustments are designed to make earnings and profits a more accurate reflection of the economic gains and losses of the corporation. Each of the adjustments is discussed below.

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a. Construction Period Carrying Charges

Section 312(n)(1) provides that for purposes of computing earnings and profits, no deduction is allowed for any amount paid or incurred as a "construction period carrying charge." Such charges must be capitalized as a part of the asset to which they relate and written off as is the asset itself. A construction period carrying charge includes property taxes (real and personal), interest paid or accrued on debt incurred or continued to acquire, construct, or carry property, and other carrying charges, but only to the extent such taxes, interest, and other carrying charges are attributable to the "construction period" for the property. The term "construction period" generally means the period beginning on the date on which construction or acquisition begins and ending on the date on which the item of property is ready to be placed in service or held for sale by the taxpayer. In the case of real property, the construction period commences with the date on which the construction or acquisition of a building or other improvement begins and ends on the date that the building or improvement is ready to be placed in service or is ready to be held for sale.

Section 312(n)(1) applies to all corporations. Further, it applies with respect to both residential and nonresidential real property, and to personal property.

The discussion of the provision in the Senate Report contains instructions for the Treasury on how to issue regulations allocating expenditures to the construction period and among different properties:

> "The committee expects that these regulations generally will adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34, as amended. For example, under those rules, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction and interest costs incurred by reason of borrowings that otherwise could have been repaid with funds expended for construction."

Section 312(n)(1) is effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

b. Intangible Drilling Costs and Mineral Exploration and Development Costs

Section 312(n)(2)(A) provides that for purposes of computing earnings and profits, intangible drilling costs incurred in connection with a productive well are to be capitalized and allowed as a deduction ratably over the 60-month period beginning with the month in which production from the well begins. Section 312(n)(2)(B) provides that mineral exploration and development costs allowable as a deduction under §616(a) or 617 are to be capitalized for purposes of computing earnings and profits and deducted ratably over a 120-month period beginning with the later of (1) the month in which production from the deposit begins or (2) the month in which the amount is paid or accrued.

The legislative history of the provision indicates that, in the case of a dry well, intangible drilling costs are to be deducted in computing earnings and profits when it has been determined that the well is dry. The legislative history also indicates that in the case of unproductive mineral property, exploration and development expenses incurred in connection with the property are to be deducted in computing earnings and profits when the property is abandoned.

Section 312(n)(2) is effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

c. Certain Trademark, Trade Name and Other Expenditures

Section 312(n)(3) provides that for purposes of computing earnings and profits, certain amortization provisions are not to apply. Specifically, amounts amortized in computing taxable income under §§173 (relating to circulation expenditures), 177 (relating to trademark and trade name expenditures), and 248 (relating to organizational expenditures) are, for purposes of computing earnings and profits, to be capitalized and treated as part of the basis of the asset to which they relate. Thus, expenditures made in connection with an asset having a reasonably determinable useful life are to be recovered for earnings and profits purposes over such useful life. Conversely, there will be no amortization for expenditures made in connection with an asset which does not have a reasonably determinable limited useful life.

Section 312(n)(3) is effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

d. Certain Distributions of Appreciated Property

Under §312(n)(4), in the case of a distribution of appreciated property by a corporation to a shareholder, earnings and profits of the corporation are to be increased by the amount of gain on the distributed property that is realized by the corporation on the distribution even if such gain qualifies for nonrecognition, for taxable income purposes, under §311(d)(2). This rule does not apply, however, to a distribution in complete liquidation of the distributing corporation. It also does not apply to any distribution to which §§301 through 307 are not applicable or to a distribution to corporate shareholders described in §311(d)(2)(A) (as amended by Act §54).

Section 312(n)(4) is generally effective for distributions after September 30, 1984. The provision does not apply, however, to any distribution to which the amendments made by Act §54(a) do not apply.

e. LIFO Inventory Adjustments

Under §312(n)(5), a corporation's earnings and profits are to be increased by the amount of any increase in the corporation's LIFO reserve for a taxable year. Conversely, any decrease in the amount of a corporation's LIFO reserve will generally decrease earnings and profits. Decreases in reserve amounts below the LIFO reserve as of the beginning of the first taxable year of the taxpayer to which this provision applies, however, will not, except as provided by regulations, reduce earnings and profits. The rationale for this exception is explained in the legislative history:

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"An exception is to be provided, under regulations, for decreases below the amount of the reserve as of the close of the taxable year of the taxpayer preceding the first taxable year to which the provision applies. Since the cumulative effect of the LIFO reserve has been to keep earnings and profits lower than they otherwise would have been, it is contemplated that the regulations will provide that in the event of a reduction in the LIFO reserve below its level as of the close of such taxable year (the pre-enactment reserve), earnings and profits will be increased as under present law *without any offsetting reduction under the new rules.*" (emphasis added)

Section 312(n)(5) applies to taxable years beginning after September 30, 1984. The mechanics of its application are illustrated in the following example. Assume that a calendar year taxpayer has a LIFO reserve of $100 at the end of 1984. Assume further that the reserve decreases to $95 at the end of 1985 and increases to $105 at the end of 1986. Finally, assume that the reserve decreases to $90 at the end of 1987. Pursuant to the exception for decreases in the reserve below the pre-enactment level, the change in the reserve for 1985 results in no adjustment under §312(n)(5). The increase in the reserve for 1986 results in a $10 increase in earnings and profits under the provision. The $15 reduction in the reserve for 1987 results in a $10 reduction in earnings and profits under the provision.

Note: The adjustment for 1987 is $10 and not $15 because §312(n)(5) does not require an adjustment to offset the inclusion in earnings and profits of reserve amounts not previously included in earnings and profits. Five dollars of the $15 decrease in the LIFO reserve for 1987 reflects an amount of the pre-enactment reserve which, prior to 1987, had not been included in earnings and profits.

f. Installment Sales

Section 312(n)(6) provides that in the case of any installment sale, earnings and profits are to be computed as if the corporation did not use the installment method. Thus, all principal payments, as determined under general Code principles, are to be treated as received in the year of sale.

The legislative history of this provision states that it applies to all installment sales, including installment sales of inventory. The provision is effective for sales after September 30, 1984.

g. Completed Contract Method of Accounting

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under §312(n)(7), a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis. Under this latter method, income is generally recognized according to the percentage of the contract that is completed during each taxable year.

Section 312(n)(7) applies to contracts entered into after September 30, 1984 in taxable years ending after that date.

h. Redemptions

Section 312(n)(8) provides that if a corporation distributes amounts in a redemption which qualifies for sale or exchange treatment under §302 or §303, the corporation's earnings and profits are to be reduced by an amount "which is not in excess of the ratable share of the earnings and profits of such corporation . . . attributable to the stock so redeemed." Under this provision, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. The reduction in earnings and profits so determined, however, is limited to the amount distributed in redemption. That is, the reduction is not to exceed this amount.

The application of §312(n)(8) is illustrated in the following example. Assume that X corporation has 1,000 shares of $10 par value stock outstanding, and that A and B each acquired 500 of original issue shares at a price of $20 per share. Assume further that X corporation, which has operated a profitable services business since its inception, holds net assets worth $100,000 consisting of cash ($50,000) and appreciated improved real property ($50,000), and has current and accumulated earnings and profits of $50,000. If X corporation distributes $50,000 in cash to A in redemption of A's shares in X corporation, earnings and profits and capital account would each be reduced by $25,000. After the transaction, X corporation would have $25,000 of earnings and profits.

The legislative history of §312(n)(8) indicates that when a corporation has more than one class of stock, its earnings and profits generally should be allocated among the different classes in determining the amount by which redemption of all or a part of one class reduces the earnings and profits account. This general rule, however, is subject to an exception: no earnings and profits generally should be allocated to preferred stock which is not convertible or participating to any significant extent in corporate growth. In the case of a redemption of such preferred stock, the distribution should be charged to capital account only, unless the distribution includes dividend arrearages. If dividend arrearages are included, earnings and profits should be reduced by the amount of the arrearages.

The legislative history also indicates that priorities "legally required" as between different classes of stock may be taken into account in allocating earnings and profits between classes. As an illustration of this principle, the legislative history offers the following example. Assume that corporation X has 1,000 shares of class A common stock and 1,000 shares of class B common stock. Both classes are $10 par value stock and were issued at the same time at a price of $20. The class A common has a preference as to dividend and liquidating distributions in a 2:1 ratio to the class B common, and only the class B common has voting rights. Assume further that corporation X holds net assets worth $210,000 and has current and accumulated earnings and profits of $120,000. If X distributes $140,000 in cash in redemption of all of the class A common, earnings and profits should be reduced by $80,000 and capital account by $60,000.

i. Special Rule for Certain Foreign Corporations

Section 312(n) applies to foreign corporations as well as domestic corporations. However, under §312(n)(9), the

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application of paragraphs (5), (6) and (7) of §312(n) (pertaining to LIFO inventory adjustments, installment sales and the use of the completed contract method of accounting) is delayed for certain foreign corporations until taxable years beginning after December 31, 1985. The corporations to which this delayed effective date is applicable are foreign corporations deriving less than 20 percent of their gross income from sources within the United States.

2. ACRS Deductions for Real Property

Act §61 amends the table contained in §312(k)(3)(A) by striking out "35 years" in the item relating to 15-year real property and 20-year real property and inserting in lieu thereof "40 years." Thus, under §312(k)(3)(A) as amended, the amount by which a corporation's earnings and profits are reduced for ACRS deductions with respect to 15-year and 20-year real property is the amount of the deduction that would be allowable if the straight-line method of depreciation had been used and the property had a 40-year recovery period.

Section 312(k)(3)(A), as amended, applies to property placed in service in taxable years beginning after September 30, 1984.

3. Distributions of Obligations Having Original Issue Discount

a. Background

Under §301(b)(1)(A) of the Code, the fair market value of property distributed as a dividend is includible in the gross income of an individual shareholder.

A corporation can distribute as a dividend its own debt obligations. The obligations may have a fair market value less than their face amount. That is, they may carry a stated interest rate which is below the prevailing market rate. In such a case, an individual shareholder would have dividend income in an amount equal to the value of the obligations distributed to him. Prior to TRA 1984, however, the distributing corporation could contend that under §312(a)(2) (providing that a corporation's earnings and profits were to be reduced by the principal amount of the obligations of the corporation that were distributed by it with respect to stock), it was entitled to reduce its earnings and profits by the principal amount of the obligations it distributed. The end result of this position was to eliminate earnings and profits at the cost of a relatively small dividend tax.

Additionally, prior to TRA 1984, taxpayers could argue that a discount obligation issued and distributed by a corporation to its shareholders with respect to its stock, was not subject to the original issue discount rules. A cash basis shareholder taking this position would report no income with respect to the discount until it was paid and the income could qualify as capital gain. On the other hand, an accrual basis obligor could claim interest deductions currently on a straight-line or ratably rather than on a constant rate basis, thereby accelerating deduction of the discount.

b. Reasons for Change

Congress did not believe that a dividend distribution should reduce earnings and profits by more than the amount includible as a dividend in the gross income of an individual recipient of such a distribution. Further, Congress believed that obligations distributed by a corporation that bear economic discount should be subject to the general original issue discount rules.

c. Explanation of Provision

Act §61 amends §312(a)(2) to provide that a corporation's distribution of its own discount obligations as a dividend reduces earnings and profits by the aggregate issue price of the obligations, not by their face amount. Under new subsection (o) of §312, the issue price is to be determined under the original issue discount rules.

Act §61 amends new §1275 (added to the Code in Act §41) to provide that any debt obligation of a corporation distributed by the corporation with respect to its stock is to be treated as if it had been issued by the corporation for property. Thus, under this provision, the original issue discount rules are made applicable to the holder and the issuer of a discount obligation distributed as a dividend.

These amendments are effective for distributions declared after March 15, 1984 in taxable years ending after that date.

4. Section 301(f): Distributions to 20-Percent Corporate Shareholders

a. Introduction

Under the new earnings and profits rules of §312(n), a corporation's earnings and profits can exceed its taxable income if its income is deferred for purposes of determining gross income but not for purposes of computing earnings and profits. Aware of this, Congress was concerned that, if a corporation with earnings and profits in excess of taxable income made a distribution to a corporate shareholder and the distribution was treated as a dividend qualifying for a dividends received deduction, it was possible for earnings to be distributed to the corporate shareholder without ever being subject to tax in the hands of the corporate shareholder.

As an example of this possibility, Congress referred to the following hypothetical. Assume that P corporation owns 100 percent of the stock of X corporation, that P's basis in the stock is $200, that P and X file separate income tax returns, and that X has no current or accumulated earnings and profits. Assume further that X sells an asset for a $1,000 installment note, realizing an $800 gain. Finally, assume that X borrows $500 secured by the installment note and distributes the $500 to P. In such event, under the new rules of §312(n), absent a special provision, P would include the $500 distribution in income but would likely qualify for a 100-percent dividends received deduction. If P later sells its X stock for $200 (the value of that stock if it is assumed that X will ultimately have a $300 tax liability, in present value terms, on account of the installment sale), it would not recognize gain or loss on the sale. As a result, P would have realized an overall profit of $500.

b. Explanation of Provision

Because of its concern over the scenario described above, Congress added, in Act §61, a new subsection (f) to §301. Under this subsection, except as regulations may otherwise provide, the taxable income of a corporate shareholder with a 20-percent or greater interest in the distributing corporation, and such shareholder's basis in the stock of

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the distributing corporation, are determined as if §312(n) does not apply to the distributing corporation. As a result, in the above example, $200 of the distribution by X to P would be a return of capital, and $300 would be taxed to P under §301(c)(3). P's basis in the X stock would be reduced to 0, and P would recognize a $200 gain on the subsequent sale of the stock.

The nonapplication of §312(n) required by §301(f) is limited to two purposes: the determination of the taxable income of a 20-percent corporate shareholder and the determination of such shareholder's basis in the stock of the distributing corporation. For purposes of computing earnings and profits of the distributing corporation, §312(n) *does* apply. Thus, §301(f) does not affect the computation of earnings and profits of either the distributing corporation or the corporate shareholder. Since §312(n) is not disregarded for purposes of computing earnings and profits, in the above example, $500 of earnings and profits would be treated as having been transferred from X to P. After the $500 distribution to P, X would have remaining earnings and profits of $300. Because of the distribution, P's earnings and profits would be increased by $500.

Section 301(f) applies only if the corporate shareholder would, but for the subsection, be entitled to a dividends received deduction with respect to the distribution. For purposes of the subsection, a 20-percent corporate shareholder is any corporation owning, directly or through the application of the attribution rules of §318, stock possessing either (a) at least 20 percent of the total combined voting power of all classes of stock entitled to vote or (b) at least 20 percent of the total value of all classes of stock (excluding certain preferred stock) of the distributing corporation. The preferred stock excluded for this purpose is nonvoting stock which is limited and preferred as to dividends.

Section 301(f)(3) expressly authorizes the Treasury to prescribe regulations to carry out the purposes of the provision. The provision is applicable to distributions after July 18, 1984, in taxable years ending after that date.

III. New Limits on the Dividends-Received Deduction [§51]

A. Introduction

A corporation holding stock in another corporation can generally deduct 85 percent of the dividends it receives from the other corporation.[42] Based upon a maximum corporate tax rate of 46 percent on ordinary income,[43] the maximum effective rate on such dividends is therefore 6.9 percent.[44]

Generally, where the corporation investing in the dividend-paying stock borrows funds to make the purchase, the interest on the indebtedness is deductible against ordinary income.[45] Thus, the investing corporations often make investments which would not be possible or economic otherwise.[46]

B. Overview

The 1984 Tax Reform Act created §246A to remove the attractiveness of the combined dividends-received deduction and interest deduction in debt-financed portfolio stock.[47] This is accomplished through a reduced dividends-allowed deduction and, where the debt obligor is a person other than the person receiving the dividend, through empowering the Treasury to issue regulations disallowing the interest deduction in lieu of reducing the dividends-received deduction.

The provision applies to "portfolio stock" which is defined as all corporate stock unless specifically exempted. If the stock constitutes portfolio stock and indebtedness was incurred to either acquire or carry such stock, the 85 percent deduction is reduced by a percentage related to the amount of indebtedness incurred. The section applies to stock with respect to which the holding period commences after the date of enactment.

C. Detailed Analysis

1. Statutory Scheme

Section 51(a) of the Act adds §246A to the Code. The statutory scheme creates a substitute percentage for determining the dividend-received deduction when applied to debt financed portfolio stock.[48] Exemption from the reduced deduction is provided in §246A(b) which specifically exempts (1) dividends qualifying under §243(b) for the 100 percent dividends-received deduction as dividends from a member of an affiliated group which includes the taxpayer corporation[49] and (2) dividends received by a small business investment company operating under the Small Business Investment Act of 1958.[50]

a. Calculation of Reduced Dividend Deduction

When corporate stock held by another corporation has been determined to be "debt-financed portfolio stock" (see D. below) the reduced dividends-received deduction is calculated under §246A(a). That subsection provides that the percentage which is substituted for the 85 percent deduction normally used is equal to the product of 85 percent plus 100 percent minus the average indebtedness percentage. The effect of this calculation is to require the corporate taxpayer to determine the percentage of the cost of the investment in the stock which is financed with borrowed money and then reduce the dividends received deduction by that percentage.[51] The determination of the average indebtedness percentage is discussed below.

To provide a limit on the corollary treatment of interest deductions, §246A(e) provides that, under regulations prescribed by the Secretary of the Treasury, any reduction in the dividends received deduction shall not exceed the amount of any interest deduction (including any deductible short sale expense) allowable to such dividend.

b. Average Indebtedness Percentage

The "average indebtedness percentage" is calculated under §246A(d). The percentage is obtained by dividing the average amount of portfolio indebtedness of portfolio stock during the base period by the average amount of the adjusted basis of the stock during the base period.[52] For this purpose, the term "portfolio indebtedness" is defined as any indebtedness directly attributable to investment in the portfolio stock.[53] "Base period" is defined as the shorter of (1) the period beginning on the ex-dividend date for the most recent dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or (2) the

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one-year period ending on the day before the ex-dividend date for the dividend involved.[54]

A special rule applies where the dividend-paying stock is not held for the entire base period. Under §246A(d)(2), the calculation of average indebtedness percentage is applied as if the base period consisted only of that portion of the base period during which the stock was held by the taxpayer. The House bill added to this a second calculation which adjusted the average indebtedness percentage by multiplying the figure obtained under the general rule (of §246A(a)) by a fraction. The numerator of the fraction would have been the number of days during the base period on which the taxpayer held the stock and the denominator would have been the number of days during the base period.[55] This provision, however, was dropped from the final version of the law.

Another special rule applies to amounts received from the short sale of portfolio stock. Under §246A(d)(3)(B), any amount received from such a sale is treated as indebtedness for the period beginning on the day on which such amount is received and ending on the day the short sale is closed. The Senate amendment had provided that the rule would not apply if no deduction was allowed to a short seller under proposed §263(h) for payment in lieu of dividend [56] but the conferees, in adopting the House version, viewed this rule as no different from the House bill provisions.[57]

D. Operation of the Statute

1. Determining the Section's Application

The term "portfolio stock" is defined as any stock of a corporation, unless a statutory exception applies.[58] The three statutory exceptions in §246A are:

a. Closely-Held Business

If, at the beginning of the ex-dividend date, the corporate taxpayer owning the corporate stock possesses at least 50 percent of the total voting power of the stock and the stock has a value equal to at least 50 percent of the total value of such stock, the stock is not portfolio stock.[59]

b. Corporate Joint Ventures

Where the corporate stock, as of the beginning of the ex-dividend date, possesses at least 20 percent of the voting power and value of all of the corporate stock and five or fewer corporate stockholders hold such stock, that stock does not constitute "portfolio stock." [60] According to the Conference Report, this provision was specifically intended to exempt certain corporate joint ventures from the dividend-received reduction rule.[61]

c. Bank or Bank Holding Company

The stock of a bank [62] or bank holding company [63] is not "portfolio stock" if, as of the beginning of the ex-dividend date the taxpayer (1) owns such stock having a value of at least 80 percent of the total value of the bank or bank holding company stock for purposes of the 50 percent total voting power test under §246A(c)(2)(A)(i) and (2) holds options to acquire stock possessing at least 50 percent of the voting power of all classes of stock of such corporation.[64]

Comment: The statute itself reads that if the taxpayer owns the requisite 80 percent of the total value of "such bank or bank holding company, for purposes of paragraph (2)(A)(i), the taxpayer shall be treated as owning any stock of such bank or bank holding company which the taxpayer has an option to acquire." This language is not clear on its face; however, its meaning and intent have been drawn from the Conference Report language at page 813.

Note: For purposes of the calculations of stock ownership under §246A(c)(2)(A) or (c)(2)(B) or (c)(3)(A), stock described in §1504(a)(4) (relating to preferred stock) is not taken into account.[65]

2. Determination of Portfolio Indebtedness

Once it has been determined that the corporate stock is portfolio stock, the amount of portfolio indebtedness must be determined in order to apply the dividends-received deduction reduction. The term "portfolio indebtedness" is defined as any indebtedness directly attributable to investment in the portfolio stock.[66] The phrase "directly attributable" is clarified at several places in the Conference Report, as well as the House and Senate Reports, and will be discussed below.

a. Portfolio Indebtedness

As noted above, portfolio indebtedness is defined as any indebtedness directly attributable to investment in portfolio stock. The touchstone appears to be whether the indebtedness is clearly incurred for the purposes of acquiring dividend-paying stock or is otherwise directly traceable to such an acquisition.[67] The House Report made it clear that neither the use of an allocation or apportionment formula nor a fungibility concept were contemplated.[68]

The law would not apply to commercial paper issued by a corporation as part of an ongoing cash management program or to deposits received by a depository institution in the ordinary course of its business.[69] However, the underlying debt obligation issued by the corporate purchaser of stock to the seller is corporate indebtedness, since the Conference Committee made it clear that purchase money indebtedness is to be treated as portfolio indebtedness.[70] The following are examples of portfolio indebtedness:

Example 1: Where stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness.[71]

Example 2: Where a nonrecourse loan is secured, in whole or in part, by dividend-paying stock, the indebtedness is portfolio indebtedness.[72]

Example 3: Where a corporation purchases stock and issues its own debt obligation to the seller, the underlying obligation is portfolio indebtedness.[73]

b. "Directly Attributable"

Section 246A(d)(3)(A) defines "portfolio indebtedness" as any indebtedness directly attributable to investment in portfolio stock. It is clear that the phrase "directly attributable" applies in cases where the corporate entity which incurred the portfolio indebtedness is different than the corporate holder of the dividend-paying stock. Thus, the phrase applies where one member of an affiliated group of corporations incurs the portfolio indebtedness and another member of the group acquires the dividend-paying stock.[74]

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It is also important to note that the law applies where the indebtedness is attributable to *carrying* the portfolio stock.[75]

Example: Where the acquisition of stock is entirely equity-financed and the purchaser at a later date obtains funds through a loan secured by portfolio stock in a situation in which the purchaser could reasonably have been expected to sell the portfolio stock instead of incurring indebtedness, the law applies.[76]

However, if all or substantially all of the stock which is acquired by the taxpayer is portfolio stock held by the acquired company in the active conduct of a trade or business, then the indebtedness is not directly attributable to portfolio stock.[77] However, if a taxpayer makes a debt-financed acquisition of 100 percent of the stock of a mere investment company, the law applies.[78]

3. Example of Section's Operation

The Conference Report contains a lengthy example of the operation of the law:

> *Example:* Assume that Corporation A pays a dividend of $1 per share each quarter. The ex-dividend dates are January 15, April 15, July 15 and October 15. On January 16, 1985, Corporation B buys 1,000 shares of Corporation A for a total cost of $100,000. Assume further that Corporation B borrows 60 percent, or $60,000, of the purchase price, that the interest rate on the loan is 14 percent per year, and that the stock is portfolio stock. In April 15, 1985, when the $60,000 debt is still outstanding, Corporation B receives dividends on the stock totalling $1,000. Corporation B then sells the stock on April 16, 1985 for $100,000. Prior to TRA 1984, Corporation B would be generally entitled to a dividends received deduction of 85 percent of $1,000, or $850. Under §246A, since 60 percent of the cost of the stock was debt-financed, 60 percent of the dividends received deduction is disallowed. As a result, Corporation B is entitled to a dividends received deduction of only 40 percent of $850, or $340. Since interest expense allocable to the dividend is $2,100 ($60,000 times 14 percent times 1/4), the special rule limiting the reduction to the amount of interest expense allocable to the dividend is not applicable.[79]

4. Regulatory Authority

Two sections of §246A grant regulatory authority to the Secretary of the Treasury with respect to the interest deduction as it relates to the dividends-received deduction. Section 246A(f) provides that where the obligor of the indebtedness is a person other than the person receiving the dividends, the regulations pertaining to the reduced dividends-received deduction shall include regulations providing for the disallowances of interest deductions or other appropriate treatment, in lieu of reducing the dividends-received deduction. The Conference Committee gives the following as an example of the application of such regulations:

Example: Two corporations, A and B, acquire all of the stock of a third corporation, C, with A using debt to acquire 30 percent of the C stock and B using equity funds to acquire the remaining 70 percent. If the money borrowed by A is directly attributable to investment in dividend-paying portfolio stock by C, under such regulations, there would be no reduction in C's dividends received deduction. Rather, interest expense paid or accrued by A on the debt incurred to acquire the C stock would be disallowed, or other appropriate treatment (*e.g.*, the equivalent of a recapture of interest deductions) provided. This result is more appropriate than a reduction in C's dividends received deduction because such a reduction would, in effect, penalize both A and B even though B's investment was not debt-financed.[80]

Section 246A also provides that under regulations prescribed by the Secretary, any reduction in the dividends received deduction shall not exceed the amount of any interest deduction (including any deductible short sale expense) allocable to such dividend.[81]

IV. Basis Reduction for Extraordinary Dividends [Act §53]

A. Introduction

Prior to the 1984 TRA, corporations having short-term capital gain, otherwise taxable at a maximum 28 percent rate, could in effect convert that gain into income taxable at a maximum rate of 6.9 percent by acquiring stock in another corporation about to pay a dividend, receiving the dividend and selling the stock for a short-term capital loss. The price paid for the stock would include the full value of the dividend if the purchase occurred after the dividend was declared but before the ex-dividend date. Provided that the purchasing corporation held the stock for at least 16 days (at least 91 days in the case of preferred stock), the dividend would qualify for the 85 percent dividends received deduction.[82] A subsequent sale of the stock could generate a loss since it would be at a price that did not include the dividend and, if the sale occurred no more than one year after the purchase, that loss could be a short term capital loss.

B. Overview

Section 53 of the 1984 TRA adds to the Code two alternate provisions designed to prevent the conversion of short-term capital gain into intercorporate dividends taxable at the maximum 6.9 percent rate. Section 53(a) adds Code §1059, reducing a corporate shareholder's basis in stock upon its receipt of an "extraordinary dividend." This is generally net §301 distributions within an 85-day period having a total fair market value of at least 10 percent (five percent in the case of preferred stock) of the basis of its stock or aggregate net §301 distributions totalling more than 20 percent of the basis of its stock over a one-year period — if the shareholder disposes of such stock after holding it for no more than one year. In such a case, the basis of such stock is reduced by the amount of the dividends received deduction obtained with respect to such distributions. Thus, the effect of this provision is to deny a short-term captial loss on the sale of the stock unless there has been a reduction in the value of the stock unconnected with the dividend. This provision is generally effective for distributions after March 1, 1984.

The second of the alternative provisions involves §53(b) of the Act. Section 53(b) amends Code 246(c) to increase from 16 to 46 days the minimum holding period that a

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corporate taxpayer must retain common stock in order to qualify for the dividends received deduction with respect to dividends paid on such stock. This amendment also provides that the holding period of an offsetting position, requiring the taxpayer to make related payments, in property substantially similar or related to the stock at the time of receipt of the dividend will disqualify the dividend from the dividends received deduction. In addition, any period during which a corporate taxpayer holds offsetting positions in substantially identical stock or securities or with respect to property substantially similar or related to the dividend paying stock will not count toward the minimum holding period either under §246(c) or under §1059. The increase in the minimum holding period for the dividends received deduction with respect to common stock applies generally to stock acquired after July 18, 1984, the date of enactment of the 1984 TRA.

C. *Detailed Analysis*

1. *Basis Reduction for Extraordinary Dividends*

Section 53 of the 1984 TRA adds §1059 to the Code in an attempt to reduce the ability of corporate taxpayers to convert short term capital gain, taxable at 28 percent,[83] into intercorporate dividends taxable at a maximum rate of 6.9 percent[84] by purchasing stock on which large dividend payments were imminent and reselling such stock shortly after the dividends were paid. Under §1059(a), a corporate taxpayer receiving an "extraordinary dividend" on stock that it holds for no more than one year must reduce its basis in such stock by the "nontaxed portion" of such extraordinary dividend. If the nontaxed portion of such dividend exceeds the corporation's adjusted basis in the stock on which the dividend was paid, the excess is treated as gain from the sale or exchange of the stock. This provision is based upon §53 of H.R. 4170 and §35 of the Senate amendment thereto. The conference added language clarifying that gain would be recognized on the excess of the nontaxed portion of the extraordinary dividend over the adjusted basis of the stock on which the dividend was paid.[85]

a. *Distributions Potentially Treated as Extraordinary Dividends*

Section 1059(a) defines an extraordinary dividend as the aggregate amount of §301 distributions to corporate shareholders payable with respect to all ex-dividend dates within the same 85-day period either (1) having a net fair market value of at least 10 percent (5 percent in the case of preferred stock) of the shareholder's basis in the stock on which the dividends are made, or (2) payable with respect to all ex-dividend dates within the same 365-day period having a fair market value greater than 20 percent of such stock. Section 1059(d)(5)(A) makes clear that a distribution need not be out of earnings and profits to be an extraordinary dividend. Not only actual dividends, but also redemptions treated as §301 distributions, are potentially treated as extraordinary dividends. Where appreciated property is distributed, §1059(d)(2) provides that the full fair market value — not merely the distributing corporation's adjusted basis — of the property distributed is included in determining the amount of the extraordinary dividend.

Note: The statutory rules call for an aggregation, not only of the amount of dividends payable as to ex-dividend dates that fall within the same 85-day or 365-day period, but also with respect to distributions to all those who receive or transfer stock in substituted basis transactions.[86]

Example: On January 30, 1985, Corp. A purchases for $100 common stock in Corp. D, which declares a dividend having a February 1, 1985 ex-dividend date. Corp. A receives a $5 dividend on such shares. On March 1, 1985, Corp. A contributes the Corp. D stock to a wholly-owned subsidiary, Corp. B. Subsequently, Corp. D declares an additional $5 dividend on those shares, which dividend has an ex-dividend date of May 15, 1985. Corp. B sells the Corp. D shares to a third party on January 30, 1986. Because Corp. A and Corp. B took the same basis in the stock, distributions payable to both are counted in determining whether an extraordinary dividend has been paid. Because the ex-dividend dates are only 74 days apart, the two $5 distributions are aggregated and considered as one $10 distribution.

In determining whether redemption distributions taxable to the recipient under §301 are extraordinary dividends, the conference committee report provides that such distributions are deemed to be made with respect to stock that is not redeemed.[87] Otherwise, since no basis is allocated to stock redeemed in transactions treated as dividends, all §302(d)–§301 redemptions would be extraordinary dividends assuming that such stock was redeemed no more than one year after its acquisition.

b. *Holding Period*

In order for the basis reduction or gain recognition rule of §1059 to come into play, the stock on which the extraordinary dividend is received must be disposed of after being held no more than one year. Presumably, the reason for the more than one year rule was to require a corporate shareholder to take a long term capital loss on the sale of such stock. However, even though the minimum holding period for long term capital gain or loss treatment was reduced to six months and one day under §1001 of the 1984 TRA, the minimum holding period to avoid §1059 treatment was not reduced.

For purposes of determining whether stock has been held for more than one year, §1059(d)(3) provides that the rules of §§246(c)(3) and (4) which exclude from a shareholders' holding period in stock any time during which such shareholders have offsetting positions in substantially identical or related stock or have substantially reduced their risk of loss by holding offsetting positions in "substantially similar or related property." In turn, the rules of §§246(c)(3) and (4) were either substantially modified, or introduced, by §53(b) of the 1984 TRA, discussed in greater detail in C, 2, *infra*.

Note: The rules of §1059 do not apply to substantial dividends on stock disposed after being held more than one year. Thus, where a corporate shareholder has or anticipates short-term capital gain but no long-term capital gain, it can take advantage of the 6.9 percent maximum intercorporate dividend rate and offset such short-term capital gain with a long-term capital loss on a sale of the dividend paying stock more than one year after acquiring such stock.[88]

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c. Nontaxed Portion of Extraordinary Dividend

The amount by which a corporate shareholder's basis in stock is reduced is the "nontaxed portion" of the extraordinary dividend received. Section 1059(b) defines that term as the excess of the net fair market value of a §301 distribution over the taxable portion of that distribution. The taxable portion of such a distribution is the portion includible in gross income less the dividend received deduction available under §243, 244 or 245 with respect to the distribution. In most cases, then, the basis reduction will be equal to the 85 percent or 100 percent dividend received deduction with respect to the distribution.[89]

d. Regulations and Effective Date

Section 1059(e) provides that the Treasury will issue regulations applying the rules of §1059 in the case of stock splits, stock dividends and reorganizations.

Section 1059 is effective for distributions made on and after March 2, 1984.[90]

2. Increased Holding Period Requirement for Certain Stock

A corporate shareholder does not qualify for the dividends received deduction under §243, 244 or 245 unless it holds stock on which a dividend is paid for the minimum period of time. Prior to the 1984 TRA, that minimum period was 16 days for common stock and 91 days for preferred stock. Section 53(b) of the 1984 TRA amends §246(c)(1)(A) to provide that the minimum holding period to qualify for the dividends received deduction with respect to dividends paid on common stock is 46 days. The 91-day minimum holding period for the dividends received deduction with respect to dividends paid on preferred stock is unchanged by the Act.

Even under pre-1984 TRA law, the mere holding of stock for the requisite amount of time was not sufficient to qualify for the dividend received deduction. Section 246(c)(3) provided that, with respect to common stock, the holding period did not include any day more than 15 days after stock became ex-dividend or any period in which the shareholder had an option or contractural obligation to sell, or made a short sale of, "substantially identical stock or securities." Section 246(c)(1)(B) denied a dividend received deduction with respect to any stock to the extent the shareholder was obliged to make a corresponding payment with respect to "substantially identical stock or securities."

Section 53(b) of the 1984 TRA amends §246(c) to conform the period after the ex-dividend date not included in the holding period to the new 46-day minimum holding period requirement of §246(c)(1)(A). In addition, §246(c)(1)(B) was modified to deny a dividends received deduction with respect to stock on which the taxpayer is required to make "related payments" with respect to "substantially similar or related property." Section 246(c)(4) now reduces a corporate shareholder's holding period not only for short sales of, or options or contracts to sell, "substantially identical stock or securities," but also for periods in which the shareholder is the grantor of an option to buy such stock or securities.

Section 246(c)(4)(C) provides that a corporate shareholder's holding period will also be reduced, in accordance with regulations, where the shareholder has "diminished his risk of loss" by holding offsetting positions in "substantially similar or related property." The scope of this provision is quite broad, as indicated by the following language from the Conference Committee Report:

> The following transactions are examples of the types of transactions that are within the scope of the rule for substantially similar or related property: (1) A short sale of common stock when the taxpayer holds convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related. The same result would obtain in the case of a short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock, or a short sale of convertible preferred stock while holding common stock. (2) The acquisition of a short position in a regulated futures contract ("RFC") on a stock index (or the acquisition of an option to sell the RFC or the stock index itself, or the grant of a deep-in-the-money option to buy the RFC or the stock index) while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index. An alternative would include holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.[91]

Section 264(c)(4) does not apply to "qualified covered calls" within the meaning of §1092(c)(4). However, an exception in the Senate bill to the reduction in holding periods for offsetting positions in "substantially similar or related property" for broker-dealers was deleted in the conference.[92]

Note: In connection with the rules reducing a corporate shareholder's holding period as a result of offsetting positions in "substantially identical stock or securities" or "similar or related property," 1984 TRA §53(c) adds §7701(f), giving the Treasury broad power to issue regulations preventing the "avoidance," through the use of related parties, of pass-through entities or "other intermediaries," of all provisions relating to the "linking of borrowing to investment" or risk diminution. Presumably, such authority could extend to the denial of interest deductions under §§264 and 265 and the at-risk rules of §465.

The rules increasing the minimum holding period for purposes of qualifying for the dividends received deduction and associated provisions are effective for stock acquired after July 18, 1984, the date the 1984 TRA was enacted.

V. Holding Period for Losses Attributable to RIC and REIT Capital Gain Dividends

A. Background — Prior Law

As a general rule, regulated investment companies ("RICs") and real estate investment trusts ("REITs") that distribute their income are treated as conduits for Federal income tax purposes. RIC and REIT income, including capital gains, is passed through and taxed directly to the shareholders. Capital gain at the entity level is generally so treated at the shareholder level as well.

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In order to prevent abuse of the pass through for capital gains, losses incurred on the sale or exchange of RIC or REIT shares held for less than 31 days is treated as long-term capital losses to the extent of corresponding capital gain dividends.[93] According to the Senate Report on TRA, the 31-day holding period requirement has not succeeded in deterring taxpayers from abusing the capital gain pass-through rule. Specifically, a taxpayer can purchase an interest in an RIC or REIT immediately before a capital gain distribution, hold the stock for 32 days but not more than one year, and then sell the stock and realize a short-term capital loss. Such loss would be netted against short-term gains, while the long-term capital gain received on the distribution would be retained in its entirety. In effect, the taxpayer is able to convert short-term capital gain into long-term capital gain.

B. TRA Amendments

The Act provides that losses attributable to capital gain dividends on RIC or REIT interests that are held for less than six months will be considered as long-term capital losses to the extent of such gain.[94] The Act also makes conforming amendments to the holding period computation rules for RIC and REIT interests.[95]

With respect to both RIC and REIT shareholders, the Act provides an exception for losses incurred on the sale or exchange of shares pursuant to a plan providing for a periodic liquidation of those shares.[96] The exception will apply to the extent provided in regulations.

C. Effective Date

The amendments will apply to losses attributable to stock and beneficial interests for which the holding period begins after July 18, 1984, the day of enactment.

VI. New Requirements for Collapsible Corporations

A. Introduction

Section 65 of the Tax Reform Act of 1984 marks the passage of 34 years since Congress enacted §117(m) of the Internal Revenue Code of 1939 (now §341),[97] to address a device first utilized in the movie and real estate industries to convert ordinary income into long-term capital gains.[98] Congress initially reacted to this problem by taxing a shareholder's gain from the disposition of his shares in a collapsible corporation[99] at ordinary rather than capital gains rates.[100] Although §341 has been complicated further by a series of later amendments,[101] the operation of the collapsible statute has always turned upon a central concept: whether, before the collapsible event (sale, liquidation or distribution), the corporation had, or had not, "[realized] a substantial part of the taxable [ordinary] income to be derived from such property."[102]

Since a corporation which first realizes "a substantial part" of its income before liquidating avoids collapsible corporation status,[103] it is not surprising that the Service and the courts have grappled with the meaning of the above-quoted phrase. Prior to the enactment of §65, neither the statute nor the regulations have defined the term "a substantial part" with precision, and not surprisingly, judicial treatment of the issue has not been uniform. The Fifth Circuit, in *Comr. v. Kelley*,[104] addressed the issue from two perspectives. It first held that the "noncollapsible" substantial part refers to the amount realized, as opposed to the Commissioner's contention,[105] that a firm is collapsible if a substantial amount of income yet remains to be realized following the taxpayer's sale of stock. Secondly, the court held that the realization of approximately one-third of total income constitutes "a substantial part." In contrast, the Third circuit in *Abbott v. Comr.*,[106] in considering the first of the described issues, took the position that a corporation is "collapsible" if a substantial amount of income yet remains to be realized.

Although not noted in the Senate or House committee report,[107] it is also to be observed that the *Kelley* interpretation has been applied by the Tenth Circuit in *Comr. v. Zongker*[108] as well as in several district courts.[109] Indeed, the Internal Revenue Service in Rev. Rul. 72-48[110] had, some years before it changed its position by enactment of §63, announcing its acquiescence essentially in the *Kelley* rationale.[111]

Section 65 effectively changes the focus of the income realization issue by substituting a realization test of "2/3" for the "a substantial part" of taxable income rule of prior law.[112]

The genesis of §65 may be traced to Treasury's concern (doubtless initially developed from field experience at the Service) with the following tax avoidance pattern:

> "The most publicized use of these [1/3 "Kelley type"] arrangements involves the conversion of existing or newly developed improved real property into condominiums that are intended to be sold separately to customers. Under one variation of this technique, the property to be converted is sold to the taxpayer's wholly owned corporation, which undertakes the conversion and improvement of the property and commences sale of the individual units. After the corporation has sold approximately one-third of the units (assuming all units are of equal value), but more than one year after the taxpayer acquired his stock in the corporation, the corporation is liquidated. The taxpayer/shareholder claims long-term capital gain treatment on the gain recognized on the liquidation. That gain derives in part from the fair market value of units received in liquidation that appreciated due to the corporation's conversion, development, and promotional activities. The collapsible corporation rules, which were enacted to deal with situations of this type, would not prohibit the planning technique described above. Since the corporation has realized a "substantial" part (*i.e.*, one-third) of the taxable income to be derived from the sale of the condominiums, it is not a collapsible corporation."[113]

Treasury statistics accompanying the foregoing statement indicate that the revenue gains resulting from enactment of a 2/3 rule would equal $57,000,000 in 1985, $196,000,000 in 1986, and $305,000,000 in 1987.[114]

Section 65 also adds a new provision which severely limits the application of the so-called 70-30 rule of §341(d)(2). This rule assures shareholder level capital gains, notwithstanding that the corporation is, in fact, a collapsible corporation (as defined in §341(b)). Under the 70-30 rule, a taxpayer must establish that at least 30

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percent of his realized gain is attributable to so-called "noncollapsible" assets of the corporation. To identify such gain, the 70-30 rule requires for this purpose a factual determination respecting both the amount of each shareholder's basis and gain and the identity and valuation of all corporate assets, noncollapsible and collapsible. Prior to §65, in situations in which a corporation owned several "collapsible" assets (respecting which the collapsible "view" was held), collapsibility could be neutralized and shareholder capital gains treatment accorded under the 70-30 rule by ensuring that other sufficient noncollapsible corporate assets (*i.e.*, to the extent of the 30 percent of a shareholder's gain) were held to which gain would be attributable. If insufficient gain were attributable to noncollapsible assets, one or more collapsible assets could be "cleansed" of such status though realization at the corporate level of "a substantial part," i.e., one-third, of the assets' potential taxable income, thus causing the total value (including the value attributable to the uncompleted part), of those assets to be taken into account at the shareholder level on the 30 percent "good" side of the 70-30 fraction. Section 65 addresses the use of this "cleansing" technique by providing the Treasury with the authority to issue regulations under which certain formerly collapsible assets are aggregated with existing collapsible assets and treated as one property for purposes of the 70-30 rule. As will be discussed hereafter, the utility of the 70-30 exception is severely restricted by this amendment, particularly as it has been implemented in recently proposed regulations.

It may also be observed that while the Conference Report makes no reference to the implications of §65 respecting transactions occurring prior to its effective date of July 18, 1984, the Senate Committee Report includes this not unusual comment: [115]

> "The committee intends that no inference should be drawn from this amendment with respect to the meaning of the 'substantial part' requirement of present law."

The quoted paragraph, while never completely conclusive should nevertheless serve to insulate pre-effective date transactions from the constraints of the described amendments.

B. Overview

Section 65 of TRA 1984 is comprised of two components. The first changes the degree of corporate level realization which must occur before a "collapsible" corporation (as defined in §341(b) is formed or availed for liquidation, sale of its shares, or distribution of its assets.[116]

The second component of §65, amends the so-called 70-30 percent rule exception authorized by §341(d)(2). Under the new provision, all inventory or other property held for sale to customers as described in §1221(1) is treated as "one item of property" for purposes of the 70-30 rule. In consequence of such aggregation of all §1221(1) properties with respect to which a "collapsible" view was held at any time during the corporate history, two-thirds corporate level realization of all the income to be realized from all the corporation's collapsible assets (in lieu of a test which would qualify as "noncollapsible" all of the value of each separate property for which one third of income realization had occurred) is now required as the "price" of qualification under the 70-30 exception.

C. Detailed Analysis

1. General Rule

Under the mechanism of §341, gain from (i) a sale or exchange of stock of a "collapsible" corporation, (ii) a distribution of its assets in complete or partial liquidation, or (iii) a capital distribution from it [117] is taxed at ordinary income rather than capital gains rates. In turn, whether or not a corporation may be characterized as a "collapsible corporation" depends upon whether such entity was "formed or availed of principally for the manufacture or construction or production of property, or for the purchase" [118] of so-called "§341" assets, including inventory (in the hands of the corporation) and other assets defined in §341(b)(3). The collapsible corporation characterization is made with a view to the corporation's liquidation, distribution to its shareholders, or sale of its shares before the realization by such corporation of "a substantial part," of the total taxable income ultimately to be derived from the property.

The approximate net dollar effect of the 2/3 rule (in contrast to the "substantial part" rule) may be illustrated as follows:

> *Example:* Corporation X, whose shareholder individual A owns all the shares at a zero basis, constructs a condominium with 100 units all of which are assumed to remain at equal value. The condominium is the sole property of the corporation. Before enactment of §65 of TRA 1984, A could have avoided ordinary income treatment if he first caused 34 units to be sold to any person (including apparently [119] an entity owned or controlled by himself) after enactment of §65, more than 67 units must be sold before a "noncollapsible" liquidation, sale, or distribution can occur (*i.e.*, before gain recognized by A can be taxed to him at capital gains rates.)

Notwithstanding enactment of §65, a liquidation, etc. nevertheless may still prove advantageous. Assume in the above example a 50 percent (federal, state and local) overall ordinary tax rate at the corporate level and a 25 percent overall capital gains rate at the individual level and that the before-tax gain on the sale of each unit is $1. In such a case, the tax at the corporate level resulting from the sale of 67 units totals $33.50. A subsequent distribution to the shareholder of $66.50, subject to a capital gains tax of 25 percent,[120] results in a net shareholder level after-tax profit of approximately $50. In contrast, prior to enactment of §65 of TRA 1984, the total required corporate level sales before liquidation of 34 units would have resulted in a corporate level tax of $17, a distribution to the shareholders of $83, and a net shareholder after-tax profit of approximately $62.00.

It may be observed that the total shareholder-corporate tax burden under the new 2/3 test approximates the individual ordinary income tax rate of 50 percent. Thus, a shareholder of a collapsible "C" corporation, (otherwise subject to an overall tax rate of 62.5 percent (50 + 12.5 percent), if all income is realized at the corporate level) may, through affirmative application of the 2/3 rule of §65,

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generate a net after-tax profit approximately equivalent to that which would be realized if the corporation conducting the activity elected Subchapter S status.

2. Determination of 2/3 Amount

Although substitution of the "2/3" fixed fraction for the generalized "a substantial part" phrase establishes mathematical parameters for collapsible corporation status, the circumstances which enter into the determination of the amount of "taxable income to be derived from" the collapsible property remain as questions of fact, unaffected directly by the new legislation. This requires a distinction to be drawn between two very different situations. In the first situation, a corporation is engaged, on the one hand, in the business of selling a product (*i.e.*, land or inventory) where, to determine total taxable income, estimates must be made by reference to past as well as anticipated corporate experience.[121] The second situation occurs where a corporation's business involves the leasing of property (*i.e.*, an apartment house or machinery) in which an estimation is made by reference to the useful life of the corporate assets.[122] To the extent that the determination of total income requires marketplace assumptions respecting future expenses and revenues, (upon which reasonable minds may differ), the task of determining the precise date when a permissible liquidation, sale, or distribution should occur remains elusive. Indeed, since the statutory "bright line" demarcation is now a numerical threshold, the Service may be tempted to assert that the corporation has failed to achieve sufficient corporate level realization of taxable income. Thus, in any situation in which a planned "collapse" is to be effected, it appears more essential than ever that consideration be given to the elements which enter into the generation of future income and expense, in order that it may be made certain that corporate level realization in excess of the two-thirds amount has been achieved.

Note: In estimating future income in the case of a real estate project in which, for example, single family lots are sold, attention should be directed to the likelihood that the earliest lots may sell at a price per unit which is less than the prices of later lots (where sales will take place after the community has been partially populated or local improvements are provided [123] and its attractiveness established.) Inflation and "tax considerations" also may influence the value of net income to be realized in the future.[124] On occasion, a contrary problem may be presented, *i.e.*, a project may not be successful and the undeveloped lots may for the foreseeable future become property of questionable marketability, underscoring the need for carefully verified market estimations before assuming a noncollapsible event can occur.

3. Aggregation of Properties for Purposes of the 70-30 Rule

a. Statute and Legislative History

Of the three statutory exceptions [125] to the general rule of §341, whereby the shareholders (of a concededly collapsible corporation may avoid ordinary income treatment), the so-called 70-30 rule has frequently been availed of under prior law, particularly in the case of a closely-held corporation in which some, but not all, of its holdings constituted constructed property. In such a case, existing regulations under the 70-30 rule [126] establish several rather stringent tests: (i) in the case of land development, gain on an undeveloped tract of land arising from development of an adjoining tract owned by the same corporation may be attributed to the developed tract [127] and (ii) in the case of a corporation developing two realty projects, gain attributable to a previously fully constructed "collapsible" project equals the decrease in total gain on liquidation that would occur if the project had never been developed.[128] Under the second of these two tests, as pointed out in 29 T.M., *CollapsibleCorporation — General Coverage*,[129] gain attributable to collapsible assets includes gain attributable to accumulated income produced by such assets, and may even include gain attributable to accumulated income derived from formerly collapsible assets.

Despite the stringency of these tests (and one must keep in mind that these tests apply primarily to constructed property), the Service apparently found them inadequate to deal with all potentially abusive uses of the 70-30 rule. In particular, the housing industry in recent years has focused upon existing multifamily residential rental units which are purchased and then converted into condominiums. This conversion process has been well-suited to the technique of avoiding collapsibility through substantial realization at an assumed one third *"Kelley* type" level and, where more than one conversion is conducted in the same corporation, a potential "parlay" of this rule into mechanisms to permit collapsible corporation clearance under the 70-30 rule. This could have occurred through one-third substantial realization with respect to a separate project, and the subsequent attribution of such gain plus the remaining two-thirds gain on the 30 percent "good" side of the 70-30 rule fraction.

To cope with this asserted distortion of the policy underlying §341, §65 of TRA 1984 provides that in applying the 70-30 rule all property described in §1221(1) (*i.e.*, inventory, stock in trade and property held primarily for sale to customers) will be treated as a "single asset." To assure reversal of the so-called "separate project" rule, the Senate Finance Committee Report adds the following:

> "[T]he Secretary of the Treasury would be authorized to prescribe regulations describing the extent to which [1221(1) property] would be treated as a single asset in applying the 70/30 rule. The committee intends that these regulations will insure that the two-thirds realization requirement cannot be avoided where the corporation's collapsible section 1221(1) properties are less than two-thirds realized in the aggregate but where some of its collapsible properties have been two-thirds or more realized." [130]

The Senate Finance Committee then adds:

> "Thus, if the aggregate of the corporation's collapsible §1221(1) properties is less than two-thirds realized, all of the corporation's collapsible §1221(1) properties, including any collapsible section 1221(1) property that has been two-thirds or more realized, will be treated as collapsible property for purposes of the 70/30 rule. The committee intends that, for purposes of applying this aggregation under the '70/30' rule, *all property with respect to which the taxpayer has, or at any time had, a collapsible view will be treated as collapsible property. . .*" (emphasis supplied.)[131]

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In light of the unusually broad sweep of the Senate Finance Committee language, question may be raised as to whether any category of §1221(1) property can fall beyond the scope of the aggregation rule. Such a situation may be envisaged in the case of an ongoing corporation that was not created with the "collapsible view" and has engaged for 30 years in the manufacture and sale of inventory items. The corporation commences a new, collapsible, activity, such as the construction of an apartment building, with respect to which the requisite view (intention to liquidate) was held. Although gain attributable to the apartment house would be regarded as collapsible gain, the gain attributable to the ongoing business (including that referable to the ongoing items) should be exonerated if any meaning at all is to be attributed to the Senate Finance Committee Report.[132] Accordingly, if such "ongoing" gain constitutes 30 percent or more of the total gain, qualification under the 70-30 rule should occur.

In interpreting the new "one item" rule, difficulty may also be anticipated in determining the total value of disparate projects for purposes of the 70-30 computation.

Observation: In the case of, for example, a proposed liquidation "in midstream" of a realty development of one or more of several projects, an appraisal methodology will presumably adapt to the uncertainties of the sale of the uncompleted projects. It should also be considered that the valuation will be based upon disposition of all projects, completed and uncompleted to one person in one transaction (as distinguished from a piecemeal disposition). Where the corporation in question owns publicly traded stock (which generally will constitute other than collapsible property), the valuation methodology may take into account the "one sale to one person" rule but also give effect to a premium for control or, in appropriate cases, a reduction in value attributable to blockage.[133]

On the other hand, the Senate Finance Committee adds that, "Section 1221(1) property which is not collapsible property, and which never was collapsible property, need not be aggregated under this rule." [134]

With a mandate as stern as the quoted paragraph (and notwithstanding that it is unlikely that any member of the tax writing committees, much less any of the conferees, knew in detail, if at all, the full implication of the change), the Treasury Department is certain to establish widely encompassing rules.

b. *Proposed Regulations*

In proposed regulations published in the Federal Register [135] within a remarkably rapid six weeks of the date of enactment of the TRA, the Treasury Department has, in fact, proposed broad rules implementing the new aggregation requirement for purposes of the 70-30 test. Under Prop. Regs. §1.341-4(c)(4), all property, with one exception which will be described below, must be aggregated and treated as one item of collapsible property if the following two requirements are met:

(i) It must be stock in trade of the corporation or other property of a kind that would be properly included in the corporation's inventory if on hand at the close of the taxable year, or property held by the corporation primarily for sale to customers in the ordinary course of the corporation's trade or business (§1221(1) property), and

(ii) It must be described in §341(b)(1) without regard to whether the corporation has realized two-thirds or more of the taxable income to be derived from the property.

The same proposed regulation makes it clear that all property meeting the foregoing two requirements must be aggregated and treated as a single item of property even though they are separate projects. Thus, under this proposed regulation, if after aggregation the corporation has realized less than two-thirds of the taxable income to be derived from the aggregated property, the aggregated property is treated as collapsible property for purposes of the 70-30 test.

Prop. Regs. §1.341-4(c)(8), Example (1), sets forth the following illustration of the aggregation rules:

Facts: Individual A forms corporation X on January 2, 1985, and contributes $2,000,000 in cash in exchange for all the X stock. Corporation X immediately purchases for $400,000 property that is not described in §341(b)(2) or §341(b)(3) and is not stock of another collapsible corporation. By December 31, 1985, X has sold the property and has realized all the taxable income to be derived from the property, resulting in a $100,000 after-tax profit. During the same year, 1985, X also acquires for $300,000 apiece two separate tracts of land in neighboring cities, for purposes of developing each tract into lots suitable for sale as homesites and holding them primarily for sale to customers. Each tract is expected to produce $1.25 million of taxable income. A, however, intends to sell all the X stock before 2/3 of the taxable income is derived from either tract. As of December 31, 1985, X has realized $900,000 of taxable income from tract I (72 percent), but only $250,000 (20 percent) from tract II. On January 1, 1986, A sells all the X stock.

Result: Both tracts must be aggregated and treated as one item of property to determine the amount of gain on the sale of the X stock attributable to the aggregated property. Although two-thirds of the taxable income (72 percent) to be derived from tract I has been realized by X, which would have been sufficient to place it on the 30 percent good side of the 70-30 test under prior law, less than two-thirds has been realized from the two tracts in the aggregate as follows: ($900,000 + $250,000)/($1,250,000 + $1,250,000) or 46 percent. Thus, under the proposed regulations, the two tracts constitute an item of property that is placed on the 70 percent side of the 70-30 equation. Assuming that A recognizes $750,000 of gain upon the sale of the X stock, but A would have only recognized $100,000 of gain had the two tracts of land not been acquired for subdivision and sale, the gain attributable to the aggregated property would be $650,000. Because such gain is more than 70 percent of total gain recognized by A, the entire gain on the sale of the X stock is ordinary income under §341(a).

The proposed regulations, Prop. Regs. §1.341-4(c)(6), provide one exception to these aggregation rules. If the effect of aggregating §1221(1) property with other §1221(1) property is to reduce the amount of gain recognized during the taxable year with respect to stock of a

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collapsible corporation that is attributable to collapsible assets, any §1221(1) property having this effect is excluded from aggregation. The proposed regulation further provides that such §1221(1) property is not aggregated even if that same property was previously aggregated with other §1221(1) property for purposes of a prior application of the 70-30 test. The potentially harsh application of the exclusionary rule is illustrated in the following example from Prop. Regs. §1.341-4(c)(8), Example (3):

> *Example:* Individual A forms corporation X on January 2, 1985, contributing $600,000 cash in exchange for all the X stock. Corporation X immediately acquires three tracts of land in separate cities for the purpose of developing each tract into lots suitable for sale as homesites to customers in the ordinary course of business. Tract I is expected to produce $250,000 of taxable income, tract II, $50,000 and tract III, $700,000. A, however, intends to liquidate the corporation before two-thirds of the taxable income is derived from any of the projects. Thus, A has a collapsible view with respect to each of the three separate projects. By December 31, 1985, X has realized 100 percent of the taxable income from tracts I and II, but only $400,000 (57.1 percent) from tract III. On January 2, 1986, A liquidates the corporation, thereby recognizing gain. According to the proposed regulation, only tracts II and III are aggregated in determining whether they constitute a single item of collapsible property for purposes of the 70-30 test; tract I is excluded from aggregation. Because less than two-thirds of the taxable income has been realized from those tracts in the aggregate (($50,000 + $400,000)/($50,000 + $700,000) or 60 percent), tracts II and III constitute an item of property that is collapsible. If more than 70 percent of A's gain is attributable to that aggregated item, all of A's gain is subject to §341(a).

Comment: The proposed regulation's exclusionary rule, as interpreted in the foregoing Example, has no basis in the legislative history; in fact, it may be considered contrary to specific language in the Senate Finance Committee Report. In the passages previously quoted from the Report, the Finance Committee indicated that aggregation should be required only "where a corporation's collapsible §1221(1) assets are less than two-thirds realized in the aggregate. . ." Here, 70 percent of the income from the aggregated properties (($250,000 + $50,000 + $400,000)/($250,000 + $50,000 + $700,000)) was realized, a percentage that clearly satisfies the two-thirds test, yet the proposed regulation and the Example provide for aggregation. Moreover, even assuming aggregation should be required in these circumstances, the selective aggregation performed in the Example is at odds with legislative intent. As previously mentioned, the Finance Committee stated an intention that all property with respect to which the taxpayer has, or at any time had, a collapsible view should be treated as collapsible property for purposes of the 70-30 aggregation requirement. In the Example, the shareholder had an intention to liquidate the corporation prior to the realization of two-thirds of the taxable income to be derived from *any* of the projects. Thus, until two-thirds of the taxable income from tract I was realized, that tract was a collapsible asset in the corporation's hands, even though by the time of liquidation that tract (as well as tract II) ceased to be collapsible by reason of the two-thirds test. Accordingly, under the Finance Committee language, tract I should be aggregated with tracts II and III for purposes of the 70-30 test. If this were done, then 70 percent would be realized from the aggregated properties, thereby satisfying the two-thirds test. The aggregated properties would then be placed on the 30 percent good side of the 70-30 fraction. However, notwithstanding the realization of two-thirds of the taxable income on an aggregate basis and the Finance Committee's pronouncements concerning aggregation, the proposed regulation requires aggregation even though the two-thirds test is met in the aggregate as well as selective exclusion of a formerly collapsible asset under the aggregation test when that aggregation would be beneficial to a taxpayer.

To preclude taxpayers from using separate corporations to avoid the impact of the aggregation rule, Prop. Regs. §1.341-4(c)(5) provides for the aggregation of §1221(1) assets held by separate but related corporations, where one of the purposes of forming or availing of the related corporation was to avoid the application of the aggregation rules. The proposed regulation leaves unanswered what degree of "relatedness" must exist before such aggregation will occur. In the two examples in Prop. Regs. §1.341-4(c)(8) illustrating this related corporation rule, the related corporations formed to avoid aggregation are wholly-owned subsidiaries of a parent corporation. Presumably, however, less than 100 percent control will also suffice in the appropriate circumstances for the aggregation of assets held in separate corporations, but no indication is given respecting any threshold amount of control that must exist. Also left open to question is the applicability of this rule in the case of brother-sister corporations.

One further issue that merits attention in the final regulations but is not addressed in the proposed regulations is the relationship of the three-year exemption for purchased property in §341(b)(3) to the aggregation rule. Under §341(b)(3), §1221(1) property that is purchased by a corporation is not treated as collapsible property under §341(b)(1) once such property has been held for at least three years, even if a collapsible view existed with respect to such property. In view of the Senate Finance Committee statement concerning the aggregation of all §1221(1) property with respect to which the taxpayer at any time had a collapsible view, §1221(1) assets held for at least three years are arguably subject to aggregation for purposes of the 70-30 rule notwithstanding that they would not be treated as collapsible assets for any other purpose of §341.

Clarification of the new rules enacted in §65 on the Service's existing ruling policy should also be expected. Under this ruling policy,[136] rulings are not ordinarily issued on the collapsible status of a corporation unless the following three conditions are satisfied: (i) the corporation has been in existence for at least 20 years or it has clearly demonstrated that it has realized a substantial part of the taxable income to be derived from manufacturing, producing, or purchasing property as defined by §341(b)(1)(A) and as described in Rev. Rul. 72-48, 1972-1 C.B. 102, (ii) the corporation has had an aggregate change in the shareholders' interest of not more than 10 percent (excluding transfers among family members or §303 redemptions) during the period of 20 years or period of realization of a

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substantial part, and (iii) has conducted substantially the same trade or business during the applicable period. Presumably, the Service will continue this ruling policy after making the obvious modification of substituting the two-thirds test for the substantial part test that presently is provided as an alternative to the 20-year requirement.

While it may be anticipated that some taxpayers will seek to circumvent the new two-thirds test of substantial realization by forming separate corporations for limited areas of real estate, for example, and thereafter sell the shares of each corporation so incorporated, attention should be directed to the decision in *Herman Katz*.[137] In that case, successive sales of shares caused the selling shareholder to be treated as a person holding shares for sale to customers, notwithstanding the fact that he was not a security dealer.

D. Effective Date

Act §65(d) provides that the amendments made by §65 are effective for sales and exchanges, and distributions made after the date of enactment, July 18, 1984. In light of the use of the word "made" a question can be raised in the following situation:

Example: Assume a real estate construction corporation, otherwise collapsible, sells one-third of its properties (sufficient to meet the *Kelley* test of substantial realization) on June 17, 1984. On June 18th, the sole shareholder of the corporation sells all of his stock, receiving 10 percent cash and 90 percent in the form of a note payable January 1, 1985. Such a person may contend, notwithstanding certain opposition from the Commissioner,[138] that because the "sale" occurred before the effective date of TRA §65, the note part of the proceeds (including the installment payments due after the effective date) are not subject to the new law. While there is no doubt that realization of 90 percent of proceeds occurred after the effective date, the position may be taken the effective date of the sale (*i.e.*, when title passed and benefits and burdens of ownership were transferred) occurred after the effective date.

VII. Recognition of Gain Upon Distribution of Partnership Interest by Corporations

A. Introduction

1. Background

Section 311(a) provides that a corporation does not recognize gain upon distribution of property with respect to its stock except where the distribution includes certain defined property. The property with respect to which gain is recognized under §311 is LIFO inventory, property subject to liabilities which exceed the adjusted basis of the property, and appreciated property distributed in redemption of stock.[139] In addition, the nonrecognition provision of §311 is specifically inapplicable to distributions of installment obligations which trigger recognition of gain under §453B(a).[140]

Section 336 provides that corporations do not recognize gain upon distribution of property in complete liquidations with the exception of LIFO inventory and installment obligations subject to §453B(a).[141]

Section 337(a) provides that a corporation does not recognize gain upon the sale of property if the sale occurs within a twelve-month period following the adoption of a plan of complete liquidation and if the assets of the corporation are distributed in complete liquidation within the twelve-month period. Specifically excluded from the nonrecognition treatment are sales of inventory (other than bulk sales),[142] installment obligations arising from non-bulk sales of inventory,[143] and installment obligations arising from sales of non-inventory property where the sale occurred prior to adoption of the plan of complete liquidation.[144] Section 453B contains similar provisions with respect to transfer of installment obligations arising from §337 liquidations.[145]

Section 751 provides that the amount of money or the fair market value of property received in exchange for a partnership interest which is attributable to unrealized receivables or substantially appreciated inventory is treated as an amount realized upon sale or exchange of property which is not a capital asset. Unrealized receivables are defined to include amounts subject to recapture under §§1245 and 1250.

Under these sections, it is clear that corporate distributions of the defined property will trigger recognition gain and that sales or exchanges of partnership interests attributable to §751 property will trigger recognition of gain as ordinary income. However, it has not been clear that gain is recognized upon a distribution by a corporation of a partnership interest (where the partnership holds property defined in §§311, 336 or 751) or the sale of a partnership interest in a §337 liquidation (where the partnership holds assets which would not qualify for §337 treatment if directly disposed of). The Claims Court recently held that distribution of a partnership interest by a corporation is a disposition of the partnership property for purposes of recapture under §1245.[145]

In an analogous situation, the Internal Revenue Service has taken a negative position on the issue. In Revenue Ruling 60-352, 1960-2 C.B. 208, the Service ruled that a taxpayer recognized gain on the donation of his limited partnership interest to an exempt organization where the partnership held installment obligations arising from the sale of subdivided land. The Service stated:

> Thus, while the partnership interest generally may be regarded as constituting a partner's interest in the profits and surplus of the partnership, the fundamental principles of Federal income taxation require that an interest in income earned by the partnership which has not been realized, or has not yet been subjected to taxation, be treated as distinct from any "partnership interest" which is recognized as a capital asset for income tax purposes. Therefore, unrealized or untaxed rights to partnership income may be transferred with, but not as a part of, the partnership interest which constitutes a capital asset.
>
> * * *
>
> Based on the foregoing, it is held that a transfer of a limited partner's interest in a partnership appurtenant to which is a right to share in unrealized partnership income reflected in installment obligations receivable by the partnership constitutes a transfer of a capital asset coupled with a disposition of such installment obligations subject to the provisions of section 453(d) of

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the Code. To the extent that the transaction constitutes a disposition of installment obligations receivable, the gain is taxable to the transferor as ordinary income.[147]

2. Outline of New Provisions

TRA §75 adds Code §386 which provides that upon distribution of a partnership interest or sale of an interest in a §337 liquidation, the corporation will recognize gain attributable to the corporation's share of the partnership's "recognition property." Recognition property is the property which is specifically excluded from nonrecognition treatment under §§311, 336 or 337. Where tiered partnerships are involved, §386 provides that each partnership is treated as owning the recognition property of the partnerships in which it owns interests.

3. Effective Date

New §386 is effective with respect to distributions, sales and exchanges made after March 31, 1984, in taxable years ending after that date.

B. Detailed Analysis

1. Distributions

Section 386(a) provides that for the purpose of determining gain to a distributing corporation the distribution by a corporation of a partnership interest shall be deemed a distribution of the corporation's proportionate share of any recovery property held by the partnership. Where the distribution is made other than in complete liquidation, recognition property is the property excluded from nonrecognition under §311: LIFO inventory, property subject to liabilities in excess of basis, appreciated property distributed in redemption of stock, and installment obligations subject to recognition of gain upon disposition under §453B. The proportionate share is determined in accordance with the principles of §751. Additionally, §7701(g) provides that in determining gain or loss with respect to property, fair market value is deemed to be not less than the amount of any outstanding indebtedness on the property.

Example: Corporation A owns a 25 percent limited partnership interest in Partnership X. X owns an office building with outstanding nonrecourse indebtedness of $1,000,000 and a basis (after adjustments for depreciation) of $500,000. A distributes its interest in X to its shareholders as a dividend. Since the nonrecourse indebtedness exceeds the adjusted basis of the building, the building is recognition property under §§311(c) and 386(c)(1). Under §311(c), A would recognize 25 percent of the $500,000 difference between liability and basis (or $125,000 of gain) upon the distribution.

Example: Rather than holding an office building, X holds stocks and bonds with a cost basis of $100,000 and a fair market value of $150,000. In complete redemption of one stockholder's shares, A transfers a 15 percent interest in X. A will recognize $7,500 in gain upon the redemption.

Where the distribution is in complete liquidation, only LIFO inventory and installment obligations qualify as recognition property.[148] Thus, if each of the two distributions above had occurred pursuant to the complete liquidation of A, A would not recognize any gain.

In both distribution situations, if the partnership holds an interest in another partnership which holds recognition property, the recognition property is attributed through the intermediate partnerships to the corporation.[149] Thus, similar to the changes discussed in Chapter 37 (III), tiered partnerships may not be used to avoid the operation of §386.

Similar rules are to apply by regulation to interests in trusts.[150]

2. Sales Pursuant to §337

Section 386(b) provides that for purposes of determining the amount and character of gain recognized on a sale of a partnership interest in a §337 liquidation, the corporation is deemed to have sold its proportionate share of partnership recognition property. In the case of a §337 liquidation, recognition property consists of property described in §337(b): inventory, installment obligations arising from inventory, and installment obligations (from whatever source) attributable to sales occurring prior to adoption of the plan of complete liquidation.[151]

Similar rules are to apply to interests in trusts.[152]

3. Distribution of Partnership Interest Treated as Exchanges

Section 761(e) treats partnership or corporate distributions of partnership interests as exchanges for purposes of §§708, 743 and any other section of subchapter K specified by regulation. Thus, if a corporation holds a 50 percent interest in a partnership and distributes the partnership interest to its shareholders, the partnership terminates. A similar problem will occur where tiered partnerships are disassembled.

Observation: Termination can obviously have an unfortunate impact on the nondistributing partners. Members of partnerships with corporations or partnerships holding significant percentages of interest will want to be sure that restrictions against distribution are present in the partnership agreement.

Note: The main focus of this change was with respect to the §743 basis adjustment. Neither the House nor Senate bills contained the §708 provision or the discretionary provision for the Treasury Department. Both provisions were added by the Conference Committee.

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[1] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)
[2] *See, e.g., Bacon-McMillan Veneer Co. v. Comr.*, 20 B.T.A. 556 (1930).
[3] §311(b).
[4] §311(c).
[5] §1245(a) and §1250(a).
[6] §453B(a).
[7] §1248(f).
[8] §301(d)(2)(A).
[9] §§301(d)(2)(B) and 1223(2).
[10] *See* S. Print No. 169, 98th Cong., 2d Sess 171 (1984).
[11] §54 of H.R. 4170 and §36 of the Senate amendment thereto.

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[12] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1190 (1984); S. Print No. 169 (Vol. I), 98th Cong., 2d Sess. 176-77 (1984).
[13] Former §311(d)(2)(A) of the Code.
[14] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1191 (1984); S. Print No. 169 (Vol. I), 98th Cong., 2d Sess. 178 (1984).
[15] This last exception was added as a floor amendment introduced by Sen. Levin (D-Mich.).
[16] If the acquiring and acquired corporations where consolidated for the year of the distribution, the acquiring corporation's basis in such stock might have been correspondingly reduced under Regs. §1.1502-32(b)(2)(iii), thus mitigating the problem.
[17] H.R. Rep. No. 861, 98th Cong., 2d Sess. 819-23 (1984).
[18] *Id.*
[19] §311(d)(2)(A).
[20] §311(d)(2)(B).
[21] *See Court Holding Co. v. Comr.*, 324 U.S. 321 (1945).
[22] *See, e.g., Davant v. Comr.*, 366 F. 2d 874 (5th Cir. 1966).
[23] G.C.M. 38882 (July 23, 1982).
[24] Regs. §1.301-1(e).
[25] §301(d)(2)(B).
[26] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221 (1984).
[27] The five pre-TRA 1984 exceptions are: distributions to certain noncorporate shareholders in partial liquidation, §311(d)(2)(A)(1); distributions of stock or obligations of certain 50 percent controlled subsidiaries, §311(d)(2)(B); §303 distributions, §311(d)(2)(C); distributions to private foundations in redemption of certain excess business holdings, §311(d)(2)(D); and distributions by regulated investment companies in redemption of stock on demand, §311(d)(2)(E).
[28] Regs. §1.311-2(a)(2).
[29] H.R. Rep. No. 861, 98th Cong., 2d Sess. 820 (1984).
[30] Act §54(d)(1).
[31] Act §54(d)(5).
[32] Act §54(d)(6).
[33] Act §54(d)(4).
[34] Act §54(d)(3).
[35] S. Print No. 169, 98th Cong., 2d Sess. 172 (1984).
[36] §301(d)(2).
[37] The exception for §1248 was necessary so that a U.S. corporation's distribution to a U.S. shareholder of stock in a foreign corporation in which the distributing corporation owned a 10 percent interest would not trigger gain to the distributing corporation under §1248(f)(1) of the Code. The exception to §1248(f)(1) contained in §1248(f)(2) is contingent upon the distributee shareholder having a tacked on holding period in the stock distributed to it.
[38] Act §54(d)(2).
[39] §301(c)(2).
[40] §301(c)(3).
[41] *See Jarvis v. Comr.*, 43 B.T.A. 439, aff'd 123 F. 2d 742 (4th Cir. 1941); and Rev. Rul. 79-376, 1979-2 C.B. 133.
[42] Code §243.
[43] §11(b).
[44] H. Rep. 432, 98th Cong., 2d Sess. 1180 (1984) (hereinafter "H. Rep.").
[45] §163.
[46] H. Rep. at 1180.
[47] In 1983, several deduction problems and proposals involving dividends received were set forth by the "staff of the Senate Committee on Finance in *The Reform and Simplification of the Income Taxation of Corporations*, S. Print 98-95, 98th Cong., 1st Sen. (Sept. 22, 1983). These problems included corporations making leveraged investments in preferred stocks; offsetting common and preferred stock; making stock purchases immediately prior to a dividend record date; and the investment bias created against noncorporate forms of investment, including partnerships. *Id.* at 47-48. The proposals would have extended the holding period for dividend paying stock to the then applicable one year long term capital gain treatment holding period; disallowed 85 percent of the interest on the debt incurred to finance the purchase or to carry the stock; and increased the basis in stock sold short in lieu of receiving dividends. *Id.* at 78-79. None of these provisions were enacted in these forms in the 1984 Act.
[48] §246A(a).
[49] §246A(b)(1) ("qualifying dividends (as defined in section 243(b) without regard to section 243(c)(4))").
[50] §246A(b)(2).
[51] H.R. Rep. No. 861, 98th Cong., 2d Sess. 811 (1984) (hereinafter "Conf. Rep.").
[52] §246A(d)(1)(A) and (B).
[53] §246A(d)(3)(A).
[54] §246A(d)(4)(a) and (b).
[55] *See* H. Rep. at 1182.
[56] *See* S. Rep. No. 169, Vol. I, 98th Cong., 2d Sess. 166 (1984) (hereinafter "S. Rep."). Section 263(h) was enacted in the final law.
[57] Conf. Rep. at 812.
[58] §246A(c)(2).
[59] §246A(c)(2)(A)(i) and (ii).
[60] §246A(c)(2)(B)(i) and (ii).
[61] Conf. Rep. at 813.
[62] The term "bank" has the meaning given that term by §581 of the Code. *See* §246A(c)(3)(B)(i).
[63] The term "bank holding company" means a bank holding company within the meaning of §2(a) of the Bank Holding Company Act of 1956. *See* §246A(c)(3)(B)(ii).
[64] §246A(c)(3)(A).
[65] §246A(c)(4).
[66] §246A(d)(3)(A).
[67] H. Rep. at 1181.
[68] *Id.*
[69] *Id.*
[70] Conf. Rep. at 813.
[71] H. Rep. at 1181.
[72] *Id.*
[73] Conf. Rep. at 813.
[74] *See* H. Rep. at 1181.
[75] Conf. Rep. at 813.
[76] *Id.*
[77] Conf. Rep. at 813.
[78] *Id.*
[79] Conf. Rep. at 811-812.
[80] Conf. Rep. at 814.
[81] §246A(e).
[82] §243(a).
[83] §1201(a)(2).
[84] *See* §243.
[85] H.R. Rep. No. 861, 98th Cong., 2d Sess. 817 (1984).
[86] §1059(c)(3)(C).
[87] H.R. Rep. No. 861, 98th Cong., 2d Sess. 817 (1984).
[88] §1222(11).
[89] This will be true even where appreciated property is distributed. Section 311(d)(1), as revised by the 1984 TRA §54, provides that distributing corporations will recognize gain on virtually all distributions to corporate shareholders that are treated as dividends. Thus, under §301(b)(1)(B), the amount of a §301 distribution will in most cases be its fair market value.
[90] Act §53(e).
[91] H.R. Rep. No. 981, 98th Cong., 2d Sess. 818 (1984).
[92] *Id.*
[93] §§852(b)(4)(A); 857(b)(7).
[94] §§852(b)(4)(A); 857(b)(7).
[95] These rules incorporate those contained in §246(c)(3), relating to deductions for dividends received.
[96] §§852(b)(4)(D); 857(b)(7)(C).
[97] *See* Act §65.
[98] *See* 29 T.M., *Collapsible Corporations — General Coverage* 1-2. *See also, O'Brien v. Comr., 25 T.C. 376 (1955), and Herbert v. Riddell*, 103 F. Supp. 369 (S.D. Cal., 1952).
[99] §341(b)(1).
[100] *See* H.R. Rep. No. 2319, 81st Cong., 2nd Sess. 56-57, 96-98 (1950); S. Rep. No. 2375, 81st Cong., 2nd Sess. 45-46, 88-91 (1950); Conf. Rep., H.R. Rep. 3124, 81st Cong., 2nd Sess. 28 (1950).
[101] *See, e.g.*, §341(e) added by §20 of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1506, 1615-1620. This provision constitutes the longest sentence in the Internal Revenue Code.
[102] §341(b)(1)(A).
[103] Corporate level income realization effectively resolves problems at which §341 is directed, since the corporation thereby becomes subject to tax on previously unrealized income.
[104] 293 F.2d 904 (5th Cir. 1961), aff'g, 32 T.C. 135 (1959), non. acq. 1962-1 C.B. 5, non acq. withdrawn, acq. substituted, 1972-1 C.B. 2.
[105] 293 F.2d at 908-909.
[106] 258 F.2d 537 (3rd Cir. 1958), aff'g, 29 T.C. 795 (1957).
[107] S. Rep. No. 169 (Vol. 1), 98th Cong.2d Sess. 210-212. See also H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1382-1384 with no reference to the impact of the legislation about prior laws made.
[108] 334 F.2d 44 (10th Cir. 1964), aff'g, 39 T.C. 1045 (1963), acq. 1972-2 C.B. 3.
[109] *See, e.g., Winn v. United States*, 243 F. Supp. 282, 290 (W.D. Mo. 1965).
[110] 1972-1 C.B. 102.
[111] The ruling contained the following caveat: "Although such a corpora-

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tion [*i.e.*, a corporation which has realized more than one-third of the income to be derived from the property] is not collapsible, the Internal Revenue Service is not precluded from applying other provisions of the Code to tax the gain as ordinary income." *Id.*

[112] The Senate Finance Committee Report made clear the adoption of the *Abbott v. Comr.* view. S. Rep. No. 169 (Vol. 1), 98th Cong., 2nd Sess. *supra* note 107, at 211, which includes no reference to the import of the legislation about prior law.

[113] Department of the Treasury, Administration's "Revenue Provisions in 1985 Budget, Treasury Department General Explanations February 17, 1984," in CCH *Standard Federal Tax Reports*, Vol. 71 No. 10 Part II February 23, 1984, 145-146. [Hereinafter cited as Treasury Explanation.]

[114] *Id.*, at p. 146.

[115] S. Rep. No. 169, *supra* note 107, at 211. Under Act §65(d), the amendments made by §65 are effective for sales, exchanges, and distributions made after July 18, 1984.

[116] §341(b)(1).

[117] §301(c)(3)(A).

[118] §341(b)(1).

[119] *See* Treasury Explanation, *supra* note 113 and accompanying text.

[120] This example presumes that the amount distributed equals the after-tax proceeds of prior sales by the corporation plus the net value of other units, which is assumed to equal the amount of gain from sale of such units.

[121] *See Zongker v. Comr.*, 39 T.C. at 1052-1053. *See also, Manassas Airport Industrial Park v. Comr.*, 66 T.C. 566 (1976), aff'd per curiam 557 F.2d. 1113 (4th Cir. 1977)

[122] *C.E.G. Sidney v. Comr.*, 273 F.2d. 928 (2nd Cir. 1960) aff'g 30 T.C. 1155 (1958). These issues are fully discussed in 29 T.M., *Collapsible Corporations — General Coverage)* A-31-32.

[123] Along these lines, Regs. §1.341-4(c)(3) addresses the situation in which developing land enhances the value of adjoining (undeveloped) land. The addition of capital improvements can enhance the value of benefitted property. Section 164 addresses the tax consequences of new taxes assessed due to the increase in value of such property.

[124] Even if gross income is expected to remain the same, taxable income may increase. In *Pomponio v. Comr.*, 33 T.C. 1072 (1960) aff'd 288 F.2d 827 (4th. Cir. 1961) the Tax Court and Second Circuit Court of Appeals held that net income from rent already realized was not a substantial portion of total expected net income, even if the realized portion of gross income was substantial, since an especially large portion of expenses in earlier periods decreased net income of earlier periods below the level of net income in later periods.

[125] *See* §341(d) which exonerates (i) 5 percent or less shareholders (§341(d)(1)), (ii) all of the otherwise collapsible gain if 30 percent or more of a shareholder's gain is attributable to noncollapsible property (§341(d)(2)), and (iii) gain from the collapsible property that is realized more than 3 years after the completion of the collapsible activity (§341(d)(3)).

[126] Regs.§1.341-4(c). *See also: Nicholson, supra,* note 98, at A-43-52.

[127] Regs. §1.341-4(c)(3).

[128] Regs. §1.341-4(c)(4).

[129] 29 T.M., *Collapsible Corporations — General Coverage* A-44-45. In *Day v. Comr.*, 55 T.C. 257 (1970), acq. 1972-2 C.B.-1, the Commissioner argued that a corporation was collapsible where it was developing three projects from which the firm had realized over 90 percent of the income to be realized from the first two projects and had realized 56 percent from the third. Frederic Nicholson, in 29 T.M., *Collapsible Corporations — General Coverage*, raises the possibility that the Commissioner viewed the corporation as collapsible because the income from the first two projects was applied to the construction of the third project, which the Commissioner argued to be collapsible property. Conceivably, the Commissioner considered gain on the first two projects to be on the 70 percent bad side of the 70-30 equation since its income was applied to a collapsible project. The 70-30 issue, however, was not addressed in the case, since the Tax Court held that the third project was *ab initio* "noncollapsible."

[130] S. Rep. No. 169, *supra* note 107, at 211.

[131] *Id.* at 211-212.

[132] *See, e.g.*, Rev. Rul. 56-244, 1956-1 C.B. 176, and Rev. Proc. 84-39, I.R.B. 1984-18, 7.

[133] *See, e.g., Champion v. Comr.*, 303 F.2d 887 (1962), rev'g 19 T.C. 253 (1960) which holds that the depressing impact of a sale of a large block of stock on the value of the stock must be applied in measuring the value of the stock; that is, the impact of "blockage" must be taken into account. This concept which is especially important in estate and gift taxation is examined in detail in the following Tax Management Estate, Gift and Trust portfolios: 248 T.M., *Blockage;* 176 T.M., *Gifts — Determination of Tax* A-6; and 132 T.M., *Valuation of Assets* A-7.

[134] S. Rep. No. 169, *supra* note 107, at 212.

[135] 49 F.R. 34523 (August 31, 1984).

[136] Rev. Proc. 84-22, I.R.B. 1984-13, 18, as modified by Rev. Proc. 84-39, I.R.B. 1984-18, 7.

[137] 19 T.C.M. 1035 (1960).

[138] The Commissioner might argue, however, that post-TRA 1984 installments would be taxable ordinary income pursuant to §341. In *Snell v. Comr.*, 97 F.2d 891 (5th Cir., 1938), the Fifth Circuit Court of Appeals noted, "[the taxpayer] chose to defer realization of the profits on the deferred installments. These thereby were left to fall under such provisions of the law as might be of force at their maturity. That the law might be charged, not only in the tax rate but in any other of its provisions, was a risk the taxpayer took in deferring the realization of his gains. The Board rightly applied to them the law as it stood when the gains became taxable." *Id.* at 893. *See also, Klein v. Comr.*, 42 T.C. 1000 (1964), where a statutory change after an installment sale altered the tax treatment of the post-sale installment payments arising from gain from a 1952 sale of a partnership interest. *See generally* 48 T.M., *Installment Sales*, A-55-56.

[139] §311(b), (c), (d).

[140] §311(a).

[141] §336(a).

[142] §337(b)(1)(a) and (b)(2).

[143] §33(b)(1)(B).

[144] §337(b)(1)(C).

[145] §453B(d)(2).

[146] *Holiday Village Shopping Center v. The United States*, 84-2 USTC ¶9549 (Cl. Ct.).

[147] 1960-2 C.B. 209-210.

[148] §386(c)(1).

[149] §386(c).

[150] §386(d).

[151] §386(c)(2).

[152] §386(d).

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CHAPTER 32

MODIFICATIONS IN RULES RELATING TO CORPORATE REORGANIZATIONS, ACQUISITIONS, AND REDEMPTIONS

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I. Liquidation Requirement in "C" Reorganizations [Act §63]

A. Introduction

Section 63 of TRA 1984 continues the piecemeal revision of the politically noncontroversial but intricate corporate reorganization provisions of the Code which was first commenced in the 1982 revision of corporate liquidation rules through enactment of §338.[1] Although an effort at technical refinement doubtless underlay the introduction of §338 of the Code, it has become increasingly clear to the Congress in recent years that the acquisition fever of the 1980's, propelled by a combination of low capital gains rates, ACRS allowances, global availability of capital, and deduction of interest costs, have placed unanticipated stress upon the operation and interplay of the various reorganization and related provisions of the Code. In response to the foregoing, together with growing public awareness of "aggressive" interpretations of Subchapter C, Congressman Fortney H. Stark,[2] introduced H.R. 6295 [3] in 1982, *"The Corporate Takeover Act of 1982."* Public hearings followed in the House.[4] The Senate Finance Committee considered similar issues as part of its "comprehensive look at the fundamental rules of corporate taxation." [5] Although the House Ways and Means Committee did not act directly on the Stark Subcommittee recommendations in its 1982 legislative action,[6] the Senate Finance Committee considered several Subchapter C issues, including §63, which now appear in the TRA of 1984.[7]

The perceived anomaly at which §63 is principally directed is the asserted opportunity to convert dividends into returns of capital. The circumstance in which this could have occurred was described by the Senate Finance Committee staff as follows:

> "The complexity under the statute concerning qualifying consideration [in a corporation acquisition] is rivalled by the rules concerning the disposition of unwanted assets and the survival of the acquired corporation. Under a statutory merger the acquired corporation terminates by operation of law. In the case of an asset acquisition — a so-called C reorganization — the acquired corporation may be continued, so that the corporate shell may survive.
>
> *Example III-2:* T has a capital loss carryforward of $2. T's assets have a basis of $6 and a fair market value of $12. P acquires all of the assets of T in exchange for common stock of P with a fair market value of $10 and cash of $2. T distributes all of the stock of P to its shareholders, and invests the cash in common stock of unrelated corporations. In year 2, T adopts a plan of complete liquidation and distributes the portfolio common stock to the T shareholder. The gain recognized by T in year 1 is offset by the loss carryforward." [8]

The Senate Finance Committee staff also felt the relatively narrow statutory objective of §368(a)(1)(C) (to facilitate nontaxable acquisitions in states in which uniform merger or consolidation rules were not enacted) was capable of being thwarted through the use of C reorganizations to accomplish "divisive" reorganizations without the constraints intended to be applicable to such provisions.[9] As described by the Senate Finance Committee:

> "Different provisions [other than §368(a)(1)(C)] are intended to apply to divisive transactions. The committee is concerned that since a distribution by the transferor corporation of all its assets is not required in connection with a C reorganization, and after such a reorganization the transferor may be able to engage in an active trade or business and not merely serve as a holding company for its shareholders' interests in the acquiring corporation, transactions that are somewhat divisive in nature can qualify as reorganizations without qualifying under the provisions generally applicable to divisive transactions.
>
> ". . . the C reorganization provisions were intended to apply to transactions that resemble, in substance, statutory mergers or consolidations. In the case of a statutory merger or consolidation, the transferor is liquidated by operation of law. The committee is concerned

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that substantially similar transactions should be treated consistently for Federal income tax purposes." [10]

Section 63 achieves the Congressional (and Congressional staff) objective noted above.[11]

B. Overview

Section 63 of TRA 1984 contains three components: under the first, characterization of a corporate acquisition as a C reorganization is denied unless the transferor corporation, in pursuance of the plan of reorganization, distributes the consideration which it receives (in stock, securities and other properties) received from the acquiring entity, together with the transferor corporation's "other properties."

The second component permits a waiver of the "total distribution" requirement of the first rule, in situations not elaborated in the statute, which are to be authorized by the Secretary by regulation,[12] and which can occur subject to "any condition" which the Secretary may prescribe. The Conference Report emphasizes, however, that such waivers will be granted only "if a distribution would result in substantial hardship, [and that] as a general rule a waiver is to be granted only on the condition that the transferor corporation and its shareholders be treated as if the retained assets are distributed and then contributed to the capital of a new corporation." [13]

Under the third component (which adds §312(h)(2) to the Code), the Secretary, in a reorganization under §368(a)(1)(C) or (D) is directed to make a "proper allocation" of the acquired corporation's earnings and profits between the acquiring corporation and the acquired corporation (or to any corporation in control of the acquired corporation immediately before the reorganization.) According to the Conference Report, the conferees "anticipate" that the regulations will also provide consistent rules for A, C and nondivisive D reorganizations. The conferees also suggest that the earnings and profits allocation regulations under §355 [14] (relative to corporate separation) will be reconsidered.

C. Detailed Analysis

1. General Rule of Operation

In adding yet another subparagraph to the various "special rules" of §368(a)(2), (which elaborate upon the basic reorganization description provisions of §368(a)(1)(C)), §63 of TRA 1984 further circumscribes the circumstances in which a C reorganization can occur.[15] Under such new provision, §368(a)(2)(G), a transaction otherwise qualifying as a nontaxable C reorganization will "fail" (and thereby become taxable to the corporate transferor and its shareholders who receive transferor corporate shares) unless the transferor corporation (*i.e.*, the target) distributes to its shareholders: (i) the stocks, securities and "other properties" which it receives under the plan of reorganization, and (ii) all of its other properties.

The total distribution rule of new §368(a)(2)(G) seems intended to parallel in substance (although not in precise language) the required distribution rules of §368(a)(1)(D).[16] Under this latter provision, a transaction can qualify as a D reorganization only if "... in pursuance of the plan [of reorganization], stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under §§354, 355, or 356." [17] The language of §368(a)(2)(G) may tolerate, however (as indeed the courts and the Service have indicated with respect to the less specific circumstances of §368(a)(1)(D)) [18] retention by the transferor of limited assets in an amount not sufficient to frustrate the general objective of both sections — which will permit satisfaction of all liabilities of the transferor.[19]

Although the Senate provision would have required that the transferor satisfy the assets distribution "within a twelve-month period beginning on the date of the acquisition," [20] the rule as finally enacted simply mandates that the distribution occur "... in pursuance of the plan of reorganization." [21] Thus, the law as finally enacted is not only less explicit than the Senate language; but may in fact, allow more time in absolute terms within which to effect a qualifying distribution.

Observation: Assume a C reorganization in which, under the plan, final distribution of items required to be distributed can take place only after state regulatory clearances have been obtained. For reasons beyond the control of the distributor, final distribution does not occur for a period of eighteen months. The transaction would appear to qualify as a C reorganization notwithstanding the rules of §368(a)(2)(G) in the light of the unavoidable delay in effecting final distribution. On the other hand, if the regulatory clearances were delayed — even if for reasons beyond the transferor corporation's control — for an inordinately long time (such as four years or more), it would appear that a question could be raised as to whether the transaction was in fact finally implemented pursuant to the initial plan of reorganization or pursuant to a subsequent arrangement.

2. Waiving of the Total Distribution Rule

Section 368(a)(2)(G)(ii) authorizes (but does not require) the Secretary to "waive" the required distribution rule "... subject to any conditions the Secretary may prescribe." [22] In elaborating upon this provision, the Conference Report states that the conferees "endorse" the Senate Committee report language which indicates that under regulations exceptions to the required distribution rule may include circumstances in which "substantial hardship" will occur as a result of a forced distribution "... such as the loss of a valuable nontransferable charter ..." [23]

Note: An example of substantial hardship may include a situation in which a corporate franchise to operate in a certain jurisdiction would be permanently forfeited unless retained by the transferor corporation. In such a case, the parties to the reorganization could agree that the transferor corporation will remain in existence solely for the purpose of protecting the viability of the charter. Under those conditions (and assuming that the corporation has no other activities or assets), the transaction would appear to qualify as a C reorganization.

Notwithstanding the situation in which certain assets may be retained for an extended period (or even permanently, as indicated above), the Conference Report adds (without, however, statutory cognizance) that in any situation in which a waiver of the total distribution rule occurs, the

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availability of the waiver will be "conditioned" upon treating the transferor and its shareholders as if the assets to be retained have been distributed to the transferor's shareholders and thereafter contributed to the capital of the firm or (as the Conference Report states) to "a new corporation." [24] In such event, the legally retained assets would, for tax purposes, be owned by a party other than the legal owner with a presumed carryover basis to the new corporation. Although it is likely, in such a case, that the shares of the transferor corporation would also have been transferred to the transferee, the difference between the legal and tax ownership of the retained properties may require reconsideration of tax and local law. There is, for example, no exoneration from the requirement of filing an income tax return, modified or otherwise specially identified, presumably for the transferor during the subsequent years in which it operates solely as a title holding company. Hopefully, the regulations will treat this issue.

Doubtless other situations beyond those referred to in the Conference Report will be described as possible exceptions to the required distribution rule. Some of those which may be envisaged in addition to a delay attributable to regulatory rules, include other unavoidable external circumstances such as a cloud on title which precludes transfer of assets; the assertion of third party claims for contract (respecting which the transferor remains beyond the party's control) which precludes completion of the transaction within the time frame contemplated under the plan.

3. Treatment of Earnings and Profits of the Transferor Corporation

Section 63(b) of TRA 1984 adds paragraph (2) to §312(h), the purpose of which is to establish the authority of the Secretary to allocate earnings and profits in a "proper" manner among constituent corporations in both C and D reorganizations. Although the statute as finally enacted limits itself to a delegation of authority to promulgate regulations, the Conference Report makes clear that the transferor corporation's earnings may be allocated "between and among" the (i) transferor and (ii) a corporation which, immediately before the transaction, controls the transferor and (iii) the acquiring corporation in a C reorganization.[25] The Senate Finance Committee Report also states that "among other things" regulations will prescribe rules for allocation in situations in which ". . . one corporation owns 80 percent or more" of the transferor before the transaction.[26]

In referring to a corporation "in control" [27] of the transferor before the transaction, as one of the persons to which earnings and profits may be ascribed, consideration was apparently given by the conferees to a situation in which boot received by a "controlled" transferor would become subject inappropriately to the dividends received deduction. Alternatively, the converse situation may obtain, in that where appropriate, capital gains treatment to the controlling corporate shareholder may be required. Presumably, the earnings and profits allocation rules will take these factors into account.

The effect of the foregoing is to grant the Treasury virtually unlimited authority to ascribe earnings and profits to any of the constituent corporations in such a manner as will implement the Senate Committee and Conference Report objectives. This precludes situations in which the transferor corporation can thereby effect after a transfer in a C reorganization capital, in lieu of dividend, distribution on the grounds that all of the earnings, on hand before the transaction, have been transferred to the transferee. Regulations may accordingly be anticipated which, in general, will assure that earnings and profits will "follow" the assets to which they were related. On the other hand, notwithstanding that the earnings and profits are deemed to be transferred as of the closing date of the transfer of the assets to the acquiring corporation in a C reorganization,[28] a subsequent distribution of boot, pursuant to the plan of reorganization should be taxed to the transferor's shareholders as if such distribution had been made prior to the asset transfer, subject to the constraints of §356, and to the extent of the earnings and profits of the transferor.[29] Of course, in determining the amount of earnings and profits which are "inherited" by the transferee any amount first "treated as a dividend" will reduce such inherited amount. While such a rule eliminates double counting in dividend situations, neither the statute nor the Committee Reports treat the case in which in a C reorganization with boot, all or part of which is taxed as a capital gain.[30] In that case, presumably, an allocation can, and will be, made under authority of the regulations with a portion but not all of the earnings and profits of the transferor allocated to the transferee.

4. Planning Considerations

The direct consequences resulting from the enactment of §368(a)(2)(G) to C reorganizations are of course, evident. For the first time since the enactment of the 1954 Code, transferor shareholders in both acquisitive and divisive reorganizations will be required, as a condition to nontaxable treatment, to receive all of the assets of the transferor (less, of course, assets used to satisfy claims). Thus, if the transferor or its shareholders desire to retain assets of the transferor in corporate solution, a taxable transaction may prove to be the "tax price" resulting from the retention of assets.

Note: Circumstances sometimes are presented when the "tax cost" of corporate level recapture of investment tax credit and depreciation, together with gain from the sale of assets, may be of a minimum amount (or the corporate transferor may have an inherent net corporate level loss.) If a taxable transaction is in fact effected in a situation such as this, the earnings and profits of the transferor would not appear to be inherited by the purchasing transferee.

On the other hand, while the Senate version of §63 specifically allowed the retention of assets to meet claims [31] no such provision is contained in the law as finally enacted. Presently, the regulation will make reasonable allowance for this form of asset retention. If in such a case the transferor makes a "conservative" provision for such an event, which proves ultimately to constitute a greater amount than has been actually needed, the existence of such excess and its later distribution could: (a) destroy the "C" reorganization, or (b) be treated, by definition as part of the transaction and therefore "boot."

Notwithstanding the constraints of §368(a)(2)(G), certain other limited opportunities may exist to preserve corporate level cohesiveness. For example, assume that a closely

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held corporation intends a transfer of its assets to a transferee in a transaction otherwise qualifying as a C reorganization desires in addition to retain the consideration received from the transferee (or its parent corporation) at the corporate level. In such a case it may be possible for the corporate and individual shareholders of the transferor, immediately prior to the transaction, to transfer their shares to a newly formed holding company which then becomes the corporate transferor's shareholder. Although, in such case, it seems clear that the earnings and profits of the transferor corporation will be inherited by the transferee, if the shareholders of the newly formed holding company are identical with those of the transferor, no question can be raised as to whether a distribution for tax purposes has in fact, occurred. Such result may differ, however, if a substantial number of shareholders of the transferor corporation differ (for example, if new persons purchase shares in the holding company).

Finally, reference should be made to the interaction of §311(d)(1) as amended by §54 of TRA 1984 and the new C reorganization provisions. Henceforth, to the extent that a transferor corporation retains or receives from a transferee appreciated property subject to the rules of §311(d)(1), corporate level gain will be recognized to the transferor on the distribution of the property. Although the recognition of such gain would not appear to impinge upon the otherwise generally nontaxable treatment of the reorganization, transferor shareholders will be required to take the cost of the new corporate level gain rules into account, or otherwise to avoid retention or receipt of appreciated property.

5. *Effective Date*

The "trigger points" on application of §63 are the dates of adoption of a plan of reorganization and the date of enactment of TRA 1984. Thus, C reorganization transactions effected pursuant to plans adopted after July 18, 1984 fall within the provisions of the new law. By the same token, transactions concluded after July 18, 1984 pursuant to a plan of reorganization adopted on or before such date also avoid the newly enacted constraints. Of course, the determination of the date upon which a plan of reorganization has been adopted is a question of fact, and while the new law does not require that such a plan be adopted in writing, taxpayers desiring to establish a plan adoption date on or before July 18, 1984, (particularly if the plan is an unwritten one), will bear the usual burden of proof with respect to the facts concerning the date of such adoption.

II. Revised Control Requirement in "D" Reorganizations [Act §64] [32]

A. Introduction

The problem of dividend "bail-outs" and stepped-up basis effected through the technique of liquidation of a corporation by its reincorporation has plagued the courts, the Treasury Department and the Internal Revenue Service since the early days of the income tax.[33] This is a result of the limitless patterns whereby a majority or a significant portion of prior shareholders of a corporation may emerge as continuing owners of the legally new, but economically the same, enterprise, notwithstanding the liquidation event. The enactment of §64 of TRA 1984 signals Congress's apparent belief that the existing legislative and judicial arsenal to be inadequate to cope with this capital gains-dividend arbitrage and asset basis step-up. Additionally, recent Code rate and structural changes (such as truncation of income tax rates at 50 percent and reduction of corporate double tax effect through expansion of the scope of Subchapter S provisions) have been insufficient to deter motivation for many liquidation-reincorporation transactions.

Indeed, the TEFRA legislation of 1982 circumscribed F reorganization parameters so that a transaction can qualify under §368(a)(1)(F) [34] only if a single corporation (*i.e.*, "one corporation" [35]) is redomesticated. This served merely to complicate the liquidation and reincorporation issue, since it effectively removed the F reorganization from the Commissioner's attack devices.

Section 64 of TRA 1984 engages the problem by defining "control" [36] for purposes of §368(a)(1)(D) by reference to §304, and thus on the basis of a 50 percent test (with attribution under §318), rather than in terms of the 80 percent test of prior law. Such an approach was envisioned and suggested over 25 years ago by the Subchapter C Advisory Group.[37]

In its monograph *The Reform and Simplification of the Income Taxation of Corporations* [38] prepared in the fall of 1983, the staff of the Senate Finance Committee set forth these illustrations of the problem:

> *Example III-9:* X corporation has a basis of $100 in its depreciable assets, cash of $100, potential recapture liability of $100; the fair market value of its assets is $300. X corporation has earnings and profits of $100.
>
> X liquidates. Six months after the liquidation (not pursuant to a plan), an unrelated co-venturer, B, is found. All of the business assets are contributed to new Y corporation, in exchange for 75 percent of the stock. B contributes $100 in exchange for a 25 percent stock interest.
>
> Because the stock ownership requirements for a D reorganization are not satisfied and because of the absence of a plan, the transaction may well survive challenge as a liquidation-reincorporation, and it will have bailed out the $100 of earnings and profits at capital gains rates.
>
> *Example III-10:* Same facts except B is A's spouse.

Because no attribution rules apply for determining whether the D reorganization stock ownership tests are satisfied, the preceding example will also likely escape being held to be a liquidation-reincorporation.[39]

The staff response to the foregoing problem is reflected in a paragraph in a later portion of the report:

> "Taxpayers' ability to engage in liquidation-reincorporation transactions would be restricted in transactions involving corporations with overlapping share ownership of 50 percent or more, because no step-up in the basis of acquired assets would be permitted. In determining whether such common stock ownership exists, the attribution rules under section 318 would apply." [40]

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Similarly, in testimony before the Senate Finance Committee regarding revisions of Subchapter C, Deputy Assistant Secretary Ronald A. Pearlman stated:

> "We are supportive of the acquisition proposals primarily because they will bring consistency and symmetry to corporate transactions, which we do not believe is present in current law, and will minimize the significance of form rather than maximize that significance as is present under current law." [41]

Finally, whether or not the statutory lowering of the reincorporation threshold from 80 to 50 percent coupled with attribution will in fact suffice to preclude so-called abusive situations in the future can be determined only after the significance of the following paragraph concerning §64 changes contained in the Conference Report becomes fully apparent:

> Under the conference agreement, control means the ownership, directly or indirectly, of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all shares of all classes of stock. The conferees believe that by taking value into account this definition increases the utility to the Internal Revenue Service of the D reorganization provisions as a means of preventing taxpayers from bailing out earnings and profits at capital gains rates in liquidation-reincorporation transactions.

In addition, the conferees wish to clarify that they do not intend that recharacterization as a D reorganization under this provision be the exclusive means for the Service to challenge liquidation-reincorporation and similar transactions. For example, it is not intended that this provision supercede or otherwise replace the various doctrines that have been developed by the Service and the courts to deal with such transactions. *See, e.g.*, Rev. Rul. 61-156, 1961-2 C.B. 62; *Telephone Answering Service Co. v. Comr.*, 62 T.C. 423 (1974), aff'd, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977); and *J.E. Smothers v. U.S.*, 642 F.2d 894 (5th Cir. 1981)." [42]

B. Overview

Section 64, not itself an operational provision, changes the definition of "control" for the purposes of nondivisive reorganizations described in §368(a)(1)(D) by reducing the required share ownership from 80 percent to 50 percent. This is accomplished by incorporating (by reference) the standards for "control" set forth in §304(c). Under §304(c), control is defined to mean ". . . the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock." [43]

In determining ownership percentages the constructive ownership rules of §318 are fully applied, and broadened (as occurs under §304(c)), so that the 50 threshold ownership percentages in attributing ownership to and from a corporation are eliminated.[44] Thus, the threshold ownership test may not be avoided, as described in the staff example III-10, *supra*, by causing shares of the transferee corporation to be owned by a spouse or any other individual within the attribution rules of §318.

Example: Individual A, who owns one hundred percent of the stock of corporation X, transfers such shares to a new corporation, Y, whose shares are owned as follows: A — 40 percent, B (an individual unrelated in all respects to A) — 40 percent, and C (a partnership of which A is a 50 percent partner) — 20 percent. Under the above factual circumstances, A is treated as in "control" of corporation X because the threshold control requirement of §368(i)(1) is reduced from 80 percent to 50 percent and the constructive ownership rules of §318 are applied. Thus, although A in the described example holds direct ownership of only 40 percent, his 50 percent ownership in partnership C causes half of the shares of such partnership (*i.e.*, 10 percent) to be attributed to him, causing his actual and constructive share ownership to reach the 50 percent threshold level.

In addition to §64, §63 of TRA 1984 adds a new provision (§312(h)(2)) to the Code, directing the Treasury to prescribe by regulation the "proper allocation with respect to the earnings and profits" of the constituent properties in a D, as well as a C, reorganization. Thus, in a typical "liquidation-reincorporation" D reorganization, to the extent that assets are retained by the transferor in such a transaction, an appropriate percentage of the transferor's earnings and profits attributable to the transferor's assets will remain with the transferor to assure dividend treatment if and when a corporate distribution from the transferor is made.[45]

C. Detailed Analysis

1. In General

Apart from its use in corporate separations (*i.e.*, a corporate spin-off, split-off or split-up [46]), the D reorganization mechanism was also designed to enable a corporation to effect a "practical" redomestication of substantially all of its business whether or not in a qualifying reorganization under §368(1)(F) without income tax effect at either the shareholder or corporate level. The possibility of overlap between §368(a)(1)(D) and other Code provisions was taken into account, to a limited extent, in 1954. Thus, §368(a)(2)(A) prescribes that if a transaction could have been described as both a C and a D reorganization, such a transaction is classified as a D reorganization. This factor (coupled with a requirement, under §368(a)(1)(D), that a D reorganization must also meet the requirements of §354, §355, or §356), was intended to assure that in the case of a nondivisive D reorganization the transferee corporation would acquire "substantially all" of the transferor's assets and that stock, securities or other property received by the transferor from the transferee, as well as properties retained by the transferor, would be distributed in pursuance of the plan of reorganization to the transferor's shareholders.[47] Other areas of overlap, not taken into account in 1954, have been the subject of more recent legislation. Thus, a nondivisive D reorganization involving more than one corporation often alleged by the Service to constitute an F reorganization was eliminated by TEFRA.[48] And, in the case of a reorganization under §368(a)(1)(G) (which involves the transfer of all or part of the assets of an insolvent corporation to another corporation in specified types of bankruptcy reorganizations), the possibility of

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overlap was statutorily characterized as a G reorganization.[49]

Notwithstanding these somewhat ineffective statutory changes, the problem of defining a D reorganization in many situations has continued as a thorny issue for government and taxpayers alike.[50]

2. Liquidation-Reincoporation Problems

The principal area of controversy has revolved around taxpayer desire to accumulate earnings at capital gains rates on the grounds that the required liquidation of the transferor under §354(b)(a) constituted a capital gain to the transferor's shareholders.[51] In situations in which the transferor shareholders held stock at a potential loss, classification of a liquidation-reincorporation as a reorganization would also have eliminated the loss allowance, whereas treatment as a liquidation would provide a capital loss to the shareholders.

To cope with taxpayer ingenuity, the Commissioner had developed several theories to characterize the transaction in question as a D reorganization (despite the 80 percent "control" test) by utilizing other Code provisions or judicial rules to find dividend treatment without the benefit of basis step-up.[52]

The theories advanced by the government in liquidation and reincorporation situations in which the shareholders of the selling transferor corporation or their families continue to hold significant share ownership include the following:

a Characterization of the Transaction as a Recapitalization Under §368(a)(1)(E)

In a ruling issued in 1961,[53] the Service treated the sale of "substantially all" of one corporation's assets to a new corporation, formed by management of the seller, in which shareholders of the "selling" corporation held 45 percent of the new entity after the transaction as an F reorganization. Because the shareholders of the transferor owned much less than 80 percent of the transferee, no possibility of characterization of the transaction as a D reorganization was possible. Indeed, absolute, (although perhaps not working) control shifted to unrelated parties (in this case, public shareholders) who then held 55 percent of the shares.

Since issuance of Rev. Rul. 61-156 the Service has adopted a "no ruling" policy in Rev. Proc. 62-32.[54] This policy, which appears to be unaffected by the enactment of §64, indicates that no rulings will be issued where shareholders of a liquidating corporation own more than a "nominal amount," (*i.e.*, more than 20 percent) in value of the transferee corporation. No reference is made in Rev. Proc. 62-32 to the Service's no ruling position respecting the application or nonapplication of the attribution rules (under §318 or otherwise), to determine whether the 20 percent threshold has been reached. One would believe, however, that since the issuance of rulings is a matter of discretion, that the Service will in fact apply the principles of §318 in such a case (although, perhaps not literally in every instance). For example, in a nonfamily situation, involving corporations or ties of partnerships where the economic relationship of the parties may be rather remote, the Service will probably not feel it necessary to apply principles of constructive ownership.

b. The Functionally Unrelated Concept

In any situation in which substantial continuity of ownership continues between the shareholders of the transferor and the transferee, the Service has taken the position that the distribution of cash or other property to shareholders of the transferor constitutes a dividend and that the sale of assets by the transferor to the transferee corporation, is an independent event, "functionally unrelated" to the sales transaction.[55]

Furthermore, in Rev. Rul. 61-156, the Service took the position that, notwithstanding a significant change of ownership, one component of the transaction was a recapitalization of essentially one corporation. Thus, one may also view that Ruling as a further application of the functionally unrelated test.[56]

3. The "No Complete Liquidation" Approach

Allied to the functionally unrelated concept is the theory of "no complete liquidation" best ennunciated in *Telephone Answering Service Co., Inc. v. Comr.*, (hereinafter cited as TASCO).[57] In that case, a corporation was purportedly completely liquidated after a directly operated business was transferred to a new wholly owned subsidiary and another subsidiary was sold to unrelated third parties. Apparently experiencing difficulty in characterizing the transaction (which effectively could be described as a corporate split-up) as a D reorganization,[58] the court held that since the company's business continued without change in share ownership, no complete liquidation occurred (and thus that §337 did not apply).

4. Significant Change of Ownership

It is to be emphasized that despite the holding of Rev. Rul. 61-156, a constant difficulty for the government has been presented in situations in which a significant (*i.e.*, more than 20 percent) change in ownership has occurred. For example, in *Gallagher v. Comr.*,[59] the transferee shareholders after the transaction held 73 percent of the stock of the transferor corporation. And in *Berghash v. Comr.*,[60] a corporation wholly owned by the taxpayer sold its operating assets to a newly formed corporation for cash and notes which were distributed as part of the liquidation. The new shareholders of the transferee (who, as was the case in *Gallagher*, were employees of the transferor) obtained a 50 percent interest in the firm. In each of these instances, capital gains treatment was accorded the shareholders of the transferor on the grounds that §368(a)(1)(D) did not apply (since such shareholders were not 80 percent owners of the transferee) and that none of the other judicial or administrative theories were applicable under the circumstances.

The objective of §64 — to establish a more effective statutory basis for a finding of reorganization treatment in transfers between commonly controlled corporations — is readily evident. Not only has the control test been reduced from 80 percent to 50 percent, but the addition of the attribution rules of §318 to the control definition precludes treatment of family members, or other persons within the attribution circle, from characterization as third parties in computing the amount of share ownership of the transferee held by the shareholders of the transferor.[61] By the same token, the Conference Report's continuing emphasis upon

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Rev. Rul. 61-156, *TASCO*, and *Smothers* suggests that the principles underlying these cases, all favorable to the government, will have ongoing importance. In fact, the Conferees stated that in enacting §64 their intention was not to "supersede or otherwise replace the various doctrines" [62] developed by the Service and the courts. Consequently, one may anticipate that the Commissioner will continue to apply the doctrines with renewed vigor.

Also to be noted is §63 of TRA 1984 which directs the Treasury to make "proper allocation" of earnings and profits between the transferor and transferee in a consistent manner with respect to C and D reorganizations. Pursuant to a suggestion of the Conference Committee, this may involve reconsideration of the regulations relating to allocations of earnings and profits in transactions under §355.[63]

Reference should also be made to §304. Changes made in 1982 to §304(b) were intended to eliminate the overlap between §351 and §304. Consequently, in a transaction in which both provisions could apply the earnings and profits of both the transferee and transferor are taken into account by reason of §304(b)(2). In light of the coordination of the definition of control between §304 and §368(a)(1)(D), the concept of combination of earnings and profits to ascertain dividend characterization is further fortified.

The degree to which a corporate distribution to shareholders is appropriately treated as a dividend in a situation in which the amount of the distribution exceeds the earnings of the transferor, but not the combined earnings of the transferor and the transferee, was not totally clear under prior law.[64] Under §§63 and 64 of TRA 1984 the Treasury now has the authority to establish that the combined earnings of both the transferor and transferee will be taken into account in characterizing the cash distribution from the transferor.[65]

In light of the enactment of §64, the practical operational consequences of situations in which less than a 50 percent change of ownership occurs but "substantially all" of the assets of the transferor have been transferred remains uncertain. Similar questions may arise in situations in which substantially all of the transferor's assets are sold to the transferee, and less than 50 percent of ownership changes hands (determined on the basis of the new provision including §318), but persons "close" to the transferor such as employees represent the new shares (*i.e.*, a typical leverage buy-out).

Finally, it is important to observe that, notwithstanding the evident intention of the draftsman to add important weapons to the government's arsenal in liquidation and reincorporation situations, taxpayers may find the new reduced control definition to be affirmatively useful. For example, if a nontaxable amalgamation of two related enterprises is desired, §64 will permit this result without the necessity of a statutory merger by enabling the introduction of new parties to the extent of 50 percent control as part of the transaction. Similarly, the use of a D reorganization may prove desirable in situations in which unrelated corporations desire to unite in a practical merger in which each party retains equal (*i.e.*, 50 percent) control of the resultant corporation.

D. Effective Date

The principal rule respecting the effective date of §64 has been set forth in the Conference Report as follows:

> "The conferees wish to clarify that the provision applies to transactions pursuant to a plan adopted after the date of enactment by any corporation which would be a party to the reorganization if the transaction qualifies as a reorganization." [66]

Under the foregoing rule, it seems clear that little problem will be presented respecting the effective date in the normal situation in which no question arises as to the date of the adoption of a plan — whether written or oral — of reorganization. It is entirely possible, however, that situations will arise in which an allocation may be made and circumstances surrounding a transaction may indicate that a plan of reorganization *de facto* was adopted before date of enactment notwithstanding that the more formal arrangements occurred after the date of enactment. The resolution of issues such as this one will ultimately depend upon all the facts and circumstances.

It also may be theoretically possible to envisage a situation in which the plan of reorganization has been adopted before the date of enactment but a corporation becomes a party to the reorganization only after such date. For example, if a transferor corporation plans a nondivisive D reorganization before date of enactment, but forms the transferee corporation after such date, it would appear that the transaction would be governed by prior law rather than the new rule of §64.

It also seems clear that a transaction not fully physically implemented until after July 18, 1984 will avoid the lower percentage strictures of §64. In a situation in which, for example, shareholders of the transferor corporation hold 75 percent of the shares of the transferee in a transaction carried out pursuant to a pre-July 18, 1984 plan of reorganization, the Commissioner will be required to assert dividend taxation (assuming in his view that such a result is appropriate and in accordance with judicial principles).[67]

The absence of a customary "no inference" clause in the Committee reports is also not surprising, since §64 is simply a reduced percentage amount. Any focus on prior law would simply reinforce the inapplicability of §368(a)(1)(D) to ownership situations which fail the 80 percent test.

III. Effective Date Delay for 1976 TRA NOL Rules

A. Introduction

As part of the Tax Reform Act of 1976, P.L. 94-455, Congress revised the rules introduced by the Internal Revenue Code of 1954 governing the carryover of net operating losses (NOLs) following certain stock purchases and reorganizations. Section 382(a), as amended by the 1976 rules, provides that where, as a result of certain stock purchases, §351 exchanges, redemptions, and other transactions, those holding at the end of a corporation's taxable year the fifteen largest shareholdings have increased their shareholdings by more than sixty percentage points within the preceding three taxable year period, the corporation's available NOLs are reduced. These NOLs are reduced regard-

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less of whether the loss corporation continued any of the businesses it carried on prior to the stock acquisition transactions. That reduction would be 3.5 percent for each percentage point above sixty but below eighty, and 1.5 percent for each percentage point above eighty, that the percentage ownership (in terms of the fair market value of all stock or of all participating stock) of the now largest shareholders increased.

Under the original 1954 Code provision, the available NOLs are reduced only if (1) by purchases or by redemptions, shareholders holding the ten largest shareholdings of a loss corporation as of the end of a taxable year have increased their holdings by more than fifty percentage points within the preceding two taxable year period and, (2) the loss corporation does not continue to carry on any business substantially similar to one it carried on prior to the beginning of the two year period. Where those two conditions are met, none of the corporation's NOLs are available.

With respect to reorganizations, §382(b) would provide that where a corporation with NOL carryovers is a party to an (A), (B), (C), (F) reorganization, or, if it qualifies under section 354, a (D) reorganization and the shareholders of the loss corporation, as a result of their ownership of such stock, end up after the reorganization owning less than forty percent of the fair market value of all stock (or of all participating stock) of the *de facto* acquiring corporation,[68] the available NOLs are reduced. The NOLs are reduced 3.5 percent for each percentage point below forty but above twenty, and 1.5 percent for each percentage point below twenty, that the former loss corporation shareholders own in the acquiring corporation. Where the reorganization is a triangular reorganization, these rules treat the shareholders of the loss corporation as receiving in the reorganization the percentage of stock in the acquiring corporation equal to the percentage of the controlling corporation's stock they receive multiplied by the percentage of acquiring corporation stock held by the controlling corporation.

Under the original 1954 version of §382(b), where a corporation with NOL carryovers is a party to an (A), (C), (F) reorganization, or if §354(b)(1) is satisfied, then a (D) or (G) [69] reorganization and the shareholders of such corporation receive in the reorganization less than twenty percent of the fair market value of the outstanding stock (other than nonvoting stock that is limited and preferred as to dividends),[70] the available NOLs are reduced. These NOLs are reduced by the percentage equal to five times the number of percentage points below twenty represented by the fair market value of acquiring corporation stock received by shareholders of the loss corporation in the reorganization. For purposes of determining how much stock in the acquiring corporation that shareholders of the loss corporation receive in a triangular reorganization, the 1954 rules treat stock received in a corporation controlling the acquired corporation as stock in the acquiring corporation itself. Thus, if the acquiring corporation's only assets are those of the loss corporation, the shareholders of the loss corporation would be deemed to own 100 percent of the acquiring corporation's stock.

The rules enacted in the 1976 Tax Reform Act were originally scheduled to apply with respect to (1) all reorganizations pursuant to plans adopted on or after January 1, 1978 for taxable years beginning on or after January 1, 1978, and, (2) to all acquisitions described in §382(a) occurring on or after January 1, 1978 (the earliest "lookback" date) for taxable years beginning on or after July 1, 1978. Prior to the 1984 TRA, the January 1, 1978 effective date for both reorganizations and earliest lookback date for other acquisitions as well as the July 1, 1984 taxable year effective date for applying the rules to transactions other than reorganizations had been extended three times; first, to January 1, 1980 and July 1, 1980, respectively,[71] second, to January 1, 1982 and July 1, 1982, respectively,[72] and then to January 1, 1984 and July 1, 1984, respectively.[73] The extension to January 1, 1980 of both the effective date for reorganizations and the earliest lookback date for other acquisitions, which did not occur until November 6, 1978 — ten months after the original effective date of the new law — was accompanied by another provision. This provision gave taxpayers the option of applying the new rules with respect to acquisitions occurring, or reorganizations pursuant to binding written contracts or options entered into, before September 27, 1978 if such acquisitions or reorganizations occurred before the end of the taxpayer's first taxable year ending after June 30, 1978.[74]

B. Detailed Analysis

1. Legislative History

Section 805 of H.R. 4170 would have changed the effective date of the changes in the NOL carryover rules so that they would apply to acquisitions occurring, and reorganizations pursuant to plans adopted, on or after November 1, 1984 with respect to taxable years beginning on or after November 1, 1984. The House Ways and Means Committee Report accompanying H.R. 4170 stated that the reason for this delay was "to allow time for further study and analysis" of unspecified problems with the 1976 changes.[75] Section 48 of S. 2130 would have changed the effective date for the changes in the NOL carryover rules so that they applied to acquisitions occurring, and reorganizations pursuant to plans adopted on or after, January 1, 1986. The Senate bill would have applied those changes to all taxable years beginning after December 31, 1985. The Senate Finance Committee Report accompanying the bill mimicked the House committee report as to the reasons for change.[76]

2. Delay of Effective Date

a. In General

The Conference Committee agreed with the Senate to delay the effective date of the 1976 rules so that they apply only with respect to acquisitions occurring, and reorganizations pursuant to plans adopted, on or after January 1, 1986. The changes are to apply for determining the availability of NOL carryovers for taxable years beginning on or after January 1, 1986.

Example: Corp. L, whose sole class of stock has a fair market value equal to $1,000, has NOL carryovers of $100. On December 1, 1985, Corp. L and Corp. A, a corporation whose stock is worth $2,000, both adopt a plan of reorganization pursuant to which Corp. L and Corp. A will be merged, with the shareholders of Corp. L receiving in exchange for all their stock $1,000 worth of stock in Corp. C. Corp. C owns 100 percent of the

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stock of Corp. A and certain other subsidiaries. The stock of Corp. C prior to the reorganization is worth $6,000. On March 1, 1986, the reorganization takes place according to plan. Because the plan of reorganization was adopted before January 1, 1986, the 1954 rules, rather than the 1976 rules, of §382(b) apply.

Under §382(b) as it appears under the 1954 Code, the shareholders of Corp. L would be deemed to receive in the merger 1,000/3,000 or 33.3 percent, of the stock of Corp. A. Thus, §382(b) will not apply to reduce the Corp. L carryovers available to Corp. A.

On the other hand, if the plan of reorganization had been adopted on January 15, 1984, the 1976 rules would have applied. Thus, the shareholders of Corp. L would have been deemed to have received only (1,000/7,000) x (3,000/3,000) x $3,000 = $429, or 14.3 percent, of the stock in Corp. A. Thus, only approximately 22.4 percent, or $22.40 of Corp. L's NOL carryovers would be available to Corp. A.

b. Section 382(a) Transactions Straddling Effective Date

By having the earliest lookback date for the 1976 version of §382(a) the same as the taxable year effective date, the legislation may have inadvertently expanded a loophole. Certain stock ownership changes would have been subject to either the 1954 rules or the 1976 rules but, due to the apparent inapplicability of the 1954 rules for taxable years beginning on or after January 1, 1986, may escape both such rules.

A combination of stock purchases or other transactions described in §382(a) beginning in the last taxable year beginning before 1986 and ending in 1986 in the first taxable year beginning on or after January 1, 1986 in which a total of more than 60 percent of a loss corporation's stock changes hands may not be subject to either the 1954 or the 1976 rules. Neither rule is applicable where less than fifty percent of a loss corporation's stock is acquired in the pre-1986 transactions and less than sixty percent of such stock is acquired in the post-1985 transactions. In this case, even if the corporation's business is discontinued in 1985, the 1954 version of §382(a) would not apply (assuming no other stock purchases or redemptions within the two taxable year period before 1986) because, as of the end of the last taxable year beginning before January 1, 1986 — the last taxable year to which the 1954 rules would apply — there would have been less than a fifty percent change in stock ownership. The 1976 version of §382(a) would not apply because there would be less than a sixty percent stock ownership change (assuming no other §382(a) stock acquisitions occurred within the three year period beginning January 1, 1986) beginning January 1, 1986 — the first date that stock acquisitions can be counted in determining whether the 1976 version of 382(a) applies.

Under all previous effective date schemes for the 1976 rules, this could have happened but only with respect to transactions separated by periods ranging from six months and one day, where the acquired corporation had a taxable year beginning July 1, to 17 months and one day, where the acquired corporation had a taxable year beginning June 1.[77]

Example: Corp. L, a calendar year taxpayer whose stock has been owned equally by the same twenty shareholders since 1982 and is in the X business, has NOL carryovers of $100. On December 31, 1985, A, who is not a shareholder of Corp. L, purchases 45 percent of the stock of Corp. L for cash and immediately thereafter Corp. L discontinues the X business and enters the unrelated Y business. In an unrelated transaction, B, who is also not a shareholder of Corp. L, on March 1, 1986, acquires by purchase another 45 percent of the stock of Corp. L. No other changes in stock ownership occur between January 1, 1984 and the end of 1988. It would appear that neither the 1976 rules or the 1954 rules would apply to these transactions. Even though more than fifty percent of the stock in Corp. L was acquired by purchase within two taxable years and Corp. L's historic business was discontinued, the 1954 rules would not apply because ownership of less than fifty percent of the stock in the corporation changed hands during the two taxable years prior to the expiration of the 1954 rules. Even though ownership of more than sixty percent of the stock of Corp. L changed by purchase during the three taxable year period ending December 31, 1986, the 1976 rules would not apply because only 45 percent of the Corp. L's stock changed hands on or after January 1, 1986, when the new rules are to become effective.

This apparently expanded "window of opportunity" may be of only limited value for planning purposes. First, if two acquisitions described in §382(a) that straddled the January 1, 1986 effective date for the 1976 rules could be considered part of the same transaction, presumably the Service could treate the second acquisition as occurring at the same time as the first and thus take the position that both acquisitions occurred prior to January 1, 1986. If so, the 1954 version of §382(a) would apply to reduce the available NOL carryovers to the last taxable year beginning before January 1, 1986. Moreover, given the propensity of Congress to postpone the effective date of the 1976 rules and its stated intention to reconsider those rules before they become effective, whether or when this prospective gap in effective dates will arise in reality is uncertain.

c. 1984 Transactions Prior to Enactment

Unlike the 1976 rules which were postponed after they were to be effective, the 1984 TRA provides no election to apply the new rules with respect to acquisitions occurring, or reorganizations pursuant to plans adopted, on or after January 1, 1984 but before enactment of the 1984 TRA. Presumably, the reason for this is that the House of Representatives passed H.R. 4170, which contained a provision to delay the 1976 Tax Reform Act rules on October 21, 1983, more than two months before transactions that would have come under the 1976 rules could have occurred.

3. 1976 TRA Rules to Apply to (G) Reorganizations

Section 62 of the 1984 TRA applies §382(b) to §368(a)(1)(G). Because shareholders of an insolvent or bankrupt corporation rarely receive any stock in a corporation that acquires it (or in any corporation controlling such acquiring corporation), this amendment will in many cases effectively eliminate the availability of NOLs of acquired bankrupt or insolvent corporations — which would be the result under the 1954 rules in the case of a merger or asset acquisition involving an insolvent corporation in which the

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shareholders of the insolvent corporation did not receive stock.

IV. Technical Amendments to Corporate Acquisition and Redemption Rules

A. Distribution of Appreciated Property in Redemption

1. Introduction

Section 311(b)(2) provides three exceptions applicable only to distributions with respect to "qualified stock," as defined in §311(e), to the now general rule of §311(d)(1) that distributions of appreciated property by a corporation triggers gain recognition to the distributing corporation. Distributions in redemption of stock held by noncorporate shareholders in partial liquidation are exempt from the general rule if the stock redeemed is "qualified stock." [78] Dividend distributions to noncorporate shareholders of property (other than inventory, receivable and similar property) used in the active conduct of a trade or business do not subject the distributing corporation to gain recognition under §311(d)(1).[79] Finally, distributions by corporations of stock or obligations in certain more-than 50 percent controlled subsidiaries are exempt from the general rule if those distributions are with respect to "qualified stock." [80]

The term "qualified stock" is defined in §311(e)(1) as stock held by a "person (other than a corporation)" who, at all times in the five years prior to the distribution (or throughout the existence of a less-than five year old corporation) owned actually or constructively at least 10 percent of the value of the distributing corporation's stock. Where an S corporation, a partnership, an estate or a trust held stock, it was not clear prior to the 1984 TRA whether such a shareholder or its owner or beneficiary was considered the relevant shareholder.[81]

2. Detailed Analysis

Section 712(j) of the 1984 TRA adds new §311(e)(1)(C) to the Code, providing explicit rules for determining whether stock actually owned by "pass through" entities — S corporations, partnerships, trusts and estates — is "qualified stock" and whether distributions made with respect to stock so owned are made with respect to stock owned by a "person other than a corporation."

Under new §311(e)(1)(C)(i), the determination of whether stock that is actually owned by a pass through entity is and has been owned by a person other than a corporation is made at the owner or beneficiary, and not at the entity, level. Thus, where a partnership holds stock, the determination of whether that stock has been held by a noncorporate shareholder depends on whether the partners are corporations or individuals. The legislative history of this provision suggests that, for this purpose, each owner or beneficiary will be treated as owning an amount of stock in the distributing corporation that is actaully owned by the entity in proportion to his "interest in the entity." [82] For purposes of the five-year rule, an owner of an entity that receives a §311(d) distribution will not be treated under §311(e)(1)(C) as owning an interest in the distributing corporation before that person actually acquires an interest in the entity.

Note: Even if an individual does not own an interest in an entity that owns stock in the distributing corporation, for purposes of the five-year and 10 percent tests of §311(e)(1), that individual may by virtue of §311(e)(1)(B) nonetheless be treated as owning stock owned by the entity.

Under new §311(e)(1)(C)(ii), the determination of the amount of a §311(d) distribution that is considered distributed to noncorporate shareholders is determined as if the distribution was made directly to the owners or beneficiaries of the pass through entity receiving the distribution "in proportion to their respective interests." [83] Neither the statute nor the legislative history gives any guidance as to how an owner's or beneficiary's interest in a pass through entity is determined in complex cases. Moreover, the language of the provision suggests that a special allocation of a §311(d) distribution received by a pass through entity among its owners or beneficiaries will not be taken into account in determining whether the distribution is to a noncorporate shareholder.

> *Example:* On January 1, 1985, Corp. D makes a distribution meeting the requirements of §311(e)(2)(A)(ii) through (iv) to Partnership P of stock in a subsidiary having a value of $100 but in which Corp. D has a $50 adjusted basis. Partnership P has been owned 50 percent by Corp. X, a C corporation, and 50 percent by individual A ever since A contributed his 20 percent interest in Corp. D stock to the partnership on January 1, 1978. The Partnership P agreement provides that all distributions received with respect to its Corp. D stock are to be allocated to A. Under new §311(e)(1)(C)(ii), it appears that this allocation would not be given effect for §311(d)(2)(A) purposes. Thus, 50 percent of the distribution would be treated as received by Corp. X and thus would be ineligible for §311(d)(2)(A) treatment. Corp. D would recognize $25 of the $50 gain realized on the distribution.

The amendments made by §712(j) of the 1984 TRA are effective for distributions made on or after September 1, 1982.[84]

B. Purchases Treated as Asset Acquisitions

1. Introduction

Under §§334(b)(2) and 332 of the 1954 Code as originally enacted, a corporation that purchased at least 80 percent of the voting shares, and at least 80 percent of all other stock (other than nonvoting preferred stock) of a target corporation within a 12-month period took a basis in the assets of the target corporation based upon the price paid for the stock if the purchasing corporation liquidated the target corporation pursuant to a plan adopted within two years after the date the purchase was completed. In 1982, Congress repealed §334(b)(2) and enacted §338 of the Code as part of the Tax Equity and Fiscal Responsibility Act (TEFRA).

The major purpose behind the enactment of §338 was to permit corporate purchasers of controlling stock interests in other corporations to take a basis in the assets of the acquired corporations corresponding to the amount paid for the stock without having to liquidate the acquired corporations and to liquidate such corporations without having to

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take such a basis in the assets distributed in the liquidation. A subsidiary purpose was to end the perceived abuse occurring where a purchasing corporation could obtain a stepped-up basis in the appreciated assets of the target corporation acquired in the liquidation but could retain the historic basis in assets of the target corporation having a basis greater than fair market value by acquiring, or having an affiliate require, those assets separately from the liquidation in carryover basis transactions.

Thus, §338 as originally enacted permitted all corporations making "qualified stock purchases" — non-carryover basis acquisitions other than §351 exchanges, acquisitions from decedents and acquisitions from related parties of at least 80 percent of the voting shares and at least 80 percent of the number of nonvoting shares (other than nonvoting stock limited and preferred as to dividends) of a target corporation — to elect to treat each such transaction as a §337 sale of all of the target corporation's assets to a new target corporation.[85] The target corporation did not need to be liquidated; the purchasing corporation needed merely to elect within 75 days after the "acquisition date" — the date on which the purchasing corporation first satisfied the qualified stock purchase rules with respect to the target corporation — such treatment.

In order to ensure that all assets acquired from the target corporation and its affiliates are treated consistently, the original §338 rules provided that, with certain exceptions, any assets acquired by the purchasing corporation or its affiliates from the target corporation or its affiliates within the "consistency period" — the two-to-three year period beginning 12 months before the date of the first acquisition of stock included in the qualified stock purchase and ending 12 months after the after the acquisition date — triggered a deemed §338 election with respect to the qualified stock purchase.[86] Similarly, all qualified stock purchases made within the consistency period by the purchasing corporation or any affiliate of the stock of a corporation and its affiliates must be treated consistently; *i.e.*, if a §338 election was made with respect to the first such qualified stock purchase, a §338 election must be made with respect to all subsequent qualified stock purchases and if a §338 election was not made with respect to the first such qualified stock purchase, such an election may not be made with respect to any subsequent qualified stock purchase within the consistency period.[87]

As is true of any major change in tax law, the enactment of §338 gave rise to numerous ambiguities and problems as to its interpretation and operation. Some of those problems were addressed in the Technical Corrections Act of 1982.[88] However, many problems remain. Those that came to the attention of Congress and were deemed soluble became the subject of §712(k) of the 1984 TRA.

2. Overview

In response to numerous problems raised by practioners and commentators,[89] §712(k) of the 1984 TRA makes numerous changes in the operation of §338 of the Code. Most of these changes were based upon provisions included in §612(k) of H.R. 4170, although several changes were added by the conference committee. No provision comparable to §612(k) of H.R. 4170 was contained in the Senate bill.

Although the changes to §338 made by the 1984 TRA are denominated as "technical corrections", and are in fact quite technical, these changes make more than an insubstantial impact on the operation of that Code section. A familiarity with the workings of §338 is essential to understanding the changes. The Ways and Means Committee Report and the Conference Report — and in some cases the language of the 1984 TRA — give minimum guidance.

The changes to §338 contained in the 1984 TRA refine the definition of "purchase" by excluding all acquisitions of stock in reorganizations (and potentially in all partial nonrecognition transactions), by treating as a purchase the deemed transfer of stock of target corporation subsidiaries in a §338(a) deemed asset sale and by treating as a purchase the distribution by a target corporation of stock in a subsidiary if the target corporation was itself the subject of a §338 election. The time for making a §338 election was extended until the 15th day of the ninth month beginning after a qualified stock purchase.

For purposes of computing a target corporation's recapture tax liability, the deemed asset sale triggered by a §338 election is treated as being made at the fair market value of the target corporation's assets. The deemed purchase price in such sales for purposes of determining the "new" target corporation's adjusted basis in its assets is to be grossed up for stock held by minority shareholders and can be grossed up for stock held by the purchasing corporation that was not acquired in a qualified stock purchase if the purchasing corporation elects to treat such nonrecently purchased stock as having been sold for a price based on the price paid for stock acquired in the qualified stock purchase. In the case of §338 elections following qualified stock purchases of less than all of the stock of a target corporation, the amount of gain recognition from which the target corporation is shielded on its deemed §338 (a) sale is limited to the percentage of stock purchased (up to one year after the acquisition date) by the target corporation in the absence of post-acquisition date liquidations in which miniority shareholders recognize gain.

The asset consistency rules under §338(e) are now absent regulations to the contrary, triggered by asset acquisitions within the consistency period involving partial gain recognition or foreign assets. The Treasury is now authorized to issue regulations coordinating with the general rules respecting the treatment of foreign corporations and their shareholders the treatment of qualified stock purchases of or by foreign corporations. Specific provisions attempt to deal with sales by target corporations pursuant to §337 liquidation plans pre-exempted by qualified stock purchases, estimated taxes on §338(a) deemed asset sales, application of the collapsible corporation rules to dispositions of target corporation stock by minority shareholders, and the availability of consolidated return reporting of interrelated §338(a) deemed asset sales by affiliated target corporations.

Finally, the 1984 TRA amends §269 of the Code to provide that the liquidation, within two years following a qualified stock purchase as to which no §338 election was made, of a target corporation with net operating loss carryovers could result in the elimination of such carryovers

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if the principal purpose of the liquidation was the avoidance of federal income taxes.

The amendments made by §712(k) are generally effective for qualified stock purchases completed on or after September 1, 1982. However, taxpayers can elect not to have the amendments relating to the definition of qualified stock purchases effective for pre-October 20, 1983 transactions if the operation of those amendments would disqualify otherwise qualified stock purchases. The application of §269 to liquidations following qualified stock purchases as to which no §338 election is made is effective for liquidations after October 20, 1983.

3. Detailed Analysis

a. Definition of Purchase

In order to have a qualified stock purchase, there must be an acquisition by "purchase" of at least 80 percent of the voting stock and at least 80 percent of the nonvoting stock (other than nonvoting stock that is limited and preferred as to dividends) within a 12 month period.[90] Under §338 as originally enacted, a "purchase" was defined as any acquisition of stock other than (i) one in which the acquiring corporation took a basis in whole or in part carried over from the transferor of such stock; (ii) by inheritance; (iii) in a §351 exchange; or (iv) from a party the stock owned by which would be attributed under §318(a) (other than §318(a)(4)) to the acquiring corporation. For this purpose, certain indirect acquisitions were considered purchases. Under §338(h)(3)(B) as originally enacted, where a corporation made an actual purchase of the stock of a second corporation which caused the first corporation, by operation of §318(a), to be treated as owning stock in some third corporation, the purchasing corporation was deemed to have purchased the amount of stock in the third corporation that it was thereby deemed to own by operation of §318(a).

These rules created several problems that §712(k) of the 1984 TRA seeks to address.

(1) Acquisitions in Nonrecognition Transactions

Operation of the definition of purchase in the original §338 would have resulted in certain stock acquisitions occurring in tax free reorganizations or other nonrecognition transactions being treated as qualified stock purchases. For example, a corporation acquiring stock of the target corporation in a merger qualifying under §368(a)(2)(E) could be deemed to make a qualified stock purchase. Under proposed regulations under §358, in such a merger, the acquiring corporation would not take a carryover basis in the target corporation's stock. Instead, it would take a basis in the target corporation stock equal to the acquiring corporation's basis in the subsidiary which merged into the target corporation plus the net basis of property transferred by the acquiring corporation to the subsidiary that was not distributed to the target corporation shareholders plus the target corporation's net basis in its assets.[91] To permit a step-up in the basis of the target corporation's assets where the target corporation's shareholders (and possibly the target corporation) do not recognize gain would confer an unintended benefit.

To remedy this problem, §712(k)(5) of the 1984 TRA amends §338(h)(3)(A)(ii) to provide that acquisitions of stock in exchanges governed by §§354, 355 or 356 of the Code and, to the extent described in regulations, any other transactions in which gain or loss is not fully recognized by the target corporation shareholders transferring the stock are not considered "purchases" for purposes of §338. By eliminating from purchase status §356 distributions, the amendment appears to go beyond correcting the oversight in the statute and precludes from purchase treatment distributions of stock in reorganizations on which gain would be recognized — to both the transferor of the target corporation stock[92] and to the transferee.

Example: Corp. P owns 25 percent of the stock of Corp. S, which stock has a fair market value of $100 and in which stock Corp. P has an adjusted basis of $50. On January 1, 1985, Corp. A, unrelated to Corp. P, acquires Corp. S in a merger qualifying as tax free under §368(a)(1)(A). In consideration for its Corp. S stock, Corp. P receives $50 worth of Corp. A stock and 25 percent of the stock of Corp. T, which has a value of $50 and in which Corp. A has a $25 adjusted basis. All other Corp. S shareholders receive solely Corp. A stock. On July 1, 1985, Corp. A purchases the remaining 75 percent of the stock in Corp. T. Because Corp. A received 25 percent of the Corp. T stock in a §356 distribution, its acquisition of the Corp. T stock cannot be a qualified stock purchase, even though both Corp. T and Corp. A would recognize gain on the distribution. However, if Corp. P received no Corp. A stock in the merger but only the Corp. T stock along with $50 in cash, the distribution to it would be taxed under §302 and not §356.[93] Because, under the 1984 TRA amendments to §311,[94] Corp. S would be taxed on the distribution, it would seem that Corp. P's receipt of Corp. T shares in connection with the merger would be part of a qualified stock purchase.

(2) Qualified Stock Purchases Resulting from Section 338 Elections

Under pre-1984 TRA §338(h)(3)(C), where a corporation acquired in a purchase transaction stock in a second corporation, it was deemed to have purchased the amount of stock in a third corporation owned by the second corporation to the extent that the purchasing corporation was thereby deemed under §318(a) as owning such stock. Thus, where a corporation made a qualified stock purchase with respect to a corporation that in turn owned at least 80 percent of the value of the voting and nonvoting shares of a third corporation, the purchasing corporation could be deemed to have made a qualified stock purchase with respect to the third corporation.

However, if the purchasing corporation made a timely election to apply §338 with respect to its actual purchase of its stock in the second corporation, the second corporation could arguably be deemed to have made a qualified stock purchase with respect to the third corporation by virtue of the deemed sale of all of the second corporation's assets. One argument against such treatment was that the deemed asset purchase was from the "old" target corporation, which was arguably related to the "new" target corporation, thus precluding a purchase.[95]

The ambiguity as to the status of target corporation subsidiaries could lead to conflicting results where a corporation made a qualified stock purchase of less than all the

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stock of a corporation that owned at least 80 percent of the voting and nonvoting stock of a third corporation if the purchasing corporation was not thereby deemed to own at least 80 percent of the voting and nonvoting stock of the third corporation. Moreover, even where a qualified stock purchase of a third corporation would be made under both provisions, it was not clear whether the actual purchasing corporation or the target corporation was the purchasing corporation having responsibility to make the §338 election. Finally, if the second corporation was deemed as a result of a §338 deemed sale of its assets to have made a qualified stock purchase with respect to the third corporation, the acquisition date for such purchase would probably not be the same date as the acquisition date for the qualified stock purchase of the second corporation's stock since §338(a)(2) treats a "new" target corporation as acquiring the assets of the "old" target corporation on the day after the acquisition date with respect to the qualified stock purchase of the target corporation. This would seem to preclude target corporations and their subsidiaries that were all the subject of §338 elections from filing consolidated returns with respect to the deemed §338 sales.

Section 712(k)(5) of the 1984 TRA contains several amendments to the definition of purchase in §338(h)(3) that are intended to set forth the rule that a corporation that makes a qualified stock purchase with respect to a second corporation does not thereby purchase the stock of any subsidiaries of that second corporation. Instead, the "new" target corporation is deemed to have purchased in the deemed asset sale triggered by a §338 election all of the stock owned by the "old" target corporation and the "new" target corporation has the exclusive right to make a §338 election with respect its subsidiaries.[96]

The rule in former §338(h)(3)(B), that a purchase of stock in a second corporation caused the purchasing corporation to be treated as purchasing stock owned by the second corporation treated under §318(a) as owned by the purchasing corporation, was repealed. Thus, a corporation directly making a qualified stock purchase will not thereby be deemed to make indirectly any other purchase of stock.

(a) Deemed Asset Sale as "Purchase"

New §338(h)(3)(B) provides that the term "purchase" includes a §338(a)(2) purchase deemed to have occurred as a result of a §338 election. Unfortunately, the statute does not specifically state whether such deemed purchases must satisify the criteria in §338(h)(3)(A) or whether deemed purchases are automatically considered purchases. The structure of the 1984 TRA amendments suggests that deemed purchases will not be considered §338(h)(3) purchases unless they also satisfy the conditions set forth in §338(h)(3)(A), but the House Ways and Means Committee Report [97] suggests that the general restrictions on the definition of "purchase" do not apply to such deemed asset purchases.

If §338(a) deemed purchases are subject to §338(h)(3)(A), then such deemed purchases would be subject to §338(h)(3)(A)(ii), which now provides that acquisitions of stock in which gain or loss is not fully recognized may, under regulations, be denied purchase status. Of course, gain or loss is not fully recognized in a §338(a)(2) deemed asset sale. Given the legislative intent behind §338(h)(3)(B), regulations could not be issued under §338(h)(3)(A)(ii) denying purchase status to all §338(a) deemed asset sales. However, it is possible — assuming that new §338(h)(3)(B) is subject to §338(h)(3)(A) — that regulations could limit the types of deemed asset sales that could qualify as purchases.

Section 338(h)(3)(A)(iii) provides that acquisitions of stock from transferors, the stock owned by whom is considered owned, by virtue of §338(a), by the acquiring corporation, are not purchases. It was apparently not clear prior to the 1984 TRA, and it is certainly no clearer after its enactment, whether the deemed sale of assets by an "old" target corporation and the deemed purchase of those assets by a "new" target corporation would be an acquisition from a related party. Taking a formalistic approach, one could argue that the old and the new target corporations are not related at any time because the old target corporation goes out of existence (at least for most purposes) at the end of the acquisition date while the new target corporation does not come into existence until the following day.[98] If, on the other hand, the old target corporation were deemed to exist on the day after the acquisition date — the date on which the new target corporation is deemed to acquire all its assets — the old target corporation and the new target corporation would be related provided that, after the qualified stock purchase, the purchasing corporation owned at least 50 percent of the *value* of all of the target corporation's stock.[99]

(b) Acquisitions from 50 Percent-Purchased Related Parties

If the old and the new target corporations are considered related parties, new §338(h)(3)(C)(i) provides an exception to the unrelated transferor requirement for purchase status where at least 50 percent of the value of the stock of the related transferor was acquired by purchase within the meaning of §338(h)(3)(A) or (B). This would appear to apply to deemed transfers of stock in §338(a)(2) sales following qualified stock purchases, assuming that such sales are otherwise subject to §338(h)(3)(A). If that assumption is true, only qualified stock purchases in which the purchasing corporation acquires by purchase at least 50 percent of the total value of all target corporation stock could be assured of generating qualified stock purchases of at least 80 percent controlled subsidiaries of the target corporation.

The language of new §338(h)(3)(C)(i) appears to apply to situations other than §338(a)(2) deemed asset sales. For example, the statute puts no limit on the time of the stock purchase or the identity of the purchaser.[100] However, the operation of those rules in practice may be circumscribed. Although an actual acquisition of stock from a 50 percent commonly controlled sister corporation more than 50 percent of the value of whose stock was purchased by someone at sometime may pass the unrelated transferor test, it would in most cases fail the §338(h)(3)(A)(i) fair market value basis test because it would be treated under §304(a) as a contribution to the purchasing corporation's capital by the common shareholder following a dividend from the transferor corporation.[101]

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(c) Deemed Asset Sales as Qualified Stock Purchases

Where a §338(a)(2) deemed sale pursuant to a §338 election is itself considered a stock purchase under new §338(h)(3)(B) and (C), the draftsmen of §338 presumably intended that the target corporation treated as making such sale is automatically deemed to make a §338 election. The process by which such a result is reached is as follows. Under §338(h)(5), a "new" target corporation is a member of its purchasing corporation's affiliated group. Under §338(h)(8), a stock purchase by any affiliate of a purchasing corporation is treated as a stock purchase by the purchasing corporation itself. Under §338(f)(1), a §338 election is deemed made with respect to any qualified stock purchase by the purchasing corporation of any corporation that was affiliated with the target corporation at any time during the consistency period.

Literally read, §338 following the 1984 TRA changes reaches that result with some difficulty. The amendment to what is now §338(h)(8) deleted — for other, valid, reasons — the language that stock or asset acquisitions made by an affiliate of the purchasing corporation are considered made bythe purchasing corporation — the only corporation whose stock acquisitions matter under the consistency rules.[102] New §338(h)(8) somewhat cryptically states that "stock and asset acquisitions made by members of the same affiliated group shall be treated as made by 1 corporation." That rule could, although under a strained reading, be read as limited to requiring the aggregation of all stock acquisitions by members of an affiliated group solely for purposes of determining whether a qualified stock purchase of a target corporation has been made. That strained reading would be bolstered by the following language in the Ways and Means Committee report describing the status of a qualified stock purchase deemed made by a "new" target corporation as a result of a §338(a) deemed asset sale: "if a qualified stock purchase and election are made with respect to the second [*i.e.*, the target] corporation, the deemed purchase of the third corporation's [*i.e.*, the target corporation's subsidiary] stock will . . . be treated as a qualified stock purchase permitting an election by the second corporation, or deeming an election to be made under consistency of treatment requirements, with respect to the third corporation".[103] This language seems somewhat at odds with a statutory scheme that would mandate an election.

Technically, under pre-1984 TRA law, if a §338(a)(2) deemed asset sale also constituted a qualified stock purchase by the target corporation, the acquisition date for such qualified stock purchase would be the day after the acquisition date for the qualified stock purchase of the target corporation's stock. Where numerous tiers of target corporations were involved, theoretically numerous consecutive acquistion dates would be involved. Section 612(k)(1) of H.R. 4170 would have modified that rule so that all qualified stock purchases resulting from §338(a) deemed sales which resulted from actual qualified stock purchases would take as their acquisition date the acquisition date for the actual qualified stock purchase. The conference committee modified that rule so that the acquisition date for qualified stock purchases resulting from §338(a) deemed sales will be determined under regulations. The Conference Report states that this provision is intended to give the Treasury Department authority to determine a single acquisition date for all interrelated qualified stock purchases.[104] Presumably, this authority could also be used to establish differing acquisition dates for different purposes.

The provisions related to §338(a)(2) deemed asset purchases that involve stock are effective for transactions occurring on or after September 1, 1982.[105] However, where, by application of the new rules to a pre-October 20, 1983 transaction that would otherwise be a qualified stock purchase, such transaction no longer qualifies as a qualified stock purchase, the purchasing corporation may elect not to have new provisions apply.[106]

(3) Distributions of Stock by Target Corporations

Section 338(h)(3)(B), as initially enacted, provided that an acquiring corporation that purchased stock in one corporation was held to have purchased all stock owned by the purchased corporation that was thereby constructively owned by the purchasing corporation. However, §338(h)(3)(A)(iii), as it was initially enacted, excluded from the definition of purchase all acquisitions of stock from any person where the acquiring corporation took a carryover basis in such stock or from a transferor the stock owned by which would be attributed to the acquiring corporation under §318(a) (other than paragraph (4) thereof). As a result, where a corporation made a qualified stock purchase with respect to a second corporation that owned stock in a third corporation and, received in a liquidation or as a dividend stock in the third corporation, the purchasing corporation was not considered as purchasing stock in the third corporation. Such a transaction would have qualified as a "purchase" under former §334(b)(3).[107]

The amendments contained in §712(k)(5) of the 1984 TRA provide that an acquisition of stock from a target corporation that was the subject of a qualified stock purchase and a §338 election may qualify as a purchase even though the acquiring corporation takes a carryover basis in such stock, provided that at least 50 percent of the value of the transferor corporation was the subject of a purchase.[108] Thus, where a purchasing corporation makes a qualified stock purchase involving at least 50 percent of the value of the stock of the target corporation and the target corporation distributes to the purchasing corporation as a dividend (or in a redemption treated as a dividend) or in liquidation stock in a third corporation, the purchasing corporation is treated as purchasing the third corporation stock so acquired.

In many cases, this rule will not be of significant help because, where a target corporation that is the subject of a §338 election owns at least 80 percent of the voting and nonvoting shares of a subsidiary, under new §§338(h)(3)(C)(i) and 338(h)(3)(B) the deemed asset sale by the target corporation will be a qualified stock purchase of the subsidiary as to which the target is probably deemed to make a §338 election to step-up the basis of the subsidiary's assets.[109] However, where less than 80 percent of the voting and nonvoting shares of a subsidiary are held by the target corporation, this provision will give the purchasing corporation after its qualified stock purchase of the target corporation discretion as to whether to make a §338 election with respect to such subsidiary if it acquires by

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purchase the requisite additional shares in the subsidiary to make a qualified stock purchase.

Example: On January 1, 1985, Corp. P acquires by purchase from Corp. A all of the shares of Corp. T., which owns 50 percent of the only class of stock in Corp. TS, and makes a §338 election with respect to Corp. T. On October 1, 1985, Corp. T is liquidated, with Corp P receiving Corp. T's 50 percent interest in Corp. TS. On September 1, 1986, Corp. P acquires by purchase from a party unrelated to it or former Corp. T the remaining stock in Corp. TS. Even though Corp. P obtains 50 percent of the Corp. TS stock from "new" Corp. T, a related party, and receives a carryover basis in the Corp. TS stock so acquired, such stock is acquired by purchase because of §338(h)(3)(C)(i) and (ii). Corp. P is not bound by its election with respect to Corp. T as to its treatment of the qualified stock purchase of Corp. TS because Corp. TS was not an affiliate of Corp. T during the portion of the consistency period ending on January 1, 1985. The same result would occur even if Corp. P acquired the remaining 50 percent stock interest in Corp. TS. Even though, in such a case, Corp. TS would have been affiliated with Corp. T until January 1, 1985, the stock consistency rules would not apply because the qualified stock purchase of Corp. TS would not have occurred until September 1, 1986, after the consistency period had expired.

As is true of the provisions relating to qualified stock purchases resulting from §338 elections, the new rules treating as purchases distributions from target corporations are effective for transactions occurring on or after September 1, 1982. However, if the application of these new rules would cause a pre-October 20, 1983 transaction that would otherwise be a qualified stock purchase to lose its qualified stock purchase status, the purchasing corporation may elect not to have the rules apply.[110] Note that no such election is provided where application of these rules would cause a pre-October 20, 1983 transaction to become a qualified stock purchase and thereby trigger a deemed §338 election.

(4) Aggregation of Purchases by Affiliated Groups

Under the prior version of §338(h)(7), an "acquisition of stock or assets by any member of an affiliated group which includes a purchasing corporation" was "treated as made by the purchasing corporation." Where a single corporation had purchased at least 80 percent of the voting and nonvoting stock of a target corporation within a 12-month period, it was clear under that provision that acquisitions of certain assets from the target corporation or an affiliate, and acquisitions of at least 80 percent of the stock of affiliates of the target corporation by affiliates of the purchasing corporation within the consistency period would trigger the consistency rules of §338(e) or (f). However, it was not clear whether stock purchases by affiliates would be aggregated to determine whether or not a qualified stock purchase had been made in the first instance.

Under Section 612(k)(2) of H.R. 4170, §338(h)(7) would have been renumbered §338(h)(8) and would have been amended to provide that, solely for purposes of applying the §338(e) and (f) consistency rules, acquisitions of stock or assets by members of the same affiliated group were treated as having been made by a single corporation.[111]

However, the conferees modified the House decision and provided in new §338(h)(8) (former §338(h)(7)) that acquisitions of stock or assets by members of the same affiliated group are aggregated for all purposes of §338, including the determination of whether a qualified stock purchase has occurred and the determination of the purchase and sale price for the §338(a) deemed asset sale in the event a §338 election is made.[112] Thus, if two affiliated corporations each acquire by purchase within a 12-month period 40 percent of the voting and nonvoting stock of a third corporation, the affiliated group can make a §338 election with respect to the purchase corporation, barring the operation of §338(f)(2). The amendment does not specify which corporation or corporations must make the election in the case of such a combined purchase. Nor does the amendment specify when the pertinent corporations must be affiliated — throughout the 12-month acquisition period, merely on the acquisition date, or some other time period.

The new rules treating certain acquisitions of stock from related parties as purchases are effective with respect to all post-August 1982 stock purchases.[113] However, the 1984 TRA provides that, if a pre-October 20, 1983 purchase would have been a qualified stock purchase but for the operation of the new rules, then the new rules will not apply unless the purchasing corporation so elects in accordance with regulations.[114]

b. Section 338(a) Election

Barring the operation of the §338(e) and (f) consistency rules, §338 has no impact in the absence of a timely election by the purchasing corporation to have its provisions apply.[115] Under §338 as it was originally enacted, a purchasing corporation had 75 days after the acquisition date to file a §338 election.[116] Under the Technical Corrections Act of 1982, which amended the TEFRA provisions enacting §338, elections for certain qualified stock purchases which were completed between September 1980 and August 1982, inclusive, could be made at any time before March 1, 1983.[117]

The 1984 TRA changes the time deadline for making §338 elections with respect to both future qualified stock purchases and to qualified stock purchases between September 1980 and August 1982, inclusive. For qualified stock purchases with acquisition dates after August 31, 1982, 1984 TRA §712(k)(4) amends §338(g)(1) to permit a §338 election not later than the 15th day of the ninth calendar month beginning after the acquisition date. Thus, for any qualified stock purchase having a January acquisition date, the §338 election must be made no later than the following October 15. Although the amendment by its terms is applicable to all qualified stock purchases having post-August 1982 acquisition dates, the practical effect of the amendment was to give retroactive extensions of time to make §338 elections as to qualified stock purchases completed between November 1, 1983 and May 4, 1984, inclusive.

With respect to qualified stock purchases completed between September 1980 and August 1982, inclusive, the

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1984 TRA extends the time for making §338 elections to September 16, 1984, 60 days after the date of enactment of the act.[118]

c. Deemed Asset Purchase and Sale Price

Under §338(a), where a qualified stock purchase is followed by an actual or deemed §338 election, the target corporation is treated as selling its assets to a "new" target corporation in a single transaction that qualifies as a sale under §337. Thus, the "old" target corporation recognizes gain only to the extent that there is depreciation and investment tax credit recapture[119] and certain other gain that would override the nonrecognition rule of §337. The "new" target corporation takes a basis in its assets based upon the stock purchase price, "grossed up" to take into account purchases of less than 100 percent of its stock.[120]

Prior to the 1984 TRA, §338 raised numerous issues concerning the proper amount realized by the "old" target corporation on a deemed sale where there was potential recapture tax liablility, the proper method of grossing up the new target corporation's basis in its assets where less than all of its stock was purchased as part of a qualified stock purchase, and other matters. Section 712(k) of the act tried to deal with those issues through numerous amendments to §338. Those amendments changed the structure of §338 so that the sale price for purposes of computing the "old" target corporation's recapture gain is not necessarily based upon the actual price paid for its stock. To that extent, the deemed sale price may be unrelated to the deemed purchase price used for computing the "new" target corporation's basis in its assets.

(1) Deemed Sale Price

Pursuant to a stock purchase and liquidation under former §334(b)(2), the recapture tax liability of a target corporation was based upon the fair market value of the property distributed on its liquidation. Prior to the 1984 TRA, §338 provided that, where a §338 election was made, the target corporation was treated as selling all of its assets, even if less than all of its stock was purchased in the qualified stock purchase. Where less than all of the stock of the target corporation was purchased, the deemed purchase price equaled the amount the purchasing corporation paid for the target corporation stock acquired in the qualified stock purchase, along with the adjusted basis of other stock in the target corporation held by the purchasing corporation, grossed up to reflect 100 percent ownership and adjusted by any target corporation liabilities assumed by the target corporation in the qualified stock purchase. This grossed up figure was in turn used to determine the amount of recapture tax liability of the "old" target corporation.

Pre-1984 TRA law was not clear as to whether the target corporation's recapture tax liability, which would reduce the price that a purchasing corporation would be willing to pay for the target corporation's stock, was one of those liabilities added to the amount of cash and other property paid for the stock. Moreover, where substantially less than 100 percent of the value of the stock of the target corporation was purchased in the qualified stock purchase, the price, possibly discounted to reflect a continuing minority faction, paid for that stock might understate the value of the target corporation's underlying assets. Thus, the grossed up basis might not reflect the fair market value of the target corporation's assets and might reduce the amount of recapture tax liability on the deemed sale.[121]

To alleviate this problem, §712(k)(1)(A) amended §338(a)(1) to provide that the price at which the "old" target corporation is deemed to sell its assets is the fair market value of those assets. Section 712(k)(6)(C) added §338(h)(11) to provide that the taxpayer may elect to determine such fair market value in accordance with a formula to be provided in regulations "taking into account liabilities and other relevant items." In the absence of such an election, the purchasing corporation would have to establish the fair market value of the target corporation's assets, by a "proper appraisal" or otherwise.[122]

This new fair market value rule applies even where the purchasing corporation acquires all of the target corporation's stock in the qualified stock purchase and thus, at least theoretically, will operate not only to adjust for distortions caused by partial purchases but also to negate the effect of bargain purchases and bad bargains. Thus, in theory, where a purchasing corporation can establish that the fair market value of the target corporation's assets are greater than the stock purchase price, it could get a windfall in terms of a basis in excess of consideration paid. On the other hand, where the Service can establish that the fair market value of the target corporation's assets is less than the consideration paid for the stock (including liabilities assumed), the consideration in excess of fair market value will yield no tax benefit.[123]

(2) Deemed Purchase Price

Where a purchasing corporation acquires less than 100 percent of a target corporation's stock in a qualified stock purchase, under §338(b) prior to the 1984 TRA, the "new" target corporation took as its basis in its assets the purchasing corporation's basis in its target corporation stock (*i.e.*, the amount paid as part of the qualified stock purchase plus the purchasing corporation's basis in target corporation shares held for more than year or acquired other than by purchase), adjusted for liabilities of the target corporation assumed in the qualified stock purchase and multiplied by a fraction, the numerator of which was 100 and the denominator of which was the percentage by value of the target corporation's stock held by the purchasing corporation on the acquisition date. The asset basis obtained by application of this formula diverged in several respects in the asset basis obtained under former §334(b)(2).

(a) Gross Up for Minority Shareholdings

One situation in which the basis consequences under §338 prior to the 1984 TRA differed from those under former §334(b)(2) was where the purchasing corporation acquired stock in the target corporation before the 12-month acquisition period began and minority shareholders continued to own shares of the target corporation after the acquisition date. In a §334(b)(2) liquidation, the minority shareholders would generally be taxed under §331 and would take a fair market value basis under §334(a) in target corporation assets distributed to them. The purchasing corporation would take a basis in the assets distributed to it equal to its basis in its stock; *i.e.*, the amount it paid in the 12-month purchase plus the amount it paid for stock

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acquired prior to the 12-month purchase or the basis of stock acquired other than by purchase. Under §338 prior to the 1984 TRA, the gross up formula in effect did not step up the basis of the assets attributable to the minority shareholders' stock interest to the full fair market value of those assets. Although such minority shareholders were not taxed directly, as they were in a §334(b)(2) liquidation, §338(c) imposed a surrogate tax on the target corporation in lieu of the tax that would have been imposed on the minority shareholders under §331.[124]

Section 712(k)(1)(B) of the 1984 TRA amends §338(b) in several respects in an attempt to end the discrepancy between basis computations under former §334(b)(2) and under §338 where the purchasing corporation acquires target corporation stock other than by purchase or prior to the beginning of the 12-month acquisition period but owns less than all of such stock at the end of that period. Under the amendments, the price at which the "new" target corporation is deemed to acquire its assets once a §338 election is (or is deemed to be) made is the grossed up basis of "recently purchased stock" — target corporation stock purchased by the purchasing corporation [125] within the 12-month acquisition period — plus the basis of the purchasing corporation's "nonrecently purchased stock" — target corporation stock owned by the purchasing corporation on the acquisition date that is not recently purchased stock — all as adjusted for liabilities of the target corporation assumed in the qualified stock purchase.[126]

The formula used to gross up the recently purchased stock is a fraction, the numerator of which is 100 less the percentage by the value of the target corporation's stock that is nonrecently purchased stock, and the denominator of which is the percentage by value of target corporation stock that is recently purchased stock. In this way, the assets attributable to the minority shareholders' stock interest are stepped up to the same extent as are the assets attributable to the recently purchased stock.

Example: On January 1, 1976, Corp. P acquired eight percent of the value of the only class of Corp. T stock for $200,000. On January 1, 1986, when all of the assets of Corp. T are worth $10 million and there is no potential recapture tax liability, Corp. P acquires by purchase an additional 80 percent of the stock of Corp. T for $8 million leaving unrelated shareholder X with 12 percent of the Corp. T stock in which he has a $250,000 basis. Had former §334(b)(2) been in effect, upon liquidation of Corp. T under a plan adopted before January 1, 1988, Corp. P would have taken an $8.2 million basis in the Corp. assets distributed to it while X would have taken a $1.2 million basis in the assets distributed to him, assuming that the liquidation was not a §333 liquidation as to him. Under §338 prior to the 1984 TRA, Corp. T would have taken a basis in all of its assets equal to ($8.2 million x 100/88) = $9.32 million, $80,000 less than the combined $9.4 million basis that would have resulted under former §334(b)(2). Under new §338(b), Corp. T will take as its basis ($8 million x 92/80) + $200,000 = $9.4 million.

(b) Election to Gross Up Basis for Nonrecently Purchased Stock

Section 712(k)(1)(B) also adds §338(b)(3), which provides that the basis of nonrecently purchased stock may be grossed up if the purchasing corporation elects to treat the nonrecently purchased stock as having been sold for the grossed up amount. The amount to which the purchasing corporation's nonrecently purchased stock is grossed up under this election is the grossed up basis of the corporation's recently purchased stock multiplied by a fraction, the numerator of which is the percentage of target corporation stock by value represented by the purchasing corporation's nonrecently purchased stock and the denominator of which is the percentage by value of the target corporation that is not nonrecently purchased stock.[127] In other words, the purchasing corporation's nonrecently purchased stock is treated as having been sold and purchased by the purchasing corporation for an amount equal to the average per share price it paid for the recently purchased stock.

Using the above example, if Corp. P elected to step up the basis of its nonrecently purchased stock and thus of Corp. T's basis in its assets, it would be treated as having sold such stock for ($9.2 million x 8/92) = $800,000. It would thus recognize a $600,000 gain and Corp. T would increase the basis in its assets to $10 million.[128]

If a purchasing corporation elects to step up the basis of target corporation assets to their full fair market value where the purchasing corporation holds nonrecently purchased stock on the acquisition date, the target corporation is placed in the same position with respect to its assets as it would have been had minority shareholders held all target corporation stock not purchased during the 12-month acquisition period. However, the price paid to get such a basis result is different. Where nonrecently purchased stock is involved, the cost of the step up is a tax to the purchasing corporation on gain in its nonrecently purchased stock. Where minority shareholders own target corporation stock not acquired in the qualified stock purchase, the cost of the step up attributable to such stock is a tax to the target corporation.[129]

Note: It would appear that a purchasing corporation that elects to have the target corporation's asset basis fully stepped up under §338(b)(3) would be subject to ordinary income treatment on its deemed sale of nonrecently purchased shares if and to the extent that the target corporation is a collapsible corporation.[130]

(c) Aggregation of Prices Paid by Affiliated Purchasers

Section 712(k)(6)(A) of the 1984 TRA, by amending §338(h)(8) (formerly §338(h)(7)) to provide that the acquisition of stock by any member of an affiliated group is treated as an acquisition by a single corporation, is intended to affect not only whether a qualified stock purchase has been made,[131] but also the deemed purchase price paid by the "new" target corporation where a §338 election is (or is deemed to be) made.[132] The language of this statutory change does not, however, completely mesh with the rules respecting recently purchased stock and nonrecently purchased stock in §338(b). Section 338(h)(8) applies to "acquisition(s) of stock" whereas §338(b)(6) defines both

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recently purchased stock and nonrecently purchased stock in terms of "stock in the target corporation which is held by the purchasing corporation on the acquisition date." Logically, it would appear that any target corporation stock held by the purchasing corporation or any affiliate on the acquisition date would be recently purchased stock or nonrecently purchased stock; if such stock was acquired by the purchasing corporation or any affiliate during the 12-month acquisition period, it would be recently purchased stock.

d. Nonrecapture Income Recognized by the Target Corporation

Under pre-1984 TRA law, §338(c) provided that, under a §338 election, "old" target corporation may be shielded by §337 from gain recognition on the deemed sale of its assets only to the extent of the maximum percentage by value of the target corporation's stock held by the purchasing corporation during the one-year period beginning on the acquisition date. However, if the corporation was liquidated within one year after the acquisition date, §337 applied in full to the deemed sale even if the purchasing corporation never owned all of the target corporation's shares. Thus, liquidation of the target corporation no more than one-year after the acquisition date shielded the target corporation from all but recapture and certain other gain on the deemed sale.

(1) Post Acquisition Date Acquisitions of Target Corporation Shares

Under §338 prior to the 1984 TRA, post-acquisition date acquisitions of target corporation stock by a purchasing corporation permitted full asset basis step up and increased the applicability of §337 nonrecognition to the target corporation, even if those acquisitions were not taxable to the disposing minority shareholders. This was in contrast to the result under former §334(b)(2). There, if a purchasing corporation acquired in a nontaxable exchange target corporation stock from minority shareholders, either before or after completion of its 80 percent stock purchase, the basis of the assets distributed in the §334(b)(2) liquidation was limited to the purchasing corporation's adjusted basis in its target corporation stock. To the extent such stock was acquired in nontaxable exchanges, such basis was limited to the exchanging minority shareholders' adjusted basis.

To eliminate this apparent windfall, §712(k)(6) of the 1984 TRA added new Code §338(h)(7).[133] Under this provision, only purchases, presumably as defined in §338(h)(3), §302(a) redemptions and §302(d)-301 redemptions of corporate shareholders that increase the purchasing corporation's percentage ownership of target corporation stock, will increase the percentage of gain on the target corporation's deemed sale that will be protected from recognition by §337.

Thus, where a purchasing corporation makes a qualified stock purchase of less than 100 percent of the value of the target corporation's stock, elects §338 treatment and acquires the rest of the target corporation's stock in the one-year period after the acquisition date in tax-free transactions, the target corporation obtains a fully stepped-up basis in its assets at the cost of recognizing the portion of the gain realized on the deemed sale of its assets. On the other hand, where the purchasing corporation acquires less than twenty percent of the target corporation's stock in nontaxable transactions before the acquisition date, makes a qualified stock purchase of less than all of the target corporation's remaining stock, and elects §338 treatment, the target corporation will either take a reduced basis in its assets attributable to the stock acquired in the nontaxable transactions or take a fully stepped up basis in its assets but at the cost of recognizing gain on a deemed sale of the shares so acquired.[134]

Example: Corp. T owns assets in which it has an aggregate basis of $700 that are worth $1,000 and have no depreciation or investment credit recapture potential. On July 1, 1985, Corp. P purchases for $800 cash 80 percent of the only class of Corp. T stock and elects §338 treatment. On December 1, 1985 Corp. X, which owns the remaining 20 percent of Corp. T stock in which it has an adjusted basis of $20, is merged with and into Corp. P in a tax-free §368(a)(1)(A) transaction. Because Corp. X did not recognize gain or loss on the transfer of its 20 percent stock interest in Corp. T to Corp. P, only 80 percent of the gain realized by Corp. T on the deemed sale of its assets is shielded from gain recognition by §337. Thus, Corp. T recognizes .20 ($1,000 - $700) = $60 of gain on the transaction and takes a $1,000 basis in its assets. Corp. P takes a total basis in its Corp. T stock equal to $820. On the other hand, if Corp. X merged with Corp. P on June 1, 1985, it would not recognize gain on the deemed sale of its assets but would either take an $820 basis in its assets or take a $1,000 basis in its assets with Corp. P having to recognize gain on a deemed sale of its 20 percent interest in Corp. T acquired from Corp. X.

(2) Section 333 Liquidations of Target Corporations

Under §338(c)(1) prior to the 1984 TRA, a target corporation took a fully stepped up asset basis without having to pay a "surrogate tax" even though the corporation making the qualified stock purchase did not own all of the target corporation stock on the acquisition date, provided that the target corporation was liquidated under either §331 or §333 within one year after the acquisition date. Although application of that rule (where a post-acquisition date liquidation was a §331 liquidation as to the minority shareholders) resembled the result under pre-TEFRA law, the automatic basis step up under former §338(c)(1) was more favorable than the carryover basis normally accorded to minority shareholders the treatment of whom was governed by §333 prior to TEFRA.

Section 712(k)(2) of the 1984 TRA amended §338(c)(1) to provide that a post-acquisition date liquidation of a target corporation will eliminate the surrogate tax on the target corporation only if "section 333 does not apply" to the liquidation. The language of this provision seems somewhat overbroad in that it seems to require gain recognition to the full extent that target corporation stock is held by those other than the purchasing corporation where any portion of the liquidation is taxed under §333, rather than just to the extent that the liquidation is treated as a §333 liquidation. Under pre-§338 law, minority shareholders who did not elect or were not eligible for §333 treatment obtained a fair market value basis for property distributed

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to them even though §333 treatment applied to other minority shareholders.

e. Changes in Asset Consistency Rules

As previously noted, one of the purposes behind §338 was to prevent purchasing corporations from stepping up the basis in appreciated assets acquired from one or more affiliated target corporations while retaining a cost basis in other assets having a fair market value less than adjusted basis from the same or affiliated corporations. Thus, under §338(e), many acquisitions by the purchasing corporation or affiliates of assets from the target corporation or affiliates would force a §338 election with respect to the qualified stock purchase of the target corporation. Changes made by the 1984 TRA do not change this emphasis but do give the Treasury more flexibility in meeting the goal of consistency. These changes also coordinate the consistency rules with other changes made by the 1984 TRA.

(1) Conditional Exception to Asset Consistency Rules

Perhaps the potentially most important modification of the asset consistency rules is contained in §712(k)(3) of the 1984 TRA, which expanded the Service's authority to permit exceptions to the asset consistency rules subject to conditions. Prior to the 1984 TRA, §338(e)(2)(E) permitted the Service to provide exceptions to the asset consistency rules with respect to "acquisitions described in regulations." This language did not make clear whether the Service could require taxpayers to take certain actions as a condition for avoiding the asset consistency rules with respect to acquisitions of assets from the target corporation or its affiliates within the consistency period.

New §338(e)(2)(D) gives the Service explicit authority to impose conditions in this regard. This provision was not contained in H.R. 4170. The Conference Report gives as an example of the type of condition that the Service may impose a requirement that the purchasing corporation (or its affiliate) take a carryover basis in any appreciated asset acquired during the consistency period from a target corporation that was subject to a qualified stock purchase (or an affiliate thereof).[135] Thus, the intention appears to be to permit consistency period asset acquisitions from target corporations or their affiliates provided that the Service can be assured that none of the purported tax avoidance that the asset consistency rules were intended to eliminate is present. Given the extensive consequences that would result from a deemed §338 election, it would not be difficult to envision an extensive set of guidelines or an elaborate advance ruling procedure in connection with this new provision.

(2) Foreign Assets

Under §338(e)(2)(D) prior to the 1984 TRA, a purchasing corporation or its affiliates would have been permitted to acquire within the consistency period from target corporations that were the subject of qualified stock purchases, or their affiliates, assets located outside the United States without triggering a deemed §338 election to the extent provided in regulations. Presumably, the premise behind this exception was the notion that assets located outside the United States are not eligible for full ACRS or investment tax credit benefits[136] and thus that the tax avoidance that the consistency rules are designed to prevent is not present upon the acquisition of foreign assets. However, once a purchasing corporation or its affiliate acquires a foreign asset, the acquirer can get the full tax benefit from a fair market value basis without tax by transferring the asset to the United States.

Presumably as a result of this, §712(k)(3) of the 1984 TRA repealed the exception to the asset consistency rules for acquisitions of foreign assets. Given the authority of the Service to provide by regulations exceptions to the asset consistency rules for certain acquisitions, it would not be surprising to see an exception for assets, such as real property, that could be used only outside the United States. However, there is nothing in the legislative history of the repeal of the foreign asset exception, which was not in H.R. 4170, that illuminates Congressional intent in this regard.

The repeal of the exception to the asset consistency rules for acquisitions of foreign assets is effective for qualified stock purchases completed on or after September 1, 1982.[137] Although this would appear to be a retroactive change, it is not. The Service never promulgated the regulations necessary to implement this exception.

(3) Assets Having a Partial Carryover Basis

Under §338(e)(2)(B) prior to the 1984 TRA, acquisitions of assets during the consistency period from a target corporation that was the subject of a qualified stock purchase (or any affiliate thereof) did not trigger the asset consistency rules if the acquiring corporation's basis in those assets was determined "in whole or in part" by the adjusted basis of the transferor corporation therein. Because of changes to §311(d) of the Code made by §54 of the 1984 TRA,[138] under which a corporation distributing as a dividend appreciated property recognizes all gain realized on such a distribution, a corporate distributee of appreciated property received as a dividend takes a basis in that property technically computed in part based on the distributing corporation's adjusted basis even though such basis is in fact equal to the fair market value of that property.[139] Moreover, any acquisition of assets from a target corporation or an affiliate in which the acquiring corporation takes a basis in excess of the transferor corporation's adjusted basis gives the acquiring corporation a potential tax benefit inconsistent with the carryover basis retained by the target corporation in its assets in the event no §338 election is made.

Presumably because of these concerns, §712(k)(3) of the 1984 TRA amends §338(e)(2)(A) to provide that only assets acquired from the target corporation or its affiliates during the consistency period which have a basis determined wholly by reference to the transferor corporation's adjusted basis are not subject to the asset consistency rules. This narrowing of the exception disqualifies not only acquisitions resulting from dividend distributions but also acquisitions in nonrecognition transactions in which the transferor corporation recognizes some gain.[140]

Note: This new provision should not apply to liquidations of target corporations within one year following the acquisition date because the purchasing corporation would take a carryover basis in the target corporation's assets under §334(b)(1). One factor complicating this statement could be the new rules relating to §332 liquidations of U.S.

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corporations into foreign corporations where assets other than those used in the active conduct of a foreign trade or business are distributed. New §§367(a) and (e) would subject the liquidating U.S. corporation to tax on gain realized with respect to such assets in the distribution. Although the new rules under §367 do not appear to modify the §334(b)(1) carryover basis rule for assets distributed in such liquidations, to give the distributee shareholder no basis credit for gain recognized on the distribution could lead to double taxation of the gain inherent at the time of liquidation in the assets distributed. If §334(b)(1) were amended to take into account gain recognized on §332 liquidations of U.S. subsidiaries into foreign parent corporations, then — barring regulatory or statutory relief — such liquidations would trigger a deemed §338 election where recently purchased U.S. subsidiaries were liquidated. This may be an issue which can be addressed in regulations authorized by §338(i)(2), giving the Commissioner authority to coordinate the §338 rules with the rules governing taxation of foreign corporations and their shareholders.[141]

f. Other Changes to Section 338

(1) Foreign Corporations and Their Shareholders

Prior to the 1984 TRA, §338 in general applied to qualified stock purchases by and of foreign corporations in the same manner (to the extent of U.S. taxing jurisdiction over such corporations) as it applied to qualified stock purchases by and of U.S. corporations. Under amendments made to §367 by §131(a) of the 1984 TRA, U.S. corporations controlled more than 80 percent by foreign corporations are fully taxable on gain realized on liquidation except to the extent that the assets distributed in liquidation consist of assets (other than inventory, receivables, intangibles and certain other property) to be used in the active conduct of a foreign trade or business.[142] Thus, were §338 to apply to qualified stock purchases of U.S. corporations by foreign corporations, the U.S. target corporations would be able to receive a stepped up basis in their assets without payment of tax on a §338 election. A subsequent liquidation of such target corporations would in theory be subject to gain recognition under §367 but most if not all of such gain would be eliminated by the basis step up resulting from the deemed §338(a) sale. As a result, application of §338 in such cases would lead to more favorable results than a §332 liquidation would have had §334(b)(2) in effect.

Section 712(k)(7) adds §338(i)(2) providing that the Treasury is authorized to issue regulations coordinating §338 with rules governing the treatment of foreign corporations and their shareholders. Presumably those rules will not only attempt to provide rules coordinated with the rules of §367 but also rules relating to the treatment of controlled foreign corporations involved in qualified stock purchases. Because this provision is effective for transactions on or after September 1, 1982,[143] these regulations could dramatically affect transactions occuring prior to the date in 1984 TRA was enacted, although one would assume that the regulations would have to be coordinated with the rules governing foreign corporations and their shareholders as those rules were in effect on the date the transaction took place.

Note: Although the most obvious change in §338(i) was the addition of specific Treasury authority to issue regulations relating to foreign corporations and their shareholders, §712(k)(7) also modifies §338(i) to give the Treasury authority to issue any regulations necessary or "appropriate to carry out §338." Under §338(i) prior to the 1984 TRA, the Treasury had authority only to issue those regulations necessary to carry out the purpose behind the consistency rules. The above quoted language could be interpreted as representing a major expansion of the Treasury's regulatory authority under §338, but the legislative history is silent on this point. This modification was not contained in H.R. 4170 but was added by the Conference Committee, whose report did not address this language change.

(2) Separate Application of Section 337

Section 338(a) provides that a deemed asset sale from the "old" target corporation to the "new" target corporation pursuant to a §338 election is treated as a sale that qualifies for §337 treatment. However, prior to the 1984 TRA, it was unclear whether §337 applied to an actual sale of assets made by a target corporation pursuant to a plan of liquidation if the target corporation was not in fact liquidated but is the subject of a qualified stock purchase as to which the purchasing corporation makes a §338 election. On the one hand, §337 on its face applies only if there is a distribution in complete liquidation. On the other hand, the purpose of §338 is to permit treatment of qualified stock purchases as liquidations without requiring an actual liquidation.

Section 712(k)(6)(C) of the 1984 TRA adds new §338(h)(12) providing that, if any target corporation as to which the purchasing corporation has elected or been deemed to elect §338 treatment adopted a plan of liquidation no more than twelve months before the acquisition date and has not rescinded that plan as of the acquisition date, the target corporation will, for §337 and related purposes (presumably including §453(h)(2)), be treated as having distributed all of its assets as of the close of the acquisition date. Thus, §338(h)(12) can be used by a target corporation to sell, prior to a qualified stock purchase, to a party unrelated to the purchasing corporation stock in a subsidiary having recapture tax potential. Such sale will be tax-free to the target corporation and will not trigger the consistency rules. Where the purchasing corporation never owns all of the target corporation's stock at any time during the one-year period after the acquisition date, rules similar to those in §338(c)(1) are to be devised to limit the extent to which the target corporation will be shielded from gain recognition on the actual sale of assets.

This provision is effective for all qualified stock purchases completed on or after September 1, 1982.[144]

(3) Estimated Taxes on Section 338 Deemed Asset Sale

Under §6154 of the Code, most corporations whose estimated tax for a taxable year is expected to exceed $40 must pay equal quarterly installments of such tax to the IRS. Estimated taxes include all regular income tax liability less certain tax credits. Where the estimated tax due is not paid or not paid in a timely manner, §6655 imposes a penalty on the amount of underpayment.

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Where a §338 election is made or deemed to be made, the target corporation is potentially liable for income tax, and thus estimated tax, on depreciation and investment tax credit recapture and certain other items which are deemed to arise on the acquisition date, as well as on a certain portion of gain on its assets where the purchasing corporation owns less than all of the target corporation's stock. Moreover, under new §338(b)(3)(B), a purchasing corporation which owns "nonrecently purchased stock" may elect to "gross up" the basis of the target corporation's assets by treating its nonrecently purchased stock as having been sold at fair market value on the acquisition date. Because these tax liabilities are deemed to relate back to the acquisition date even though the purchasing corporation has more than nine months after the acquisition date to elect §338 treatment and even though a deemed §338 election can be based upon transactions occurring as much as one year after the acquisition date, in many cases it will be impossible for a target corporation to make timely estimated tax payments based upon the consequences of a §338 election.

Section 712(k)(6)(C) of the 1984 TRA adds §338(h)(13) to provide that the tax arising on a §338(a)(1) deemed asset sale will not be taken into account in determining whether the target corporation is liable for the penalty for underpayment of estimated tax liability. The legislative history of this provision states that, if a target corporation fails timely to file any other tax return, or pay any other tax, as to the deemed asset sale, that failure will be considered as resulting from reasonable cause provided that such return is filed and such tax is paid by the date for making the §338 election. It should be noted that this language does not take into account a §338 election deemed to arise by operation of the consistency rules more than 9½ months after the acquisition date. Neither the statute nor the legislative history provide for any forgiveness of interest payable for late payment of tax due on the §338(a) deemed asset sale.

Note: The forgiveness of penalties in §338(h)(13) apparently does not extend to the purchasing corporation's liability for any §338(b)(3)(A) deemed sale of its nonrecently purchased stock of the target corporation, even though liability for that tax relates back to the acquisition date but does not arise unless a §338 election is made or deemed to be made.

This provision applies retroactively to all qualified stock purchases completed on or after September 1, 1982.[145] It is not clear why the provision was not made applicable to prior qualified stock purchases.

(4) Application of Section 341 as to Dispositions of Minority Shareholder Target Corporation Stock

Under §341 of the Code, gain on any sale or exchange (including surrender in complete or partial liquidation) of stock in a collapsible corporation is considered ordinary income. One of the requirements for treating a corporation as collapsible is that the corporation must be formed or availed of for certain purposes with a view to the sale or exchange of its stock "before the realization by the corporation" of a substantial part of the taxable income to be derived from its property.[146] Where a target corporation is the subject of a §338 election, it is deemed to sell all of its assets in a §337 sale on the acquisition date. Thus, the target corporation would arguably be deemed to realize all of the gain inherent in its assets, even though the recognition of such gain would be limited to recapture tax liability and certain other items.

Thus, where a corporation that meets the criteria for collapsible corporation status is the subject of a qualified stock purchase of less than all of its stock as to which a §338 election is made, an argument could be made under pre-1984 TRA law that sales or surrenders in liquidation of target corporation stock by minority shareholders after the acquisition date were not subject to §341 because the target corporation had *realized* all of the gain in its assets on the acquisition date. In contrast, target corporation shareholders who sold their stock as part of the qualified stock purchased would be subject to §341.

To ameliorate this situation, §712(k)(6)(C) of the 1984 TRA adds §338(h)(14), which provides that, for purposes of determining whether §341 applies to a disposition of target corporation stock within one year after the acquisition date "by a shareholder (other than the acquiring corporation) who held stock in the target corporation on the acquisition date," §338 shall not be taken into account. Thus, if a target corporation is otherwise collapsible and shareholders who did not sell their shares on or before the acquisition date sell or exchange their shares, or receive distributions in complete or partial liquidation of the target corporation, within one year after the acquisition date, the resulting gain will be treated as ordinary income in accordance with §341. The one-year post-acquisition date limitation is designed to mesh with the rules of §338(c), under which a target corporation will recognize gain on a deemed asset sale to the extent that the purchasing corporation owns a maximum of less than 100 percent of the target corporation stock during the one-year period beginning on the acquisition date. Thus, the effect of this provision may be to permit a choice between ordinary gain recognition at the target corporation level or ordinary gain recognition at the minority shareholder level.

Note: The language of §338(h)(14) would seem to apply only to sales, exchanges or liquidation transactions involving the person or entity that owned the target corporation stock on the acquisition date. Thus, as drafted, the provision would not seem to apply to dispositions by those who received their shares as gifts or in §351 transactions less than one year after the acquisition date. Since gifts and §351 exchanges are not subject to §341, the ordinary character of gain on such shares may be transmitted into capital gain by such transfers.

(5) Combined Deemed Sale Return

In general, the consequences of a §338(a) deemed sale by a target corporation must be reported on a return separate from the return of any selling shareholder's consolidated group and from any return of any purchasing corporation's consolidated group. Under pre-1984 TRA law, where the target corporation and one or more of its subsidiaries were the subject of a qualified stock purchase, they could not file a consolidated return with respect to the §338(a) deemed sale except as provided in regulations.[147] Although the seller's inability to control a decision to make a §338 election justified keeping the deemed sale out of the seller's consolidated return and although the interest in precluding use of the purchasing corporation's losses to

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shelter the target corporation's recapture income justified keeping the deemed sale out of the purchasing corporation's consolidated return, there was no reason to prohibit a consolidated return with respect to the §338(a) deemed sales by the target corporation and all subsidiaries.

Thus, §712(k)(6)(C) of the 1984 TRA adds new §338(h)(15), providing that, under regulations, all target corporations that were members of the same consoliated group immediately prior to the acquisition date and that are the subject of a qualified stock purchase and §338 election by the purchasing corporation may report all resulting §338(a) deemed sales on a "combined deemed sale return." In order for this provision to have an impact, regulations under §338(b)(3)(B) will have to provide that a target corporation's acquisition date with respect to the qualified stock purchase of the stock of its 80 percent or more controlled subsidiaries deemed to arise by virtue of the §338(a) deemed sale is the same as the acquisition date for the qualified stock purchase of such target corporation's stock. Otherwise, the target corporation would not be a member of the purchasing corporation's affiliated group — and thus would not be acquired by the same purchasing corporation on the same acquisition date, as is required by §338(h)(15).

This provision is effective for qualified stock purchases completed on or after September 1, 1982.[148]

g. Liquidations Following Qualified Stock Purchases

Under §338 prior to the 1984 TRA, a purchasing corporation that made a qualified stock purchase of a target corporation having substantial net operating loss (NOL) carryovers or other desirable tax attributes could decide not to make a §338 election. It could then liquidate the target corporation under §332 and succeed to the target corporation's NOL carryovers under §381(a)(1) as long as one of the target corporation's businesses was continued.[149] It was possible to argue that §269(a), which permits the Service to deny tax benefits otherwise made available by the acquisition of 50 percent control over a corporation, applied to prevent the purchasing corporation's use of the target corporation's NOL carryovers. However, where the qualified stock purchase was primarily motivated by business purposes, it would not be subject to §269. The liquidation would probably not be subject to §269, even if motivated by tax avoidance, because it would be an acquisition of assets from a controlled corporation.[150]

A purchasing corporation's ability to succeed to a target corporation's NOL carryovers resulted in more favorable treatment than the available treatment under former §334(b)(2) because §381(a) provided that tax attributes of a subsidiary liquidated under §332 did not carry over where §334(b)(2) applied to the liquidation.

Thus, §712(k)(8)(A) of the 1984 TRA adds new §269(b) to the Code, relating to liquidations pursuant to plans adopted within two years after the acquisition date of target corporations that were the subject of qualified stock purchases as to which no §338 election was made. In such cases, §269(b) provides that, if the principal purpose of the liquidation is the avoidance of tax by obtaining an otherwise unavailable deduction, credit or allowance, the IRS is empowered to disallow any such deduction, credit or allowance. In fact, the legislative history states that regulations should provide that such a liquidation gives rise to a presumption of tax avoidance similar to the presumption now in Regs. 1.269-3(b)(1) with respect to certain §269(a) transactions.[151]

New §269(b) by its terms does not restrict the availability to a purchasing corporation of target corporation tax attributes following a liquidation of the target corporation pursuant to a plan adopted more than two years after the acquisition date. Thus, given the 15-year period in which NOL's may be carried over, the effect of this provision may be merely to postpone liquidations rather than to restrict purchasing corporations' use of target corporations' NOL carryovers. Moreover, the legislation does not apply to downstream mergers of purchasing corporations into target corporations under §368(a)(1)(A).[152] Where a downstream merger is involved, presumably no waiting period between the purchase and the merger is necessary. In such a merger, the NOL carryovers of the target-surviving corporation would be affected by §382(b) to the extent that such corporation had a fair market value less than 25 percent of that of the purchasing-acquired corporation.[153]

The Conference Report concerning new §269(b) stated that it was not to apply where a purchasing corporation made a qualified stock purchase of a profitable corporation, did not make a §338 election and liquidated the target corporation within two years after the acquisition date, provided that ownership of the purchasing corporation did not change as the result of the transaction.[154] This language is apparently designed to apply to §269(b) the rule contained in Rev. Rul. 63-40 [155] with respect to section 269(a) in similar circumstances under former §334(b)(2). Thus, a qualified stock purchase of a profitable target corporation by a purchasing corporation with NOL carryovers followed within two years by a liquidation of the target corporation without a §338 election would ordinarily permit the post-liquidation income generated by the target corporation's former assets to be sheltered by the purchasing corporation's NOL carryovers.

The new provision may be more restrictive than intended in one respect because the prohibited tax avoidance motivation is tested at the time of liquidation and need not be related to a desire to use the target corporation's pre-acquisition tax attributes. Thus, in theory, at least, a target corporation the stock of which is acquired solely for business reasons but which generates post-liquidation losses reported on a separate return and is liquidated by the purchasing corporation within two years after the stock acquisition could be subject to new §269(b). However, it could be argued that, because those losses would have offset the purchasing corporation's income had the two corporations filed a consolidated return after the stock acquisition, the purchasing corporation's use of target corporation losses would have been available irrespective of the liquidation.[156] Moreover, it appears that the language in the Conference Report cited above immunizes from §269(b) a liquidation following a qualified stock purchase without a §338 election where the target corporation is profitable at the time of the stock purchase.

Section 269(b) is effective for liquidations occurring on or after October 21, 1983 following qualified stock purchases completed on or after September 1, 1982.[157]

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C. *Amendments Affecting Purchases of Stock Treated as Redemptions*

1. Introduction

Under §304 of the Code, acquisitions of stock from shareholders who are deemed to own at least 50 percent of the stock of the acquiring corporation and the transferred, or issuing, corporation in exchange for property, including money or any other consideration other than stock of the acquiring corporation, are treated not as sales or exchanges but as redemptions usually taxed as §301 distributions. Thus, the receipt of such consideration is generally taxable as a dividend to the extent of available earnings and profits. Somewhat simplified, §304(a)(1) applies to acquisitions of stock of sister corporations by brother corporations ("brother-sister transactions") and treats such transactions as if the acquiring brother corporation had distributed property to the transferor shareholder in redemption. Equally simplified, §304(a)(2) applies to acquisitions of the stock of parent companies by their subsidiaries from the ultimate shareholder ("parent-subsidiary transactions") and treats the property distributed in such transactions as redemption distributions by the parent issuing corporation.

Section 226 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made substantial changes in §304. Section 304(b)(3)(A) after TEFRA provided that a transaction described in both part III of subchapter C and in §304 would be governed by §304, except for certain transactions involving the assumption of (or stock taken subject to) acquisition indebtedness and the formation of certain bank holding companies. Section 304(b)(2)(A), as amended by TEFRA, provided that, in determining the extent to which a §304 distribution is to be treated as a dividend, the earnings and profits of both the acquiring corporation and the issuing corporation are to be taken into account. Section 304(c)(2)(A), as amended by TEFRA, expanded the criteria for determining when a shareholder or group of shareholders was deemed to have at least 50 percent control of the issuing corporation and the acquiring corporation. TEFRA also made parallel changes in §306, which treats as ordinary income gain on certain preferred stock issued in situations where, had cash or other property been issued, dividend treatment would have resulted.

2. Overview

The far-reaching revisions of §304 made by TEFRA were perhaps were more far-reaching than Congress had intended.[158] As a result, the 1984 TRA amendments significantly modified several of those TEFRA revisions.

Following enactment of the 1984 TRA, §304 treats all deemed §304 distributions as having been made first, to the transferor from the acquiring corporation to the extent of its earnings and profits and thereafter, to the transferor from the issuing corporation. This treatment is designed to apply not only in determining whether the §304 distribution is a dividend, but also in determining the source of the §304 distribution and the amount of post-distribution earnings and profits of the acquiring and issuing corporations. Parallel changes are made in the determination of whether stock is §306 stock and whether a redemption of such stock is a dividend.

The 1984 TRA amendments clarify that §304 has priority over §351 transactions, and not over all reorganizations, and make inapplicable the acquisition indebtedness exception when such acquisition indebtedness was incurred with respect to purchases from related parties or is assumed in non-§351 transactions. The 1984 TRA amendments to §304(c) exempt from the constructive ownership rules applicable in determining common control certain portfolio holdings. Technical changes are made with respect to the distribution of property in connection with bank holding company formations.

The changes to §§304 and 306 made by the 1984 TRA are generally effective for distributions occurring on or after September 1, 1982.

3. Detailed Analysis

a. Computation of Available Earnings and Profits

Pre-TEFRA law provided that, in a "brother-sister" §304 transaction, the amount of earnings and profits to be taken into account in determining whether the §304(a) deemed distribution from the acquiring corporation was solely the earnings and profits of the acquiring corporation. Where a newly formed holding company or other corporation without earnings and profits was the acquiring corporation, the deemed distribution could not be treated as a dividend, but only as a return of capital or capital gain. Thus, TEFRA modified §304(b)(2)(A) to provide that, for purposes of determining the extent to which a §304 deemed distribution was a dividend, the property received by the transferor was deemed to be distributed first from the issuing corporation to the acquiring corporation and then from the acquiring corporation to the transferor. In the case of "parent-subsidiary" §304 deemed distributions, even before TEFRA, the amount of any dividend was determined as if the property received by the transferor was first distributed by the acquiring corporation to the issuing corporation and then from the issuing corporation to the transferor corporation.

However, these formulations did not necessarily ensure that the amount of a §304 deemed distribution treated as a dividend took into account the combined earnings and profits of the acquiring and issuing corporations. In the case of "brother-sister" §304 transactions in which the property received was appreciated property, the deemed distribution from the issuing to the acquiring corporation would arguably be limited to the issuing corporation's adjusted basis in the property.[159] Thus, even where the transferor was an individual, as to whom the amount of the §304 deemed distribution was the full fair market value of the property,[160] the amount of earnings and profits deemed distributed by the issuing corporation to the acquired corporation would be limited to the adjusted basis in the property.

In the case of "parent-subsidiary" §304 transactions, the constructive distribution from the acquiring corporation to the issuing corporation arguably provided opportunities to shift earnings and profits from acquiring corporations that had individual shareholders to issuing corporations that had only corporate shareholders, which in many cases would prefer dividend treatment. Those constructive distri-

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butions could also convert what, in a third-party sale, would be U.S. source income to foreign source income and vis versa.[161]

Section 612(k)(1) of H.R. 4170 would have amended §304(a)(2)(A) to provide that, as to "brother-sister" §304 transactions, in determining the amount of a §304 deemed distribution that could be taxed as a dividend, the amount of available earnings and profits would be determined as if the property received by the transferor was distributed to it first by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation. The conference committee did not object to this formulation with respect to "brother-sister" transactions but thought that, because of the potential problems outlined above, the rule should apply to "parent-subsidiary" transactions as well. Section 712(l)(1) of the 1984 TRA did just that, numbering the provision §304(b)(2)(A) and (B).[162]

The conference report accompanying 1984 TRA §712(l)(1) states that, for all purposes of characterizing the nature of a §304 deemed distribution (in either a "brother-sister" or "parent-subsidiary" transaction), the property received is deemed to have been transferred directly to the transferor from the acquiring corporation to the extent of the lesser of the amount distributed or the acquiring corporation's earnings and profits and then to the transferor from the issuing corporation.[163] Thus, if the amount distributed — determined solely by whether the transferor is a corporate or a noncorporate shareholder — exceeds the acquiring corporation's earnings and profits and the acquiring corporation is a foreign corporation more than 50 percent of whose gross income is from foreign sources and the issuing corporation is a U.S. corporation having at least 20 percent of its gross income from U.S. sources, the distribution will be foreign source income to the extent of the acquiring corporation's earnings and profits. It will be U.S. source income otherwise. Similarly, if the transferor is an individual, and the acquiring corporation has no earnings and profits, the amount of available earnings and profits will be the lesser of the issuing corporation's earnings and profits or the full fair market value of the property distributed.

The conference report also notes that the earnings and profits of each corporation deemed to have made a distribution will be reduced by the amount of such distribution deemed made by it.[164]

Note: Because §311 applies to the acquiring corporation's transfer of property received in exchange for issuing corporation stock,[165] the 1984 TRA amendments to §311(d),[166] setting forth the general rule that gain realized by a distributing corporation on its distribution of appreciated property in redemption is recognized, will cause an increase in the acquiring corporation's earnings and profits on the distribution.[167] Moreover, even where, by virtue of §311(d)(2), no gain is recognized, 1984 TRA amendments to §312 will increase the amount of the distributing corporation's earnings and profits by the amount realized on the distribution.[168]

Section 712(1)(6) of the 1984 TRA amends §306(c)(3) to provide that, in determining whether preferred stock issued in §351 transactions is §306 stock and whether a redemption of §306 stock in a transaction described in both §§304 and 351 gives rise to dividend treatment, the determination of available earnings and profits shall be made as if the issuance or distribution of property in redemption, as the case may be, were made by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation.

The provisions modifying the rules respecting the amount of a §304(a) distribution that may be a dividend are effective for stock acquired after June 18, 1984, although the taxpayer may elect to have those rules apply to stock acquired on or after September 1, 1982.[169] The rules modifying §306(c)(3), however, are fully effective for transactions occurring on or after September 1, 1982. No reason was given for the earlier effective date for the §306(c)(3) amendments and it may, at least with respect to redemptions of §306 stock, be unintended.

b. Priority of Reorganization Treatment

TEFRA amended §304 to give it priority over all provisions contained in part III of subchapter C. Where a transaction was described in §351-§368 as well as in §304(a), former §304(b)(3) provided that §304 applied to the extent that property was received by one or more transferors from one corporation in which such transferors had at least 50 percent control in exchange for stock in another such controlled corporation.

However, the focus of the TEFRA changes in this regard was to give §304 priority over §351. Little thought was given to the interaction of the reorganization rules with §304. Thus, where a controlling shareholder of one corporation transferred stock in that corporation to another corporation and received at least 50 percent of the voting stock but less than 80 percent control of that corporation plus property, what would otherwise be a fully taxable exchange[170] can be bifurcated into a §304 redemption to the extent of the property received and a tax-free §368(a)(1)(B) reorganization to the extent that stock was received.

Section 712(l)(2) of the 1984 TRA amends §304(b)(2) to provide that §304 takes priority over §351 and those portions of §§357 and 358 relating to §351 with respect to transactions described in both §§304 and 351. Although the statute does not specifically state that the reorganization provisions apply to transactions that are also described in §304, the legislative history states that such priority is intended.[171]

Note: Because §304 does not take priority over the operation of part III of subchapter C other than §351 and parts of §§357 and 358, an argument could be made that §367(a) would override §304 where a U.S. shareholder transfers stock (appreciated or otherwise) of a 50 percent controlled corporation to a more than 80 percent controlled foreign corporation and receives not only stock but also other property. Section 367(a)(1), as amended by §131 of the 1984 TRA, provides that, in the case of a transaction "described in §351," the foreign acquiring corporation is not to be considered a corporation for purposes of determining the extent to which gain is recognized. Regardless of whether §351 is the operative Code provision, such a transaction would seem to be "described in" that section. If §357(a)(1) governed and the acquiring corporation were not considered a corporation in determining the amount of gain recognized on a transfer, then arguably §304(a),

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which applies only to transfers to controlled corporations, could not apply in this respect. Thus, §1001, which would limit gain to the excess of the fair market value of the stock transferred over its adjusted basis, rather than §304(a), which would ordinarily treat as a dividend the full fair market value (in the case of an individual transferor) of property received, or the adjusted basis (in the case of a corporate transferor) of such property, would govern. On the other hand, it could be argued that §304 — at least where a deemed §304 distribution is treated as a dividend — does not seek to tax "gain" and thus that §367(a)(1) is inapplicable.

The provision limiting the priority of §304 to transactions also described in §351 is effective for transfers on or after September 1, 1982.[172]

c. Limitations on Acquisition Indebtedness Exception

While expanding the scope of §304 to apply, to the extent of property received, to transfers (described in both §§304 and 351) of stock of one 50 percent commonly controlled corporation to another, TEFRA made an exception for the acquiring corporation's assumption of (or receipt of stock subject to) indebtedness incurred by the transferor to acquire the stock so transferred.
The theory behind this exception was that, had the acquiring corporation purchased the transferred shares directly using borrowed funds, the transferor (*i.e.*, the controlling shareholder of the acquiring corporation) would not have been subject to tax.[173]

However, despite the heading to §304(b)(3) — "Coordination With §351," §304(b)(3)(B) prior to the 1984 TRA literally applied to preclude the application of §304(a) with respect to all assumptions of such acquisition indebtedness, whether incurred in connection with a transaction described in §351 or not. Thus, where a shareholder that controlled actually or constructively at least 50 percent (but actually owned less than 80 percent) of the stock of a corporation, transferred to that corporation solely for property (including the assumption of the shareholder's indebtedness incurred in acquiring the issuing corporation shares transferred) stock more than 50 percent of which the transferor actually or constructively owned, §304 would not apply to the assumption of indebtedness.

Moreover, whether or not the transfer was described in §351, the acquisition indebtedness exception applied even where the transferor acquired the stock being transferred from a related person. This permitted a transferor to purchase appreciated stock from a relative, who would be taxed at capital gain rates on the sale, and have the acquiring corporation pay for such stock with no tax to the transferor. Even if §351 did not apply and the transfer was treated as a taxable sale, there would be little if any gain realization so long as the stock was purchased from the relative at fair market value and the transfer to the acquiring corporation occurred shortly after such purchase. Although the acquisition indebtedness exception to §304 contemplated the tax-free use of corporate funds to finance a purchase originally made by a shareholder, it did not do so in a situation where both the transferor and a related seller of the issuing corporation shares would thereby avoid dividend tax.

Section 712(1)(3)(A) of the 1984 TRA provides that the exception to §304(a) treatment for the assumption of acquisition indebtedness by corporations receiving stock from 50 percent controlling shareholders applies only to transactions described in §351. Thus, the assumption of (or the receipt of stock subject to) acquisition indebtedness by a 50 percent controlled corporation qualified for the exception only where the transferring shareholder or shareholders actually own at least 80 percent of the stock of the acquiring corporation immediately after the transfer and receive some stock in exchange for the stock so transferred.[174]

One potential problem with this requirement may arise on the transfer of stock that is subject to acquisition indebtedness to the full extent of its value. In this case, even if the transferor receives stock from the acquiring corporation, it would be possible for the Service to argue that, because the acquisition indebtedness assumed equaled the full fair market value of the issuing corporation stock transferred, the acquiring corporation stock received by the transferor could be ignored, with the result that the transaction was not described in §351.[175] Satisfying §304(b)(3) in this case is important because, even if there is no gain realized, the full amount of acquisition indebtedness would be taxed as a dividend if the transaction were subject to §304(a).

Section 712(1)(3)(B) of the 1984 TRA amends §304(b)(3)(B) to provide that the acquisition indebtedness exception to §304(a) treatment applies only if the seller of the issuing corporation stock is not related to the transferor,[176] or, if such a relationship exists, the seller satisfies rules similar to §302(c)(2) with respect to the issuing and acquiring corporations. Thus, where the transferor has purchased from one (the stock owned by which is constructively owned by the transferor) the issuing corporation's stock that is transferred, the exception will apply only where the seller has no interest in either the issuing or acquiring corporation (even as an employee), does not acquire an interest in either corporation for at least 10 years after the sale, did not acquire the stock sold from a related party within 10 years prior to the sale, did not transfer within 10 years before the sale stock in either corporation to a related person who owns it at the time of the sale, and files with the IRS an agreement similar to that described in §302(c)(2)(A)(iii).[177] Thus, acquisition indebtedness incurred to purchase stock from a sibling is generally subject to the acquisition indebtedness exception while acquisition indebtedness incurred to purchase stock from a spouse, parent, child or related corporation is not, absent satisfaction of the §302(c)(2) rules.[178]

Unlike most of the 1984 TRA changes to the §304 rules, the limitations on the acquisition indebtedness exception for stock purchased from related parties are generally effective only for stock "acquired" after June 18, 1984, unless the taxpayer elects to have those limitations applied to acquisitions occurring on or after September 1, 1982.[179] Presumably, this effective date provision refers to stock acquired by the acquiring corporation, and not stock acquired by the transferor, after June 18, 1984. The limitation of the acquisition indebtedness exception to transfers described in §351 is effective for acquisition indebtedness incurred after October 20, 1983,[180] although a taxpayer may elect to have that limitation apply to any stock ac-

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quired by the acquiring corporation on or after September 1, 1982.

d. Distributions Pursuant to Formation of Bank Holding Companies

When §226 of TEFRA modified §304 to give that section priority over §351 with respect to the receipt of property by transferors, it contained an exception for certain distributions of securities to minority shareholders incident to the formation of bank holding companies.[181] One of the requirements for this exception to apply was that no controlling shareholders of the bank holding company receive "distributions of . . . property" described in §304(a).

The rule exempting from §304 treatment acquiring corporations' assumptions of acquisition indebtedness is separate from the bank holding company exception and does not exclude from property distribution status an acquiring corporation's assumption of acquisition indebtedness. Therefore, where controlling bank holding company shareholders had the bank holding company assume their indebtedness incurred in acquiring the bank stock that was contributed to the bank holding company, those shareholders would have received a distribution of property, which would have prevented application of the bank holding company exception to the minority shareholders who received securities.

Section 712(1)(4) amends §304(b)(3)(C) to provide that an assumption of (or acquisition of stock subject to) acquisition indebtedness is not a distribution of property for purposes of the bank holding company exception. The amendment is effective for bank holding company formations on or after September 1, 1982.[182]

e. Constructive Ownership Rules for Determining 50 Percent Control

Section 226 of TEFRA provided that the determination of whether the issuing and acquiring corporations were at least 50 percent commonly controlled by one or more shareholders was based upon an expanded application of the §318(a) constructive stock ownership rules. Application of §318(a)(2)(C) to the §304(c) common control test was expanded so that, even if less than 50 percent of the value of stock of a corporation was owned by a person (including a corporation), that person was deemed to own a proportionate amount of the stock owned by the corporation. Application of §318(a)(3)(C) was expanded so that, even if less than 50 percent of the stock of a corporation was owned by a person, that corporation was deemed to *all* of the stock in any other corporation owned by such person.

The operation of these expanded constructive stock ownership rules created the common control requisite for §304 treatment in situations where *de facto* common control was absent. Thus, if a shareholder owned 50 percent of the value of the stock of one corporation and owned a single share of stock in a second corporation, a sale by either corporation to the other of stock in a subsidiary would be subject to §304. Not only did this present a possible trap for unwary individual shareholders and make it relatively simple for corporate shareholders to obtain §304 dividend treatment in lieu of capital gain treatment, it might also have precluded application of the §338 rules to many stock purchases, since §304 treats an acquisition of stock as a contribution to capital, which is excluded from the definition of purchase in §338.[183]

Section 712(1)(5)(A) amends §304(c)(3) in three respects for purposes of determining whether a shareholder constructively owns at least 50 percent of a corporation's stock. First, a person is deemed to own a proportionate amount of stock actually owned by a corporation only if that person owns at least 5 percent of the value of the shares of that corporation. Second, a corporation, less than 5 percent of the stock of which is owned by a person, is not deemed to own stock in a second corporation in which that person owns shares. Third, where at least 5 percent but less than 50 percent of the value of the stock of a corporation is owned by a person, that corporation is deemed to own only a proportionate amount of the stock in a second corporation owned by that person.

Section 712(1)(5)(B) of the 1984 TRA amends §306(c)(4) to provide parallel rules for determining whether preferred stock will be treated as §306 stock when issued under circumstances in which the distribution of property instead of the preferred stock would be a dividend under §304(a).

The amendments to the constructive ownership rules operative for purposes of both §304(c) and §306(c)(4) are effective for distributions on or after September 1, 1984.[184]

V. Restrictions on Golden Parachute Payments

A. Introduction

Included among the corporate tax reform provisions of the Tax Reform Act of 1984 [185] (TRA) are rules designed to discourage so-called "golden parachute" arrangements under which excessive severance payments are made to corporate executives to ease their fall from corporate power. These new rules deny the corporation any deduction for excessive golden parachute payments, and subject the payments to a nondeductible 20 percent excise tax, in addition to income and Social Security taxes. Because these rules define an "excess parachute" by totalling payments under all contracts that either: (1) make payments contingent on a takeover; or (2) are entered into within a year prior to takeover. Subtracting "reasonable" compensation, these rules will apply to a surprising number of corporate takeover situations, irrespective of whether the acquired company is publicly or privately held. The golden parachute rules thus require careful study not simply because of their effect upon recognizable golden parachute termination pay, but also because of their interaction with traditional compensation and retirement arrangements.

The TRA rules were criticized by the tax bar and opposed by the Treasury Department as an unnecessary incursion by the federal tax laws into an area more effectively addressed by either federal securities laws or state law limitations on corporate waste. Even as these criticisms were being voiced, the golden parachute provisions were being expanded rather than limited. As finally enacted, these provisions will create considerable work for compensation advisors, by requiring proof that many payments swept into a "parachute" are nonetheless reasonable compensation, thereby allowing the deduction to the paying

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corporation and exempting the payments from the 20 percent excise tax.

B. Overview

In general, the TRA rules state that any "excess parachute payment" (1) cannot be deducted by the corporation (Code §280G), (2) is subject to a nondeductible 20 percent excise tax imposed on the recipient (Code §4999), and (3) must be included in the FICA tax base (Code §3121(v)(2)). "Excess parachute payment" means the excess of any parachute payment over whatever portion of the base amount (defined below) is allocated to that payment, and again reduced by whatever amount is clearly proven to be reasonable compensation.[186]

1. Payments Contingent on Takeover and Eleventh Hour Payments

The term "parachute payment" is defined to include any payment of cash or property in the nature of compensation to (or for the benefit of) any officer, shareholder, or highly compensated individual[187] who performs (or has performed) services for any corporation (*i.e.*, a "disqualified individual") provided that such payment:

> "(i) either (a) is, in fact, contingent (either in amount or in timing) on a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of its assets;[188] or (b) is made pursuant to an agreement (or amendment of a previous agreement) that is entered into within one year before such change in ownership or control occurs (unless it can be proven that the payments were not contingent on a change in ownership or control); *and*
>
> (ii) when aggregated with all other payments described in item (i) above, has an aggregate present value of 300 percent or more of the individual's base amount."

Although it might appear that this 300 percent computation will always allow the payment of severance pay contingent on takeover of up to three times historic compensation, in fact, the Act's broad definition of payments contingent on takeover combined with the presumptive inclusion of any "eleventh hour" contract will cause inclusion in the total parachute of many normal compensation and retirement arrangements that happen either to include contingency clauses or to have been amended during the year prior to takeover. Many, if not most, of these payments can be classified as "reasonable compensation," and therefore ultimately can be subtracted from the total parachute amount in computing the excess parachute payment.[189] However, the 300 percent calculation applies to the total parachute amount. Therefore, to the extent that payments of reasonable compensation under contingency contracts or eleventh hour agreements automatically inflate the size of the total parachute, they eliminate whatever protection the 300 percent safe harbor might have provided to classic golden parachute termination agreements.

The Conference Report's definition of "payments contingent on a change in ownership or control" states, in general, that a payment would be so treated *either*:

> (i) "if such payment would not *in fact* have been made to the disqualified individual had no change in ownership or control occurred, [*or*]
>
> (ii) if the change determines the time such payment in fact is to be made."[190]

These rules would certainly apply to any contract containing a contingency clause, and would include in the total parachute amount all payment under such contracts that are either made or accelerated as a result of the change in control. Specific examples of such contingent payments that are listed in the Conference Report include:

> (i) "payments made under a contract contingent simply on termination of employment, that are made to an individual whose employment was terminated after a change in control and "as a result of the change;"[191]
>
> (ii) payments resulting from a contract that accelerates the payment of deferred incentive compensation, or that makes payments in cancellation of stock options, contingent on a change in control; and
>
> (iii) payments resulting from a contract that accelerates the vesting of deferred incentive compensation, or that accelerates the time for exercise of stock options, contingent on a change in control."[192]

Even contracts that make no express reference to change in control or to termination may still be classified as golden parachute contracts under two separate theories. First, if, under all the facts and circumstances, it appears that the payments would not, in fact, have been made had the change in ownership not occurred, the contract may be classified as a parachute contract, even if it was entered into more than one year before the change in control. Assume, for example, that a company faced with a takeover threat agrees to pay each of its top executives $200,000 per year in each of the five ensuing years, irrespective of whether the executives continue to perform services for the company. Even if the takeover occurs more than one year after such contracts are signed, it is nevertheless possible that the Service might claim that such "pay-in-any-event" contracts were entered into solely in consideration of the threatened change in control and, therefore, that any post-takeover payments must be included in the total parachute amount.

Admittedly, proving that payments are contingent on takeover will be difficult where a contract makes no express reference to takeover, termination of services, or some other triggering event that might result from a change in control. Proof of such contingency is simplified considerably, however, under the statute's "eleventh hour" rule, which provides that contracts made (or amended in significant relevant respect) within one year prior to takeover are automatically (albeit rebuttably) presumed to be contingent on the change in control.[193]

Neither the statute nor the Conference Report offers any guidance as to how this presumptive inclusion in the total parachute amount of all payments under such contracts can be rebutted. Possible arguments that might be made would require a demonstration (using "clear and convincing evidence") that this so-called "eleventh hour" contract was entered into without knowledge of the impending takeover, or would have been entered into without regard to the takeover.[194] The taxpayer might demonstrate, for example, either that the takeover offer came as a complete surprise, or that the contract in question was one

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routinely entered into, such as an annual renewal of an employment contract, a standard employment contract for a new executive or a routine adjustment of a nondiscriminatory retirement plan.

Comment: It is unlikely that this presumption that an eleventh hour contract is contingent on takeover will be rebuttable merely by a showing that the amount to be paid under the contract is reasonable. Such proof of reasonableness can be used instead only to reduce the excess parachute amount, after the total parachute amount has been established.

Neither the statute nor the Conference Report makes clear whether it may be possible to make only a partial rebuttal of the presumption that an eleventh hour contract is contingent on takeover. For example, assume a company has an established practice of renewing its contracts with its officers every four years. Assume also that these contracts provide for the payment of compensation for the entire 4-year period, irrespective of whether the executive's services are terminated. If this company increases each officer's compensation by 75 percent when renewing these contracts in the year prior to takeover, will the parachute include only the 75 percent increase, or will all payments under the contract be included in the total parachute? In general, it would seem much more logical to include in the parachute only the increase in compensation, since the company and its directors can establish that certainly the routine renewal of the employment contracts was not contingent upon the change of ownership.

There are two additional, notable features of both the contingent payment and eleventh hour contract rules. First, these rules can apply even to individuals whose employment is not terminated as a result of the change in control, so long as the individuals receive payments described in §280G(b)(2). Second, these rules apply to "any payment in the nature of compensation" [195] made to a disqualified individual, irrespective of the identity of the payor of these presumptive parachute amounts. These features ensure the expansive application of the golden parachute rules, potentially to cover, for example, payments under consulting contracts or noncompetition agreements entered into prior to takeover. Technically, these rules could be construed to apply even to payments in the nature of hidden compensation between different shareholders that might be made in reallocation of the purchase price paid for majority and minority interests in an acquired corporation. However, in view of the fact that the purpose and structure of these golden parachute rules is to impose joint penalties on the payor (employer) and recipient (employee) of any parachute payment, it would seem both illogical and unlikely for these rules to be extended outside the employment contract to cover payments between shareholders of the target company.

Even if the golden parachute rules are restricted to cover only compensation paid by the target or acquiring company to its employer, they still will apply to a wide variety of compensation payments. In light of the broad sweep of these parachute rules, it seems likely that, in a majority of takeover situations, the key executives' total parachutes will exceed 300 percent of their historic average compensation.

2. Payments Violating Securities Laws

In addition, the 300 percent safe harbor has no application whatsoever to the alternative definition of parachute payments, which covers any compensatory payments to or for the benefit of a disqualified individual made under an agreement that violates any securities laws or regulations.[196] This alternative definition was added in recognition both of certain pending court cases challenging golden parachute payments under existing law,[197] and of pending legislation proposed by the Securities and Exchange Commission (at the recommendation of the SEC Advisory Committee on Tender Offers) that would impose an absolute ban on golden parachute severance pay contracts.[198] Unlike the Senate bill provision, the statute's application is not limited to payments violating federal securities laws and regulations, but potentially would cover payments violating state securities laws as well.

As proposed, this pending securities legislation would overlap with the "eleventh hour" contract presumption of §280G(b)(2)(C). Both provisions apply to agreements made or amended during certain tender offers that would increase the current or future compensation of a company's officers or directors.[199] Since both provisions are timing rules, both apply irrespective of whether the agreed-upon increase in compensation is dependent upon the occurrence of takeover, merger, or any other contingency.[200] However, the pending securities provision is considerably narrower than the Code rule, in that the Code provision applies to any agreements made during the year prior to a change in control, whereas the securities provision applies only to publicly held corporations, and even then only to agreements made during a tender offer for any class of securities where the offer is both (1) unconditional with respect to 10 percent or more of the securities and (2) is made at a price 25 percent higher than the average market price for the securities during the 10 trading days prior to commencement of the offer.[201]

Except in rare cases (arising with tender offers lasting more than one year) it appears that a payment violating the securities provision would also violate the "eleventh hour" presumption of unreasonability. Technically, such a payment could be double-counted for tax purposes, since it is as an agreement violating securities laws (under §280G(b)(2)(B)), and an agreement made within a year before a change of ownership (under §280G(b)(2)(C)). Treasury regulations implementing this provision are certain to include rules preventing the imposition of double penalties as such a payment. However, it is doubtful that the regulations will provide simply that §280G(b)(2)(C) would not be deemed to include any payment violating securities laws. The regulations (when issued) are more likely to permit payments described in §280G(b)(2)(B) to be subtracted from other payments entered into within one year prior to change in control only after both types of payments are subjected to the 300 percent test of §280G(b)(2)(A)(ii).

3. The "Base Amount"

The "base amount," which is used both in identifying a golden parachute payment (under the "300 percent test") and in computing the excess parachute amount (under the "100 percent test") is defined as the average annual includ-

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ible compensation of the individual for the five years immediately preceding the takeover (or such portion of that period during which the individual worked for the corporation experiencing the change in ownership or control).[202] This term includes, of course, not only all cash compensation or other §61 compensation income, but also any Code §83 income, such as from the exercise of nonqualified stock options.[203]

In recognition of the fact that an executive's income may vary significantly from year to year as a result of extraordinary bonuses or option exercise, the base amount was defined as an average over a five-year period, rather than the highest compensation in any of the five years preceding takeover.[204] In part because this averaging technique automatically reduces the base amount, the multiple of compensation used in defining safe harbor golden parachute payments was increased from 200 percent (in the Senate bill) to 300 percent (in §280G(b)(2)(A)(ii)). However, because the base amount is likely to be lower than the employee's final year's salary, in any instance where the employee continues to work for one acquiring corporation, the base amount presumably will be less than "reasonable compensation." This or any other case in which the base amount is *less* than reasonable compensation will result in surprising allocations of the taxable portion of any installment parachute payments, because (as is explained *infra*) although the base amount must be allocated (using present value computations) across any stream of parachute payments, any reasonable compensation in excess of the base amount must be allocated to the first parachute payments made.[205]

4. Reasonable Compensation

After the total parachute payment and average historic compensation have been determined, the difference between these two amounts (*i.e.*, the "excess parachute" amount) can be reduced still further by whatever amount the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered.[206] Three basic rules govern the determination of the "reasonable compensation" portion of any parachute payment:

(a) *Services adequately compensated for by nonparachute payments (such as prior years' services) cannot be taken into account.*[207] This rule is designed to prevent (except in rate cases) any justification of a parachute payment on grounds that "the executive was undercompensated in earlier years." [208]

(b) *Previously earned compensation, which was included in the parachute because its payment or vesting schedule was accelerated by virtue of the change in control, generally can be taken into account.*[209] The Conference report gives the following examples of previously earned compensation which would have been paid in the future in any event:

> "(1) payments in cancellation of a normal stock option or normal stock appreciation right, granted more than one year before the change; (2) exercises after termination of stock options or stock appreciation rights issued as part of a normal compensation package granted more than one year before the change; (3) compensation previously earned and deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the employee; and (4) amounts paid under a retirement plan that supplements a tax-qualified plan to the extent such amounts are designed to compensate a newly-hired lay employee for the loss of retirement benefits attributable to services performed for a prior employer." [210]

(c) *The amount of reasonable compensation, once determined, must be reduced by the base amount.*[211] Consider, for example, the case of Executive A, who joins a company for a salary of $100,000, and whose salary is increased thereafter by 50 percent a year. In year 4, in anticipation of a hostile takeover, the board of directors votes to pay all of its executives severance pay equal to 1½ times each executive's annual salary, contingent on takeover. The company is acquired in year 4, and Executive A receives severance pay of $498,750. Unfortunately, this amount slightly exceeds three times Executive A's average compensation over Years 1 through 3, which was only $158,333. The excess parachute amount is $340,417. Assume that Executive A can demonstrate that $200,000 of this amount was reasonable compensation. However, because total reasonable compensation must be offset first against the base amount, the residual excess parachute amount is $298,750.[212]

C. Detailed Analysis

1. Legislative History

a. H.R. 4357

The first indication of Congress's intent to examine the tax aspects of golden parachutes was the introduction on November 10, 1983 of H.R. 4357, a colorful bill focusing on "green mail" as well as "golden parachutes." In his remarks introducing H.R. 4357, Rep. Stark (D., Cal.) explained his concern about the millions of dollars being paid to corporate executives under:

> "a phenomena known as the Golden Parachute. Corporate officials have devised another way to get a better deal for themselves at the expense of the other shareholders — the golden parachutes. Management groups who see a corporate change on the horizon have established the practice of creating golden parachutes to ease their fall from corporate power. Before the rest of the shareholders can anticipate the corporate change, these officials use their power to get one last piece of the rock before they are ejected from the seat of corporate power.
>
> The components of these management protection agreements are limited only by the imagination of the players involved." [213]

H.R. 4357 sought to limit these imaginative takeover compensation arrangements by denying the corporation any deduction for payments of cash or property under any "management protection agreement" that discriminates in favor of officers, shareholders, or highly compensated employees. In addition, an employee who enters into such an agreement would include in gross income in the year of termination of services the present value of all amounts to be paid under the agreement. The term "management protection agreement" was defined by the bill as:

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"... any agreement to make one or more payments (or transfers of property) to an employee of a corporation if such employee's employment with the corporation is terminated within a specified period after a change (of a kind specified in the agreement) in the ownership or control of the corporation." [214]

This broad definition, of course, covered far more than so-called "eleventh hour" golden parachute agreements, entered into within 12 months prior to a takeover offer. The bill also would have affected any amounts paid under any takeover contingency agreement, without regard to the reasonableness or the size of the payments in relation to the executive's historic compensation.

b. S. 2323

Prior to any further House action on H.R. 4357,[215] on February 23, 1984 Senator Chafee (R., R.I.) introduced S. 2323, a bill that not only would have denied any business deduction for golden parachute payments, but also would have imposed a 90 percent federal excise tax (in lieu of federal income taxes) upon any such payment received by an individual from his employer corporation (or its parent or subsidiary corporations). The bill defined "golden parachute payment" as any payment:

"(1) in lump sum or installments;

(2) in cash, stock, or other property;

(3) pursuant to a contingent, unfunded compensation agreement;

(4) resulting from an actual or threatened change in the operating control of such corporation;

(5) after termination of such individual's employment by the corporation; and

(6) without any corresponding substantive increase in job duties, responsibilities, or title if the individual were employed by any successor corporation, or by its parent or subsidiary corporations." [216]

In introducing this bill, Sen. Chafee, like Rep. Stark, explained his concern that these "lucrative contracts allowing key business executives to bail out if a company is taken over by another firm ... 'can even exceed the market value of the company or its annual earnings ... As such, they are open to widespread abuse which should be curtailed.'" [217]

However, despite Sen. Chafee's stated focus on excessive payments, the penalties of S. 2323 were not limited to payments of large size, in relation to historic or reasonable compensation. Other points of comparison between the two bills' definitions of golden parachute contracts include:

- Like H.R. 4357, S. 2323 was not limited to "eleventh hour" parachute contracts;
- S. 2323 narrowed the H.R. 4357 definition of golden parachute payments by focusing only on unfunded agreements,[218] and by exempting payments linked to "a substantive increase" in job duties, responsibilities, or title;[219] and
- S. 2323 was broader than H.R. 4357 in that it would have penalized payments to an executive who terminated employment following even a *threatened* change in corporate control, and, further, in that it applied technically to all employees of a corporation receiving parachute payments irrespective of whether the payments could be shown to be nondiscriminatory. H.R. 4357 also applied to all employees receiving parachute payments, but its application was limited to agreements that discriminated in favor of officers, executives and highly compensated employees.

Treasury's response to S. 2323 was also significant to the evolution of the golden parachute provision. In a letter to Sen. Chafee dated March 8, 1984, John E. Chapoton, Treasury's Assistant Secretary for Tax Policy, specifically criticized the bill's "confiscatory excise tax approach," [220] and suggested in general that excessive payments under management protection agreements would be better addressed by federal securities laws than by the Internal Revenue Code. However, Mr. Chapoton went on to state that the Treasury Department "could support an alternative approach, which would deny a deduction for any excessive amounts paid under one of these agreements." [221] Under this approach, Mr. Chapoton explained:

"[i]n order to ensure that the amount of any golden parachute payment is subject to special scrutiny under §162(a)(1), a statutory presumption of unreasonableness [could] be created in the case of any payment significantly in excess of historic compensation that is paid under a certain type of management protection agreement. Such a presumption would shift from the Internal Revenue Service to the employer corporation the burden of proving the reasonableness of any golden parachute payment. In addition, we recommend that the taxability of these termination payments for social security tax purposes be clarified to establish that any payments scheduled to be made in installments would be taxable when paid." [222]

c. Senate Version of The Deficit Reduction Act of 1984

The Senate Finance Committee acted promptly upon Treasury's suggestions. On March 14, 1984, during its mark-up of the Deficit Reduction Act of 1984, the Committee approved restrictions on golden parachute agreements, structured as a rebuttable presumption that all golden parachute payments under contracts entered into after March 15, 1984 would be in excess of reasonable compensation. If this presumption could not be rebutted, no part of the payments could be deducted, and a nondeductible 20 percent excise tax was to be imposed upon the recipient in addition to regular income and FICA taxes. A golden parachute agreement was defined by the Senate bill as any agreement with officers, shareholders, or highly compensated individuals providing for contingent payments of cash or property, the present value of which exceeds 200 percent of the highest compensation in any of the five years preceding execution of the contract, which amounts are to be paid in the event of a change or threatened change in the ownership or control of either the corporation or a significant portion of its assets.[223] Any contracts that the Securities and Exchange Commission classified as golden parachute agreements also would automatically be subject to these deduction-denial and excise tax penalties.[224] Unlike the prior bills, this provision, which applied only to officers, shareholders and highly compensated individuals, would

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have applied not only if these individuals were employees, but also if they were independent contractors or any other persons (to be specified in Treasury regulations) performing personal services for the corporation.[225] In addition, the Senate bill's provisions would have applied whether or not an individual terminated employment with the corporation.[226] This provision was not expected to raise significant revenues,[227] but instead was designed simply to prevent the tax laws from being used to subsidize the payment of corporate funds to "entrenched management teams." [228]

d. Hearing on H.R. 4357

On April 12, 1984, the House Subcommittee on Select Revenue Measures held a hearing on H.R. 4357.[229] The Treasury Department opposed the bill, in a brief statement recommending that these arrangements be addressed instead by the Securities and Exchange Commission or by state law limitations on corporate waste.[230] Like Treasury, all the other persons presenting written or oral testimony for this hearing strongly objected to using the tax system to limit the use of golden parachutes. Several witnesses warned that such restrictions would only force corporations to use "front-loaded" arrangements with key executives (similar to "signing bonuses" with sports stars) or arrangements that pay compensation over a fixed period of years, without regard to continued performance of services.[231] If, despite these recommendations, the Subcommittee nevertheless decided to use the tax system to limit golden parachute arrangements, the witnesses urged the Subcommittee to make the following changes in the provisions of both the House and Senate bills:

(i) Apply the bill only to "eleventh hour" abusive management protection contracts — *i.e.*, ones entered into as a tactical device once a takeover is threatened that provide for payments contingent on a change in control. This provision should not apply to employment arrangements adopted in the ordinary course of business, such as retirement agreements providing for early vesting of benefits, deferred bonuses payable in a variety of circumstances, including takeover, severance pay guarantees triggered by events ranging from disability to a change of ownership, or transfers of restricted property under vesting schedules set to accelerate in the event of an ownership change.[232]

(ii) Except any contract approved at an annual shareholders' meeting after fair disclosure.[233]

(iii) Eliminate any excise tax on payout.[234]

(iv) Disallow a deduction under a golden parachute contract only for the unreasonable portion of the contract. (Both House and Senate bills disallowed a deduction for the entire parachute payment.) [235]

(v) Either state the factors that will be considered in determining the "reasonableness" of any contracts, or define "unreasonable" payments under a golden parachute contract as payments over any period that exceed some multiple (such as 200 or 300 percent) of historic compensation over a period of identical length, or some multiple of future compensation that would have been received had employment not been interrupted by takeover.[236]

(vi) Clarify the application of the golden parachute rules to noncash compensation, both in the parachute and in whatever base is used for comparison. For example, how do the rules apply to stock option rights that are timed to vest immediately in the event of termination of services? [237]

(vii) Delete any references to agreements specified as abusive golden parachutes by the Securities and Exchange Commission.[238]

(viii) Tax the excessive portion of the golden parachute contract as paid out. (H.R. 4357 as introduced would have taxed the present value of any golden parachute contract in the year of termination of services. The Senate bill would have taxed the entire amount of any parachute as paid out.) [239]

(ix) Subject the excessive portion of any parachute to alternative minimum tax, instead of income tax, simply to assure that an individual does not shelter his parachute payments.[240]

(x) Add transition rules to ensure that payments under preexisting golden parachute contracts (or amendments thereof) would not be taxed by this bill.[241]

e. Conference Action on The Tax Reform Act of 1984

The above-outlined criticisms and suggestions of the golden parachute proposals were considered at length by various staff members of the House Ways and Means Committee, the Senate Finance Committee, the Joint Committee on Taxation and Treasury's Office of Tax Policy. Several drafts of possible variations on the House and Senate proposals were discussed at the staff level. However, there was no House Committee action on H.R. 4357 or these variations before the commencement of conference on the Tax Reform Act of 1984. On June 15, 1984, when this issue was raised for Conference Committee consideration, the conferees were faced with a choice between the Senate golden parachute provision, or whatever alternative to that provision that might be proposed by the House Conferees.

At the conference, Senator Chafee proposed an amendment to his golden parachute proposal, that, as he outlined it, would deny a deduction, and impose a nondeductible 20 percent excise tax, on any payment found to be an excess parachute payment. The term "excess parachute payment" would be defined to include:

(i) Any payments under contracts violating securities laws or regulations; or

(ii) Any payments which (a) are contingent on a change of ownership or effective control of a corporation or a significant portion of its assets and (b) have a present value in excess of 300 percent of historic compensation, to the extent that these payments cannot, by clear and convincing evidence, be proven reasonable (*i.e.*, in rebuttal of the new statutory presumption of unreasonability).

Any payments clarified as parachute payments under the foregoing tests would be subject to the excise tax, and ineligible for a deduction, to the extent they exceeded 100 percent of historic compensation. This proposal was to apply to all contracts entered into or renewed after June 14,

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1984, and to contracts entered into before June 15, 1984 that were amended on or after that date in significant relevant respect.[242]

The Conferees adopted the golden parachute provision, as modified by Senator Chafee's explanation, on June 15, 1984.

2. Identification and Computation of Parachute Amount

a. New Issues Addressed by the Conference Report

The golden parachute rules included in the Tax Reform Act of 1984 are necessarily considerably more complicated than Senator Chafee's explanation, outlined above. The statute as drafted adds rules concerning:

(i) the presumptive inclusion of eleventh hour agreements in parachute calculations;

(ii) the exclusion of reasonable compensation from excess parachute payments;

(iii) the application of these rules only to those employees or independent contractors who are officers, shareholders, or highly compensated individuals (or their personal service corporations);

(iv) the calculation of historic compensation;

(v) the allocation of the historic compensation base amount to any stream of future parachute payments; and

(vi) the application of withholding and FICA taxes to parachute payments.

The process of identifying the components of a golden parachute is outlined in the overview section above. The computation of the excess parachute amount, after the components are identified is explained below.

b. Computation of the Excess Parachute Amount

In any case where parachute payments are to be made in installments, relatively complicated rules govern the computation of the excess parachute amount. These complications arise for two reasons.

(1) Present Value Allocation of Base Amount

First, the base amount must be allocated on a present value basis across the stream of parachute payments. Specifically, §280G(b)(3)(B) provides that:

> "[t]he portion of the base amount allocated to any parachute payment shall be an amount which bears the same ratio to the base amount as —
>
> (i) the present value of such payment, bears to
>
> (ii) the aggregate present value of all such payments."

Present values must be determined in accordance with the rules of post-Act §1274(b)(2).[243] These rules (which will be expanded under regulations to be prescribed by the Treasury Department) require the use of a discount rate equal to 120 percent of the applicable federal short-term, mid-term or long-term rate, which must be published periodically, based on the average market yield of marketable U.S. obligations of comparable maturity periods.[244]

This present value allocation rule mathematically favors payors and recipients of parachute payments since, in the years immediately following the change in control, the base amount will be a larger proportion of each parachute payment than in the later years. For example, if base compensation is $100, and total parachute payments of $500 are to be paid in five equal annual installments beginning on the date of takeover (assuming a 10 percent annual yield, based on a 9.76 percent discount rate, compounded semi-annually) the base amounts would be allocated as follows:

Year	1	2	3	4	5	Total
1. Installment Payments	$100.00	$100.00	$100.00	$100.00	$100.00	$500.00
2. Present Value of Payments	100.00	90.91	82.64	75.13	68.30	416.98
3. Base Amount Allocation	23.98	21.80	19.82	18.02	16.38	100.00
4. Excess Parachute Amount ((1) Minus (3))	76.02	78.12	80.18	81.98	83.62	400.00

Golden parachute calculations would have been attractively simplified, however, if Congress merely had allocated the base amounts on a straight line basis, thus causing a fixed (rather than an increasing) percentage of each payment to be nondeductible to the corporation and subject to the excise tax on the individual. This rule, in the example above, would have caused four-fifths of every parachute payment to be subject to the parachute penalties.

(2) Initial Year Allocation of Reasonable Compensation

The second complication of the excess parachute computations arises from an instruction in the Conference Report that "the conferees intend that any reasonable compensation in excess of the base amount be allocated to the first parachute payments made.[245] Again, this rule favors the payors and recipients of parachute payments, by postponing the inevitable penalties on these payments.

To expand upon the example above, if it can be demonstrated that $300 is reasonable annual compensation for the individual in question, then $200 (*i.e.*, reasonable compensation in excess of the base amount) must be allocated to the first parachute payments made. This rule will reduce the excess parachute amount to zero in Years 1 and 2, and to $34.22 in Year 3. Here again, it would seem more sensible to have allocated reasonable compensation under the same rules used for allocating the base amount. A present value allocation would have caused the excess parachute amount to be $28.05 in Year 1, $34.59 in Year 2, $40.54 in Year 3, $45.95 in Year 4 and $50.86 in Year 5. Better yet, a straight line allocation approach would have subjected two-fifths of every parachute payment to the penalties — the same result that would apply if the $500 were paid in a lump sum.

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This "initial year allocation" rule yields very odd results in any case where the parachute is in part comprised of reasonable payments of previously earned compensation, which were swept into the parachute by virtue of being either contingent on takeover, or amended in significant respect during the eleventh hour. These types of payments are recognized specifically in the Conference Report as reasonable compensation, and therefore not subject to penalty.[246] However, the amount of reasonable compensation in any given combination of parachute payments must be totalled, and allocated according to time of payment, not type of payment. As a result, if these reasonable deferred compensation payments were paid later in time than a classic golden parachute settlement, the deferred compensation payments, *not* the golden parachute, would be subject to the penalties of §§280G, 3121(v)(2) and 4999.[247]

(3) Parachute Penalties

(a) Denial of Deduction

Post-TRA §280G denies any deduction under Chapter 1 of the Code for any excess parachute payment. The Conference Committee Report adds that no inference is intended that golden parachutes paid under prior law were deductible, by virtue of the fact that legislation was passed to correct this perceived abuse.[248] The Committee Report also adds that no inference should be drawn as to the increased likelihood of deductibility of "payments which are not excess parachute payments," [249] such as the base amount or any additional reasonable compensation that is included in, but subtracted from, the total parachute amount.

Because the rules governing the allocation of the base amount and of reasonable compensation generally skew the parachute penalties towards payments in the out years, it is likely that the penalties will be imposed on reasonable payments of deferred compensation that are simply paid later in time than the classic golden parachute termination pay. Where these payments of reasonable compensation have been deducted long prior to their payment, in years on which the statute of limitations has run, the application of §280G will have no effect. This would occur, for example, if payments under a qualified pension plan are ever included for some extraordinary reason in the total parachute amount. To illustrate, consider the case of an executive who is covered by a qualified plan that provides for accelerated vesting in the event of corporate takeover. If the executive also receives lump-sum severance pay under a traditional golden parachute contract, the allocation rules require the pension payments, not the severance pay, to be treated as the excess parachute amounts. However, §280G could not be effectively applied to these payments, since the company would have claimed its deduction long prior to payment of the qualified pension.

This particular problem is likely to be eliminated under Treasury's broad authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of §280G.[250] Presumably, these regulations simply will prohibit the allocation of any penalty amounts to payments under a qualified pension plan. It will be difficult, however, to design regulations to ensure meaningful application of the §280G deduction-denial penalty in every situation. For example, complications arise with incentive stock options, which are never deductible to the issuing corporation (except in the event of a disqualifying disposition). Here again, in any case where all, or nearly all, of a parachute is comprised of incentive stock options, application of the §280G penalty is meaningless.

Finally, note that, although §280G denies any "deduction" under §§1 through 1399, it nevertheless may be possible, in a case where an acquiring corporation has assumed the liabilities of an acquired company to make golden parachute payments for the acquiring company to add the parachute payments to the basis of the acquired property. The Conference Report does not address this issue.

(b) Excise Tax

Post-TRA §4999 imposes a nondeductible excise tax on any recipient of an excess parachute payment equal to 20 percent of the amount of such payment. This tax is in addition to the income taxes imposed upon the disqualified individual to whom (or for whose benefit) the parachute payments are made. Where the excess parachute payments are paid not to the disqualified individual, but to their designees or beneficiaries, the excise tax apparently will be imposed on the recipient of the payments, although the executive, of course, would continue to be liable for income taxes (and presumably also for gift taxes) on these assigned amounts.

To improve compliance with the 20 percent nondeductible excise tax on parachute payments, the statute requires that the excise tax imposed on any such payments which are wages be added to the amount otherwise deducted and withheld under §3402.[251] This withholding rule does not apply, however, where an excess parachute payment is exempt from the definition of wages under §3401.[252] Thus, no excise tax withholding apparently would apply to excess parachute payments made to a beneficiary of a deceased key executive, since unpaid compensation for services rendered by the decedent are not wages subject to withholding.[253] Similarly, if payments under a qualified pension plan ever are treated as excess parachute amounts under the allocation rules (barring Treasury regulations preventing such a result) these payments are exempt from wage withholding by virtue of §3401(a)(12) and, therefore, would be exempt from excise tax withholding as well.

(c) FICA Taxes

The Social Security tax provisions applicable since 1983 to nonqualified deferred compensation were also amended by the golden parachute rules, to clarify that the FICA tax exemption otherwise applicable to payouts of deferred compensation will not apply to excess parachute amounts.[254] This provision will result in the application of employer and employee FICA taxes upon excess parachute payments of less than the base amount ($37,500 in 1984) unless the payments to which the penalties have been allocated qualify for some other FICA tax exemption.[255]

In view of the relatively small size of the FICA tax base, the application of FICA taxes will have no noticeable effect upon golden parachute payments, as traditionally defined. However, the Code's post-TRA definition of an excess parachute effectively penalizes parachutes of lesser metals than gold. This FICA rule thus may have significant

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effect upon small (*e.g.*, $50,000) annual installments of termination pay which are designated as excess parachute amounts.

3. Effective Date

As should by now be obvious, there are few (if any) kinds of severance payments made following a takeover that will not be caught and penalized by the 1984 Tax Reform Act's rules. The only reliable protection against these penalties is that the rules are effective solely for payments under contracts entered into, renewed or significantly amended after June 14, 1984.[256] However, this rule also provides that even a contract entered into before June 15, 1984 may lose its grandfathered status if:

(a) it is either amended or supplemented in any significant relevant aspect on or after that date;[257] or

(b) it is "a contract cancellable at will by either party." [258]

The concept of "amendment in significant relevant aspect" is explained in some detail in the Conference Report to include any amendment to, or supplement of a previous contract:

> "either to add or modify a change in ownership or control trigger (or similar trigger), to increase amounts payable (or, where payment is under a formula, to modify the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger. Where a golden parachute agreement in effect on June 14, 1984 is so amended or supplemented after that date, all amounts payable under the contract (and supplement) are subject to the provision." [259]

Given the frequency with which most compensation and retirement agreements are renewed, amended, or at least supplemented, this rule should reduce with impressive speed the number of parachute contracts entitled to grandfather protection.

Unfortunately, the Conference Report does not address the effect upon grandfathered contracts of agreements made after June 14, 1984 that do not modify pre-existing golden parachute contracts, but that nevertheless operate to increase the size of a particular executive's post-takeover compensation. For example, assume that a contract adopted in 1983 provided a company's president with termination pay, in the event of a take-over, equal to three times his salary in the year before the takeover. It is clear under the Conference Report that if this contract were amended to increase the size of the golden parachute to four times final pay, the 1983 contract would lose its grandfathered status.

The issue unaddressed by the Conference Report is the treatment of indirect amendments to earlier contracts. Any such indirect amendments that operate solely to increase the size of an executive's parachute almost certainly would be deemed to be implicit modifications of the earlier contract. Using the previous example, if a new contract were entered into in 1984 offering the company president post-takeover termination pay of one times salary, the 1984 contract is likely to cause the 1983 contract to be subject to the new golden parachute penalties. The same result probably would apply if the company in 1984 were to double the executive's current salary, at a time when other company executives were receiving bonuses in line with normal cost of living increases. By contrast, if the president in 1984 received a cost of living increase equal in size to that received by other company employees, this salary increase probably would not be deemed to be a modification of the 1983 golden parachute contract. Similarly, if in 1984 a new stock option plan were introduced for all company employees that contained a clause accelerating option vesting schedules in the event of a takeover, this new 1984 golden parachute contract should *not* cause the 1983 contract to lose its grandfathered status. However, until this issue is clarified either by regulations or by the Joint Committee's Blue Book explanation of the Deficit Reduction Act, practitioners and executives will continue to be concerned about the effect on earlier contracts of any new termination pay agreements.

Even more ambiguous is the Conference Report statement that "a contract cancellable at will by either party is to be treated as a new contract entered into on the date any such cancellation, if made, would be effective.[260] This remark is sensible and true as a matter of contract law, if it is construed merely to mean that no contract exists if each party, acting independently, has the right to cancel the agreement. However, a broader construction of this sentence extends its application to a contract that is cancellable at will by only one of the two parties, *i.e.*, either the corporation or the individual. Some concern has arisen among practitioners that this second reading would disqualify from grandfather protection every stock option contract in existence, since the optionee always has the right not to exercise the option. However, the mere failure to exercise an option is not "cancellation" of an option contract. Moreover, since no such intent to treat all historic option agreements as parachute contracts was ever expressed during the Conference Committee's consideration of the effective date, it seems more likely that any regulations to be issued under this provision will limit this "cancellable contract" sentence, so that it would not apply to option contracts in effect on June 14, 1984.

4. Conclusion

The major effect of the Tax Reform Act's golden parachute provisions is not upon the notorious multi-million dollar golden parachutes paid to executives of publicly held companies as part of some hostile acquisition. Admittedly, those agreements, which were infrequent prior to the 1984 Act, will become virtually impossible to design following the Act. More important, however, is the application of the §§280G and 4999 rules to traditional compensation and retirement contracts between publicly or privately held corporations and their key employees that are made, renewed or supplemented after June 14, 1984 and that either contain acceleration clauses triggered by takeover, or are entered into within a year prior to takeover. Payments under these contracts are deemed to be parachute payments, and are then subject to penalty to the extent the total parachute exceeds "reasonable compensation." Because the burden of proof rests on the taxpayer to rebut the presumption that all parachute payments are unreasonable compensation, the nondeductibility and excise tax penalties are likely to be imposed in surprising numbers of cases upon some portion of the post-acquisition pay of officers,

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shareholders and highly paid individuals. Only through careful tax planning (to reduce the size of the parachute) and persuasive argument (to justify the reasonability of parachute payments) can the penalties on excess parachutes be avoided.

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[1] In TEFRA, six important changes were made to Subchapter C, all of which were intended to circumscribe corporate transactional manipulations: narrowing the partial liquidation rules (§§346, 302), increasing gain on liquidating distributions of appreciated properties (improving the dividend characterization of transactions with commonly controlled corporations),(§§304,306), narrowing the scope of the "F" incorporation rules (§368(a)(1)(F)), broadening the application of the constructive ownership rules under §318 (§§302, 306, 356) and "simplifying" circumstances in which an acquiring corporation may obtain assets after a stock purchase of a target corporation (§338).

It may be noted in the "Preliminary Report" of the staff of the Senate Finance Committee *"The Reform and Simplification of the Income Taxation of Corporations,* Sen. Print 95, 98th Cong., 1st Sess. 3 (1983), this statement is made: "Since enactment of the 1954 Code there have been recurring recommendations from the organized tax bar to restructure substantially the corporate income tax. [*See, e.g.*, Revised Report of Advisory Group on Subchapter C of the Internal Revenue Code of 1954 (1959) (report of group commissioned by the Select Revenue Subcommittee of the House Ways and Means Committee).] When the committee heard testimony last year on proposed changes to the treatment of certain taxable acquisitions, several witnesses suggested a more comprehensive study and revision of corporate taxation. The committee's recent success with a fundamental reexamination of the rules governing small business corporations (S corporations) and the revision of the installment sales rules has demonstrated the benefits of such an approach." The report also contains references to the various other efforts of the American Law Institute and the Bar Association's review of Subchapter C provisions. In light of the complexities already occasioned through enactment of §338 (and again amended in §712(k) of TRA 1984), one may query the validity of wholesale revision of Subchapter C. Under another approach, new amendments to Subchapter C would be limited to those targeted to specific abuses, permitting to the degree possible, the remainder of the Subchapter to remain so that the Treasury and the public can continue to derive the benefits of established precedents and predictability. In fact, studies by the American Law Institute and Bar Association, and other groups have been underway for many years and have formed the basis for the staff review, which usefully notes such sources. Finally, it may be observed that the staff report is itself a very useful review of present law, and problems yet not dealt with legislatively which have aroused governmental concerns. *See also*, Liles, "Subchapter C Simplification Recent Proposals," 83-25 TMM 3 (December 12, 1983), and American Law Institute, Federal Income Tax Project: Subchapter C (1982).

[2] D., Cal., chairman of the House Ways and Means Committee Subcommittee on Select Revenue Measures in 1982.

[3] 97th Cong., 2d. Sess. (1982).

[4] Legislation relating to Tax Motivated Corporate Mergers and Acquisitions, Hearings before Subcommittee on Select Revenue Matters: House Committee on Ways and Means, 97th Cong., 2d. Sess. (1982).

[5] Reform of Corporate Taxation: Hearings Before the Committee on Finance, 98th Cong., 1st. Sess. 1 (1983) [hereinafter cited as *Hearings*].

[6] Certain provisions of H.R. 6295 however, were addressed in TEFRA. *See* 982 T.M., *Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA)*, at A-115.

[7] For a review of possible other areas which may well be the subject of future legislation, *see* a statement by Senator Robert Dole at the opening of hearings by Senate Finance Committee on "Reform of Corporate Taxation." *Hearings, supra*, note 5, at 1-8.

[8] Sen. Print No. 95, 98th Cong., 1st Sess., 28 (1983).

[9] *See* Sen. Print 169, Vol. 1, 98th Cong., 2d. Sess., 204-205 (1984), and §354(b) (hereinafter Sen. Print No. 169).

[10] Sen. Print No. 169, at 204-205.

[11] The acceptance by the conferees of §63 underscores the degree of substantive impact on business transactions of the Congressional staff in situations where the great intricacy of a provision precludes the involvement of a broad public constituency. *See, e.g.*, 982 T.M., *Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA)*, at A-112-119, examining redemption distributions of appreciated property involving a combination of §§302, 346 and 311 together with the newly augmented depreciation allowances of §168.

[12] *See* Conference Report, H.R. Rep. No. 861, 98th Cong., 2d. Sess. 845-846 (hereinafter H.R. Rep. No. 861).

[13] *Id.* at 846.

[14] *Id.*

[15] Act 1984 §63(a), Code §368(a)(2)(G).

[16] Sen. Print No. 169, at 205. *But compare* Conference Report which refers to ". . . the required distribution . . ." presumably also incorporating the "all" concept, although not clearly stating so. H.R. Rep. No. 861, at 845.

[17] *See* §368(a)(1)(D).

[18] *See* 223 T.M., *Corporate Separations—General Requirements*, p. 24-27.

[19] Sen. Print No. 169, at 205, "Except as otherwise provided by regulations, . . . [a transaction] . . . is treated as a C reorganization only if the transferor corporation distributes all of its assets (less those retained to meet claims) . . ."

[20] H.R. 4170 (as passed by the Senate), 98th Cong., 2d. Sess., §49(a).

[21] §368(a)(2)(G)(i).

[22] §368(a)(2)(G)(ii).

[23] Sen. Print No. 169, at 205.

[24] H.R. Rep. No. 861, at 846.

[25] *Id.* at 846.

[26] Sen. Print No. 169, at 205-206.

The Conference Report reiterates this point (and indeed "endorses" the entire Senate Report respecting section 63 with specified indications. H.R. Rep. No. 861, at 845-846.

[27] The definition of control, as provided in §368(c)(1) would appear to govern with respect to C reorganization transactions. This is true notwithstanding that, in the case of a non-divisive D reorganization the newly developed definition of which is found in §368(c)(2) applies. This definition, in turn, incorporates the 50 percent definition of "control" provided in §304(c).

[28] §381(c)(2)(A)

[29] *See* Regs. 1.381(C)(2)-1(c)(1), where it is stated that: transferor's earnings and profits are adjusted by the amount "properly applicable to the distribution regardless of whether such distribution occurs before or after the close of the date of transfer." Although the expression "properly applicable" is not defined and no examples are provided the expression appears to mean that all of the transferor's earnings and profits (which are otherwise deemed to be transferred) may be applied to a distribution, even if the distribution occurs after the transfer of other assets to the acquiring corporation. *See Also* Rev. Rul. 71-364, 1971-2 C.B. 182.

[30] *See* §356(a)(2). *See also* 79 T.M. *Corporate Acquisitions — (C) Reorganizations, p.* 45-48.

[31] H.R. 4170 (as passed by the Senate), 98th Cong., 2d Sess., §49(a) (1984).

[32] Section 64 is not the first Congressional use of ownership percentages to treat this problem. *See* H.R. 8300, 83rd Cong., 2d. Sess. §357 (1954).

[33] *See* H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 40, A129-A131 (1954). The House Ways and Means Committee apparently believed that §357 of H.R. 8300 would solve the problem as shown by the following statement in the Committee report: "Your committee's bill contains additional safeguards against tax avoidance not found in existing law . . . It also contains a specific provision designed to make impossible the withdrawal of corporate earnings at capital-gains rates through the device of liquidating the corporation and reincorporating the business assets, a device which has been sanctioned by certain courts under existing law." *Id.* at 40.

In the "Detailed Discussion of the Technical Provisions of the Bill" the following is noted:

> The general rule of subsection (a) provides that in any case in which one or more individuals receive assets in a complete or partial liquidation as defined in section 336 [of the House bill], from a corporation controlled by such individual or individuals, and within 5 years from the final distribution in such liquidation, such individual or individuals transferred more than 50 percent of the assets (other than money and stock or securities except stock or securities of the distributing corporation) to one or more corporations controlled by one or more of such individuals in a transaction in which, under section 351 [of the House bill], no gain or loss is recognized, the

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consequences set forth in paragraphs (1) and (2) of subsection (a) shall occur.

Paragraph (1) provides that under the circumstances above set forth, the corporation to which the assets have been transferred shall be deemed to have received such assets from the liquidating corporation pursuant to a corporate acquisition of property within the meaning of section 359(c) [of the House bill] . . .

Paragraph (2) of subsection (a) provides that an amount equal to the fair market value of the assets received in the complete or partial liquidation which are not so transferred to the corporation shall be deemed to have been received by individuals in control of such corporation or corporations as a distribution under section 353 [of the House bill] made pursuant to corporate acquisition of property." *Id.* at A130.

[34] Thereby preserving loss carryover attributes under §381(a). *See* H.R. Rep. No. 760, 97th Cong., 2d. Sess. 540-541 (1982).

[35] *See* §368(a)(1)(F) as amended by §225 of TEFRA, P.L. No. 97-248, 96 Stat. 324 (1982). In a typical "D" reorganization, of course, a transfer of assets from one corporation to another corporation (presumably without transfer of all assets and with some differences in shareholdings) occurs, thereby causing the transfer to fail as an F reorganization.

[36] *See* §368(c)(1) which continues to apply for purposes of Subchapter C, Part I (other than §304) and Part III (except for the new special rule pertaining to §368(a)(1)(D)).

[37] Advisory Group on Subchapter C of the Internal Revenue Code of 1954, *Revised Report on Corporate Distribution and Adjustments*, 85 Cong., 2d. Sess. 66 (December 11, 1958). Under existing law a number of cases have arisen in which shareholders have sought to withdraw corporate funds in a transaction which would be treated as a dividend if the distribution occurred apart from a plan of its complete liquidation. This occurs by first completely liquidating the corporation and then transferring the assets which are to remain in corporate form to a new corporation controlled by the same shareholders. The assets which are to continue in corporate ownership may be transferred by the shareholders to a new corporation in exchange for its stock or may be transferred by them to an existing controlled corporation as a contribution to capital. While, in the main, the courts have managed to deal adequately with these cases in order to prevent tax avoidance, the advisory group recommends that certain changes be made in the statute to give the Internal Revenue Service and the courts full opportunity to deal with these transactions as reorganizations and, in appropriate cases, to treat as dividends the assets which are withdrawn from corporate ownership and retained by the stockholders.

The first of the recommended changes is the deletion of the requirement in the introductory words of §368(a)(1)(D) that the transfer of assets be made "by a corporation." Thus a transfer, after the distribution in complete liquidation, made by the shareholders of the liquidating corporation to the other corporation pursuant to the plan, would be made to qualify as a reorganization to the same extent as if the transfer were made directly by the liquidating corporation to the other corporation. Secondly, in the new provision in §368(a)(1)(D)(ii) requiring that the transferor corporation be completely liquidated, it would be specifically stated that the liquidation may precede, accompany, or follow the transfer of the corporate assets to another corporation. Thirdly, as mentioned in the comments with respect to §356 (under §21), a recommended amendment to §356(a) would make the boot provisions applicable even if no stock of the transferee corporation is acquired by the shareholders in the transaction. This would occur, for example, where, after the complete liquidation, part of the assets are transferred by the shareholders as a contribution to capital of another corporation controlled by them. Finally, in the proposed §368 as revised, the control requirement in the case of clause (D) reorganizations is reduced from 80 to 50 percent. This reduction is not made for purposes of §§368(a)(1)(B), 355, 332, 334(b)(2), 351, and other provisions where an 80 percent control requirement is present in existing law.

The proposed reduction of the control test from 80 to 50 percent, coupled with the provisions making §368(a)(1)(D) applicable in appropriate cases even though no stock or securities are received from the transferee, is not intended to convert all transfers literally coming within the statutory language into clause (D) reorganizations. On the contrary, it is intended that the general doctrine requiring that the transaction be in substance a reorganization will continue to be applied. For example, to take a very clear case, a transfer of all the assets of the X corporation to the Y corporation for cash, followed by X corporation's liquidation, should not be treated as a reorganization simply because a 1 percent shareholder of X corporation controls Y corporation. Similarly, a transfer of only a small portion of the assets of X corporation to Y corporation for cash followed by X corporation's liquidation should not be treated as a reorganization even though the shareholders of X corporation control Y corporation. This problem is present under existing law and may be accentuated by the proposed reduction in the control requirement from 80 to 50 percent. It is believed that this general doctrine should be adequate to take care of those transfers which are essentially unlike reorganizations. For this reason and for the reason that an arbitrary statutory dividing line appropriate to all cases would be difficult to draw, no specific statutory provision on this point has been included in the proposed §368(a)(1)(D). However, a specific provision could be devised for (D) reorganizations and included in the statute if desired.

[38] Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (Comm. Print 1983).

[39] *Id.* at 37-38.

[40] *Id.* at 65.

[41] *Reform of Corporate Taxation: Hearing before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 9 (1983) (statement of Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, Department of the Treasury.) Beyond this statement, it does not appear that the Treasury Department directly addressed the liquidation-reincorporation issue in the hearings.

[42] H.R. Rep. No. 861, 98th Cong., 2d. Sess. 847-848 (1984). For an analysis of liquidations and reincorporations, *see* 335 T.M., *Liquidation—Reincorporation.* For details respecting the mechanics of a D reorganization, *see* 417 T.M., *Corporate Acquisitions — (D) Reorganizations.*

[43] §304(c)(1). It may be observed that under the §304(c) definition the 50 percent test is also applied with respect to a subsidiary. Therefore, shareholders of a subsidiary who may also be shareholders of the parent fall within the scope of the new control test.

[44] *See* §318(a)(2)(C) (attribution from a corporation) and §318(a)(3)(C) (attribution to a corporation).

[45] *See* §355 and 417 T.M., *Corporate Acquisitions — (D) Reorganizations*, B-201, B-301, and B-401. In a spin-off, shares of a subsidiary are distributed (generally pro-rata) to the transferor's shareholders. In a split-up, all of the shares of the transferor shareholders are surrendered in exchange for the shares of two or more transferee corporations. In a split-off, the shareholders of the transferor will retain some of their shares in the transferor and surrender only a part of such shares for shares in one or more transferees.

[46] A similar result would seem to follow even if the transferor shareholder is a corporation which can avail itself in such a case of the dividends received deduction under §243.

[47] Section 354(b)(1).

[48] P.L. No. 97-248, 96 Stat. 324 (1982).

[49] This was accomplished by adding §368(a)(1)(G) to the Code in 1981. *See* §368(a)(3)(C) which provides that in the case of a reorganization described in §368(a)(1)(G) and any other provision, the transaction will be treated as a G reorganization.

[50] Much of the liquidation-reincorporation litigation stems from the interplay of the various Code provisions and judicial doctrines (*i.e.*, step transactions); *see* 335 T.M., *Liquidation — Reincorporation. See also Davant v. Comr.*, 366 F.2d 874 (5th Cir. 1966), aff'g in part *South Texas Rice Warehouse Co. v. Comr.*, 43 T.C. 540 (1965). The 1982 changes to the F reorganization limit taxpayers' abilities to carry back subsequent net operating losses. Less certain is the effect on the liquidation and reincorporation problem with the transfer to pre-transfer years pursuant to the statutory exception for F reorganizations provided in §381(b). It appears the government's use of this approach is hampered in any situation in which more than one corporation is involved (*i.e.*, where two operating companies are merged with continuing share ownership).

[51] This is true not only with respect to the liquid assets whose direct distribution would have constituted a dividend, but also with respect to the operating assets transferred to the transferee, thereby conferring upon it a stepped-up basis for later depreciation.

[52] For a detailed analysis of these theories *see* 335 T.M., *Liquidation — Reincorporation* at A-9 to A-32.

[53] Rev. Rul. 61-156, 1961-2 C.B. 62. It should be noted that in Rev. Proc. 60-6, 1960-1 C.B. 880, the Service announced a "no ruling" policy in liquidation-reincorporation transactions where transferor shareholders continue to own 50 percent or more of the voting stock of the transferee.

[54] 1962-2 C.B. 527; *see also* Rev. Proc. 80-22, 1980-1 C.B. 654 and Rev. Proc. 69-6, 1969-1 C.B. 396.

[55] *See* 335 T.M., *Liquidation — Reincorporation* at A-17 to A-20.

[56] *Id.* at A-21 to A-23.

[57] 63 T.C. 423 (1974) aff'd, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977).

[58] Although the TASCO transaction had the effect of a corporate division, the Commissioner conceded that the transaction could not qualify under §354(b)(1) since the sale of a major part of TASCO's business

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precluded the argument that "substantially all" of TASCO's assets had been transferred to the transferee.

[59] 39 T.C. 144 (1962), acq. in result, 1964-2 C.B. 5.

[60] 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2nd Cir. 1966).

[61] *See Stanton v. U.S.*, 512 F.2d 13 (3rd Cir. 1975) rev'g 371 F. Supp. 103 (E.D. Pa. 1974); and *Ringwalt v. U.S.* 549 F.2d 89 (8th Cir. 1977), aff'g 75-2 USTC ¶9864 (D. Neb. 1975), cert. denied, 432 U.S. 906 (1977).

[62] H.R. Rep. No. 861, 98th Cong., 2d Sess., 847.

[63] *Id.* at 846.

[64] *See, e.g., American Manufacturing Company v. Comr.*, 55 T.C. 204 (1970). *But see Joseph Simon v. Comr.*, 43 T.C.M. 269 (1982).

[65] Of course, if the transferor is owned by corporate shareholders a dividend result may be sought by the taxpayer.

[66] H.R. Rep. No. 861, 98th Cong., 2d Sess., 848.

[67] For example, the functionally unrelated transaction doctrine or the no complete liquidation theory.

[68] In form, of course, the loss corporation can be the acquiring or transferee corporation, but for purposes of simplicity, this discussion will refer to the corporation whose shareholders end up with more than half of the direct or indirect control of the combined enterprises as the acquiring corporation.

[69] Inclusion in the 1954 version of §382(b) of (G) reorganizations began in 1980, when section 386(a)(1)(G) was added to the Code to govern certain bankruptcy and insolvency reorganizations.

[70] §382(c).

[71] §368 of P.L. 95-600.

[72] §9(e) of P.L. 95-167.

[73] §111 of P.L. 97-119.

[74] §368(b)(1) of P.L. 95-600.

[75] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1722 (1984).

[76] Sen. Print No. 169 (Vol. I), 98th Cong., 2d Sess. 203 (1984).

[77] Staff of Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 204, (1976).

[78] §311(d)(2)(A)(i).

[79] §311(d)(2)(A)(ii)

[80] §311(d)(2)(B).

[81] §302(e)(5) provides that, in determining wheter a partial liquidation distribution is in redemption of stock of a shareholder "who is not a corporation" for purposes of §302(b)(4), stock held by pass through entities is treated as held "proportionately" by their owners or beneficiaries. Although this affects the determination of whether §311(b)(2)(A)(i) applies, it does not settle the question of whether the stock on which the distribution is made is "qualified stock."

[82] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1616 (1984). Unfortunately, it is not clear how an owner's or beneficiary's "interest" in an entity is calculated where the entity's ownership structure involves more than a single class of equity interests.

[83] *Id.*

[84] 1984 TRA §715; §223(b)(1) of TEFRA.

[85] §338(a).

[86] §338(e).

[87] §338(f)

[88] P.L. 97-448.

[89] *E.g.*, Ginsburg, "Taxing Corporate Acquisitions", 38 Tax L. Rev. 171 at 253-319 (1983).

[90] §338(d)(3).

[91] Prop. Regs. §1.358-6(c).

[92] Rev. Rul. 73-327, 1973-2 C.B. 197.

[93] Rev. Rul. 74-515, 1974-2 C.B. 118.

[94] Section 54 of the 1984 TRA, *see* discussion in Chapter 31, I, *supra.*

[95] §338(h)(3)(A)(iii).

[96] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1617 (1984); H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221-22 (1984).

[97] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1617 (1984).

[98] *See* §338(a)(2).

[99] §§318(a)(2)(C) and 318(a)(3)(C). Because a qualified stock purchase is defined in terms of the number of voting and nonvoting shares acquired, and not the value of such shares, and because nonvoting preferred stock is not considered in determining whether a qualified stock purchase has been made but is considered in determining whether two corporations are related under §318(a), it is possible to have a qualified stock purchase without the purchasing corporation being deemed under §318(a) to own stock owned by the target corporation and vice versa.

[100] *See* discussion of related §338(h)(3)(C)(ii) in (iii), *infra.*

[101] §§304(a)(1), 301(d) and 362(a). Note that an acquisition of stock by a parent corporation from its subsidiaries is not an acquisition from a transferor, the stock owned by which is deemed owned by the transferee, Regs. §1.318-1(b)(1) and Rev. Rul. 74-605. 1974-2 C.B. 97. Such acquisitions could thus be qualified stock purchases, although the stock consistency rules could give rise to unexpected consequences in such cases.

[102] §338(f).

[103] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1617 (1984).

[104] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221-22 (1984).

[105] §§715 and 712(k)(9)(A) of 1984 TRA.

[106] §712(k)(10) of 1984 TRA.

[107] Regs. §1.334-1(c)(7)(iv) Example 3(c).

[108] New §338(h)(3)(C)(ii).

[109] *See* discussion in (ii), *supra.*

[110] §712(k)(10) of 1984 TRA.

[111] *See also* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1619 (1984).

[112] §712(k)(6) of 1984 TRA; *see* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221 (1984).

[113] §§715 and 712(k)(9)(A) of the 1984 TRA.

[114] §712(k)(10) of the 1984 TRA.

[115] §338(a).

[116] Former §338(g)(1).

[117] §306(a)(8)(B)(i) of P.L. 97-448.

[118] §712(k)(9)(B) of 1984 TRA.

[119] §§1245(a), 1250(a) and 47(a).

[120] §338(b).

[121] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1621 (1984).

[122] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1623 (1984).

[123] A similar result may occur under present law where the Service can establish that part of the consideration paid represented goodwill or going concern value.

[124] §338(c)(1).

[125] Or purchased by affiliates of the purchasing corporation, *see* new §338(h)(8), discussed IV, B, 3, a, (2), (c), *supra.*

[126] §338(b)(1) and (2).

[127] Thus, this election is potentially available in cases similar to that in Rev. Rul. 84-71, I.R.B. 84-19, 6, in which a corporation indirectly acquires more than 80 percent of the stock of a target corporation through a subsidiary which uses cash to purchase such stock and to which the minority shareholders contribute their target corporation stock in a §351 transaction. The target corporation's stock so contributed is nonrecently purchased stock.

[128] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1220 (1984).

[129] Where such minority shareholders have their shares purchased by the purchasing corporation or surrender their shares in a redemption or liquidation within one year after the acquisition date, the tax cost of the basis increase is imposed on such shareholders under §331.

[130] *See* §§341(a) and 338(h)(14).

[131] *See* discussion at 3, a, (IV), *supra.*

[132] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221 (1984). The Conference Report also states that the aggregation rule affects the deemed asset sale price, but that would seem to be the case only in the event that regulations under §338(h)(11) providing a formula for determining the fair market value of the target corporation's assets make reference to the price at which the qualified stock purchase was made.

[133] Former §338(h)(7) became §338(h)(8).

[134] §338(b)(3), discussed at IV, B3, c, (2), *supra.*

[135] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1222 (1984).

[136] §§168(f)(2) and 48(a)(2).

[137] Act §§715 and 712(k)(9)(A).

[138] *See* Chapter 31, I, *supra.*

[139] §301(d)(2)(B.)

[140] §362(a).

[141] *See* discussion in f, (1), *infra.*

[142] §367(a).

[143] Act §§715 and 712(k)(9)(A).

[144] Act §§715 and 712(k)(9)(A).

[145] Act §§715 and 712(k)(9)(A).

[146] Act §341(b)(1)(A).

[147] Former §338(h)(8).

[148] Act §§715 and 712(k)(9)(A).

[149] *See* §382(a). The revision of §382(a) enacted as part of the 1976 Tax Reform Act would require the target corporation to reduce its NOL carryovers to the extent that a qualified stock purchase, along with certain other stock transfers within a three-year period, exceeded 60 percent of the value of the target corporation's stock. However, §59 of the 1984 TRA delayed until January 1, 1986 the effective date for the modified version of §382(a).

[150] §269(a)(2). *But see* H.R. Rep. No. 432 (Part 2) 98th Cong., 2d Sess. 1623 (1984), which implies that the issue is not settled.

[151] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1623 (1984).

[152] Rev. Rul. 70-223, 1970-1 C.B. 79, treats the merger of a purchasing

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corporation into a target corporation, more than 80 percent of the stock of which was acquired by the purchasing corporation within two years prior to the merger, as a §368(a)(1)(A) transaction, rather than as a liquidation.

[153] Under §382(b) as it was amended by the 1976 Tax Reform Act, such NOL carryovers would be reduced if the target-surviving corporation had a fair market value less than two-thirds of the fair market value of the purchasing-acquired corporation. The amended version of §382(b) went into effect January 1, 1984.

[154] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1222 (1984).

[155] 1963-1 C.B. 45.

[156] *See Cromwell Corp. v. Comr.*, 43 T.C. 313 (1964), acq., 1965-2 C.B. 4.

[157] TRA 1984 §§712(k)(8)(C) and 712(k)(9)(A).

[158] *See* Ginsburg, "Taxing Corporate Acquisitions", 38 Tax L. Rev. 171, 178-87 (1983).

[159] §301(b)(1)(B).

[160] §301(b)(1)(A).

[161] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1223 (1984). With respect to the conversion of U.S. source income to foreign source income and vice versa, *see* §861(a)(2)(A) and (B).

[162] Exceptions are made to this rule with respect to the formation of certain bank holding companies pursuant to pre-June 18, 1984 regulatory applications, Act §712(1)(7)(C).

[163] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1223 (1984).

[164] *Id.*

[165] Regs. §1.311-2(a)(2).

[166] Act §54.

[167] In fact, these rules, in conjunction with §301(d)(2)(B), render moot much of the reason for amending §304(b)(2) with respect to "brother-sister" transactions.

[168] §312(n)(4), added by 1984 TRA §61(a).

[169] Act §712(l)(7).

[170] §368(a)(1)(B) would not have applied because property other than voting stock was received. §351 would not have applied because the shareholder, the only transferor, would not have had §368(c) control of the acquiring corporation.

[171] H.R. Rep. No. 432 (Part 2), 98th Cong. 2d Sess. 1625 (1984).

[172] Act §715.

[173] *See* Rev. Rul. 80-240, 1980-2 C.B. 116.

[174] Exceptions are provided for certain bank holding company formations pursuant to pre-June 18, 1984 regulatory applications, if the acquisition indebtedness involved was incurred no later than October 20, 1983, Act §712(1)(7)(C).

[175] *Cf.* Regs. §1.351-1(a)(1)(ii), stating that a shareholder who receives only a nominal amount of stock solely for purposes of qualifying a transfer under §351 is not counted in the transferor group.

[176] *I.e.*, if no stock of the seller is attributable to the transferor under the rules of §318(a), other than paragraph (4) thereof.

[177] An agreement complying with present §302(c)(2)(A)(iii) will be sufficient until regulations are promulgated. H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1625 (1984).

[178] The new rules do not apply to acquisition indebtedness assumed in connection with the pursuant to certain pre-June 18, 1984 regulatory applications, of certain bank holding companies, Act §712(1)(7)(C).

[179] Act §712(1)(7).

[180] Act §712(1)(7)(D).

[182] §304(b)(3)(C).

[183] Act §712(1)(7)(A).

[184] §338(h)(3)(A)(ii). *See*, H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1626 (1984).

[184] Act §712(1)(7)(A).

[185] P.L. 98-369 (July 18, 1984).

[186] §280G(b)(1).

[187] Personal service corporations or similar entities are treated as individuals for this purpose. §280G(c). Thus, disqualified individuals cannot avoid application of the golden parachute rules by having payments made to their personal service corporations. H.R. Rep. 861. The Treasury Department is specifically instructed to write regulations applying these golden parachute provisions in the case of personal service corporations and related corporations. §280G(e) and H.R. Rep. No. 861 at 853.

[188] Contracts expressly or implicitly contingent for takeover are included irrespective of when they are entered into relative to the takeover. §280G(b)(2)(A)(i). The Conference Report also provides that the determination of whether a particular transaction involves such a change in ownership or control is to be made on the basis of "all the facts and circumstances." H.R. Rep. No. 861 at 851.

[189] §280G(b)(4) and H.R. Rep. No. 861 at 852. *See* discussions on the definition of reasonable compensation and on the calculation of the excess parachute amount, *infra* at V.

[190] H.R. Rep. No. 861 at 851.

[191] *Id.* No tests are suggested for use in determining whether termination "results" from a change in control. Obviously this cause-and-effect relationship could become quite tenuous, as when termination occurs months or even years after the takeover.

[192] H.R. Rep. No. 861 at 851. By contrast, the parachute apparently would not include deferred compensation that was (i) fully vested as of the date of the takeover or options that were exercisable on that date, and (ii) payable under a schedule not accelerated by the takeover, because these payments and options were not affected by the contingency clause.

[193] §280G(b)(2)(C).

[194] H.R. Rep. No. 861 at 851.

[195] §280G(b)(2)(A).

[196] §280G(b)(2)(B).

[197] *See e.g., GAF Corp. v. Warner.* No._____ (N.Y. Sup. Ct.) (March 5, 1984) (Complaint), and *Wall Street Journal*, August 30, 1984 at 43 "Natomas Ex-Holders Are Cleared to Press a 'Parachute' Suit."

[198] H.R. 5693, "Tender Offer Reform Act of 1984." *See also Wall Street Journal*, March 14, 1984 at 4 "SEC Endorses Major Changes in Merger Fights." Hearings on H.R. 5693 were held May 23, 1983, but no formal action on the bill had been taken prior to the Conference Committee's approval of the Tax Reform Act of 1984. However, on June 28, 1984, H.R. 5693 was approved by both the House Subcommittee on Telecommunications, Consumer Protection and Finance and by the House Energy and Commerce Committee. (*See Daily Tax Report* of July 26, 1984 at F-4.) and by the House Energy and Commerce Committee. As of this writing, this bill is awaiting action by the full House.

[199] Proposed §14(f) of the Securities and Exchange Act of 1984, as added by §5 of H.R. 5693 and §280G(2)(C).

[200] *Id.*

[201] *Id.*

[202] §280G(b)(3)(A) and (d)(1) and (2). Code §280G(d)(2) refers only to that portion of the five-year period during which the disqualified individual was an *employee* of the corporation. A technical correction probably is needed here since, by its terms, the statute does not cover an officer or shareholder who was never an employee, but worked as an independent contractor during part of the five years preceding takeover. The Treasury may be able to solve this technical problem by regulations. However, as an extension of the related directive that Treasury issue regulations covering the case where no base amount can be calculated. This is because the individual did not commence work for the corporation until the year in which the change in control occurred. H.R. Rep. No. 861 at 853.

[203] H.R. Rep. No. 861 at 850.

[204] *Cf.* the Senate bill, which did reference the highest compensation in any of the five years preceding takeover (Code §280F(b)(1)(B), §46, S. Rep. No. 169, 98th Cong., 2d Sess., Vol. II 166-67) (1984) (hereinafter S. Rep.).

[205] H.R. Rep. No. 861 at 853.

[206] §280G(b)(4). If payments under a covenant not to compete are deemed to be "payments in the nature of compensation" and thus are included in the total parachute amount, the taxpayer might need to demonstrate that these payments were reasonable compensation for nonperformance of activities in competition with the business of the acquiring corporation.

[207] H.R. Rep. No. 861 at 852.

[208] *Id.*

[209] *Id.*

[210] H.R. Rep. No. 861 at 852-53.

[211] §280G(b)(4) and H.R. Rep. No. 861 at 852.

[212] If A's severance pay had been 1⅓ times annual salary, the golden parachute rules would not have applied. *See also* the example of H.R. Rep. No. 861 at 852.

[213] Cong. Rec. E5469 (November 10, 1983).

[214] H.R. 4357, adding §1257(c)(2)(A).

[215] The Staff of the House Ways and Means Committee briefly considered adding golden parachutes to the list of items considered during its February, 1984 mark-up of the Tax Reform Act of 1984. However, this provision was dropped from consideration because no hearing had yet been held on H.R. 4357.

[216] S. 2323, adding §4999(b).

[217] Announcement of Senator Chafee in introducing S. 2323, as cited in 36 *Daily Executive Report* G-5 (February 23, 1984).

[218] This limitation was later abandoned, after it was pointed out that even partial funding of a golden parachute agreement would protect it from any of the proposed tax penalties.

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[219] This distinction also was later abandoned, in favor of a test focusing on payments significantly in excess of historic compensation.

[220] Letter from John E. Chapoton, Assistant Secretary (Tax Policy) to the Honorable John H. Chafee of March 8, 1984 at 2.

[221] *Id.*

[222] *Id.*

[223] *See* §46(a) of the Deficit Reduction Act of 1984 as approved by the Senate Finance Committee on March 21, 1984, adding §§280F and 4999. S. Rep. No. 169 Vol. II at 166 (April 21, 1984). Note that, by penalizing only a *contract* which provided for payments in excess of 200 percent of historic compensation, the Senate bill's provision technically could have been avoided by the use of several different parachute agreements. The Tax Committee of the American Bar Association pointed out that this rule should be amended to permit aggregation of separate parachute contracts. (*See Comments on the Deficit Reduction Act of 1984*, prepared by the Tax Section of the ABA, at 143.)

[224] Section 280F(b)(3), as would have been added by §46(a) of the Deficit Reduction Act of 1984.

[225] Section 280F(b)(4), as would have been added by §46(a) of the Deficit Reduction Act of 1984.

[226] *See Explanation of Provisions Approved by the [Senate Finance] Committee on March 21, 1984*, S. Rep. No. 169 Vol. I at p. 6 (April 21, 1984) ["Explanation"].

[227] Both the Joint Committee on Taxation and the Treasury Department estimated that the golden parachute restrictions would increase budget receipts by less than $5 million annually.

[228] *See* Explanation, S. Rep. No. 169, Vol. I at 195.

[229] There was limited oral testimony on the golden parachute provision, since this hearing focused on a number of other provisions, including the debt-financed property rules for educational institutions (H.R. 676), the charitable deduction mileage allowance (H.R. 2697), nonqualified employee stock options (H.R. 4114) and group legal services plans (H.R. 5028).

[230] Statement of Robert G. Woodward, Tax Legislative Counsel, Department of the Treasury, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (April 12, 1984) at 12.

[231] Statement of Robert H. Winter before the House Subcommittee on Select Revenue Measures at 5-8 (April 12, 1984) ["hereinafter "Winter Statement"]; Statement of Robert A. Profusek at 3 (April 12, 1984); [hereinafter "Profusek Statement"]; letter from Ernest S. Christian to John Jonas, staff member on the Subcommittee on Select Revenue Measures at 3 (April 17, 1984) [hereinafter Christian Letter"].

[232] Statement of Ernest S. Christian and Donald V. Moorehead before the Subcommittee on Select Revenue Measures at 4-8 (April 12, 1984); Profusek Statement at 13; Christian letter at 4; letter from Dennis Drapkin to John Jonas, attachment entitled "Explanation of Proposed Revision of Section 46 of the Deficit Reduction Act of 1954 Regarding "Golden Parachute" Payments," at 1-2 (April 18, 1984) [hereinafter "Drapkin letter attachment"]; letter from James E. Merritt to John Jonas of May 22, 1984 at 5 [hereinafter "Merritt letter of May 22, 1984"); letter from Peter I. Elinsky to John J. Sterling, Special Counsel to the Joint Committee on Taxation of May 21, 1984 at 1-2; letter from R.J. Howe to John E. Chapoton of (May 17, 1984) attachment entitled "Detailed Description: Golden Parachute Employment Contracts" at 4-8 ("Howe letter attachment"]; letter from James E. Merritt to John Jonas of June 6, 1984, attachment entitled "Ordinary Course of Business Agreements are Not Golden Parachutes" at 1-2 ("Merritt letter of June 6, 1984 attachment").

[233] Winter statement at 8-9. Note, however, that not all the commentators agreed that shareholder approval should cleanse abusive agreements. *See e.g.*, Christian letter of 3 and Drapkin letter attachment at 3

[234] Profusek statement at 14; Drapkin letter attachment at 4; Howe letter attachment at 8.

[235] Profusek statement at 3, 12, and 14; Christian letter at 3-5 and 6; Drapkin letter attachment at 1.

[236] Winter statement at 10; Profusek statement at 3 and 12-13; Christian letter at 3-4; Drapkin letter attachment at 3-5; Howe letter attachment at 9.

[237] Winter statement at 11; Merritt letter of June 6, 1984 attachment at 1-2.

[238] Drapkin letter attachment at 4.

[239] Winter statement at 10.

[240] Christian letter at 6.

[241] Winter statement at 10; Merritt letter of May 22, 1984 at 2-5.

[242] Conference Committee statement of Senator Chafee on June 15, 1984.

[243] §280G(d)(4) and H. R. Rep. No. 861 at 851. The present value rules of §1274(b)(2) were added by §41 of the Tax Reform Act of 1984. A technical problem with this cross-reference in §280G to §1274(b)(2) is that §1274 is not effective until January 1, 1985. Presumably, Treasury's regulations under §280G will apply these present value rules without regard to the delayed effective date, but the problem may also need a statutory technical correction.

[244] §1274(d) explains the determination of the federal short-term, mid-term and long-term rates.

[245] H.R. Rep. No. 861 at 853.

[246] *See* footnote 25 above, and accompanying text.

[247] These penalties would be difficult, if not impossible, to impose in cases where the payments subject to penalty either have been accrued and deducted in previous years, or are exempt from FICA tax or withholding taxes for reasons unconnected with the golden parachute rules. *See* the discussions of this point below.

[248] H. R. Rep. No. 861 at 853.

[249] *Id.*

[250] §280G(e). *See also* H. R. Rep. No. 861 at 853.

[251] §4999(c)(1).

[252] *Id.*

[253] Rev. Rul. 59-64, 1959-1 C.B. 31 and Rev. Rul. 71-456, 1971-2 C.B. 354, superseding I.T. 3737, 1945 C.B. 319. *See also* Rev. Rul. 69-286, 1969-1 C.B. 253 (contingent allotments under an incentive compensation plan paid to an employee's beneficiary are not subject to withholding).

[254] §3121(v)(2). This exemption applies provided that the deferred compensation was taxed at the time of either vesting or performance of services. The Senate Finance and Conference Committee reports explaining this provision each note that "[p]ayments under golden parachute contracts, *like any termination pay*, are subject to FICA taxes when paid." [Emphasis supplied] S. Rep. No. 169, Vol I at 196; H.R. Rep. No. 861 at 850. The emphasized language is noteworthy, in that it may be relied upon by the Treasury Department in drafting regulations (which have not been proposed as of this writing) under §3121(v) defining the term "deferred compensation."

[255] For example, any application of §3121(u)(2) would conflict directly with the §3121(a)(5) FICA exemption for payments to or from a qualified plan.

[256] P.L. 98-369, §67(e)(1).

[257] P.L. 98-369, §67(e)(2).

[258] H.R. Rep. No. 861 at 853.

[259] *Id.* at 853-54.

[260] *Id.* at 853.

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CHAPTER 33

SPECIAL CORPORATE PROBLEMS

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I. New Rules for Determining Affiliated Group Status

A. *Background*

1. *Definition of Affiliated Group Under Present Law*

In order to be eligible to file consolidated returns or to take advantage of the 100 percent dividend-received deduction of §243(b), a group of related corporations must constitute an "affiliated group". Under the present version of §1504(a), an affiliated group is defined as one or more chains of includible corporations connected through stock ownership with a common parent corporation, which is itself an includible corporation, if (i) the common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations, and (ii) any other includible corporations are connected to each other or to the common parent under the same basic stock ownership test. For example, assuming that a group of related corporations has only one class of stock outstanding, if Corporation A owns 80 percent of the stock of Corporation B and Corporation B, in turn, owns 80 percent of stock of Corporation C, and Corporations A, B, and C are all includible corporations, these corporations constitute an affiliated group.

Includible corporations, under §1504(b), are any corporations except (i) organizations exempt under §501, (ii) certain insurance companies,[1] (iii) foreign corporations,[2] (iv) §936 possessions corporations, (v) regulated investment companies and REITs, and (vi) a DISC or former DISC. However, insurance companies and possessions corporations are includible corporations for purposes of the 100-percent dividends received deduction.[3]

In determining whether includible corporations are affiliated, certain stock is not counted under §1504(a). Stock excluded from the computation includes nonvoting stock that is limited and preferred as to dividends, employer securities (within the meaning of §409A(1))[4] held in a tax credit employee stock ownership plan, or qualifying securities (within the meaning of §4975(e)(8)) that are held in a ESOP meeting the requirements §4975(e)(7). The Service has ruled that nonvoting preferred stock, which participates in earnings with common stock after payment of the preferred dividends, will not be considered limited and preferred as to dividends.[5] However, nonvoting preferred stock, although convertible into common stock on a one-for-one basis, is not counted for purposes of §1504(a).[6] Similarly, stock having contingent voting rights is ignored unless and until the contingency occurs.[7] Unexercised stock warrants are also disregarded.[8]

If an affiliated group that files consolidated returns acquires the requisite 80 percent stock ownership in another corporation, that corporation must be included in the consolidated return of the affiliated group commencing generally with the day sufficient stock is acquired.[9] Likewise, if the stock ownership requirements cease to be met with respect to a member, it can no longer be included in the consolidated return of the affiliated group as of the date the ownership requirements cease to be met.[10] There are, however, generally no restrictions on a former member rejoining the affiliated group or joining any other affiliated group.[11]

2. *Use of Consolidated Returns to Traffic in Tax Benefits*

One of the chief benefits of filing consolidated returns is that a profitable corporation can take advantage of tax losses and tax credits generated by another corporation that cannot presently use such benefits. Under existing §1504, it is possible for a profitable corporation to join in filing a consolidated return with a loss corporation even though the profitable corporation owns substantially less than 50 percent, in terms of value, of the stock of the loss corporation. The House Ways and Means Committee Report accompanying the TRA describes what it terms a "common situation" in which this has occurred.[12]

> *Example*: A corporation such as a foreign corporation that cannot itself use tax benefits will engage in a new venture that is expected to generate tax losses or credits. That corporation will find another corporation able to use the tax benefits, and the two corporations will form a new corporation to conduct the venture. The new corporation will have two classes of common stock,

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Class A, which will be normal common stock, and Class B, which will also be common stock except that it will have only minimal voting rights compared to the Class A stock but will be convertible into Class A stock at any time in a ratio permitting it to obtain control. The corporation able to utilize the tax benefits acquires all the Class A stock for $400, and the other corporation acquires all the Class B stock for $1,600. Because of the voting right differences, the Class A stock has 80 percent of the voting power of all classes of stock of the newly-incorporated venture. Since no nonvoting stock is outstanding, the second test under existing law relating to 80 percent ownership of all other classes of stock is not relevant. Since, as described above, only currently existing voting power is considered in determining whether corporations constitute an affiliated group—conversion rights are disregarded—the newly incorporated venture and the profitable corporation satisfy the first test for affiliation relating to 80 percent voting control and are likely to file consolidated returns. An affiliated group exists even though the profitable corporation owns only 20 percent in value of the venture and even though the Class B stock will likely be converted into Class A stock by the other corporate partner after a period of time. The Ways and Means Committee states that the applicability of §269, concerning acquisitions made to avoid tax, is uncertain in such a case.[13]

The Ways and Means Report further observed that the foregoing result can be accomplished by using convertible debentures, convertible preferred stock, or warrants in lieu of issuing Class B stock.

After reviewing the foregoing techniques, the Ways and Means Committee Report concluded that they are little more than a means of transferring tax benefits whereby the corporation unable to utilize the new venture's tax benefits is largely selling those benefits to the profitable corporate partner.[14] The Report further concluded that two corporations should not be permitted to file consolidated returns unless one owns a significant percentage of the value of the second, as well as 80 percent of the voting power of the second.[15]

Although not mentioned in any of the committee reports accompanying the TRA, the formation of a consolidated return group between a profitable and a loss corporation is not without unfavorable tax consequences. Any tax losses flowed through by the subsidiary to the profitable parent company must reduce the parent's basis in the stock of the subsidiary, except stock that is "limited and preferred" as to dividends, under the rules of Regs. §1.1502-32(b). When losses exceed basis, as commonly occurs in these consolidated return joint ventures, the parent company must establish a "excess loss count" with respect to the loss subsidiary.[16] This excess loss account must be taken into income by the parent when it ceases to file consolidated returns with the loss subsidiary under Regs. §1.1502-19. However, under Regs. §1.1502-19(a)(2), the income included is treated as gain from the sale of stock and, consequently, that income will generally be treated as capital gain. The excess loss account rules thus allow for the conversion of the parent company's ordinary income into capital gain, assuming the subsidiary's losses passed through to the parent corporation are ordinary losses. However, after disaffiliation, the subsidiary loss company still remains liable for any recapture taxes on property owned by the subsidiary that may have contributed to the subsidiary's losses during the period of consolidation.

Note: Based on the fact that the investment adjustment rules in Regs. §1.1502 require negative adjustments for losses only in the basis of subsidiary stock that is not "limited and preferred" as to dividends, some taxpayers have sought to avoid the adjustment rules through ownership solely of voting preferred stock in the subsidiary. The Service's response to this technique has been to deny permission to include subsidiaries whose stock is owned in such a manner from joining in the parent's consolidated return unless the parent makes proper adjustments to prevent the possibility of a double deduction.[17]

B. Outline of New Provisions

Congress's response to the perceived abuse of the consolidated return rules has been to enact in the TRA [18] a more stringent definition of the term affiliated group, effective generally for taxable years beginning after 1984. Under the new definition, corporations must be linked together through ownership of at least 80 percent of the fair market value of all outstanding stock, as well as 80 percent of the voting power of all classes of stock, in order to constitute an affiliated group. In determining stock ownership for this purpose, only nonvoting, nonparticipating stock that is limited and preferred as to dividends, redemption rights, and liquidation rights and that is not convertible into any other class of stock may be disregarded.

Once a corporation ceases to be a member of an affiliated group, that corporation (or any successor) may not be included in any consolidated return filed by that group for a 60-month period. However, under certain conditions to be prescribed in regulations, inadvertent changes in relative value that are not significant will be disregarded in determining if affiliated group status continues.

The new provisions also give the Treasury the authority to issue regulations to treat warrants or convertible obligations as stock and options as having been exercised in determining whether corporations are affiliated and to disregard certain decreases in voting power. In addition, the regulations may provide that certain stock will not be treated as stock for purposes of the affiliated group rules.

As stated above, these rules are generally applicable to taxable years beginning after 1984. However, various transitional rules are provided, the principal one being that for corporations filing consolidated returns under present law for a taxable year that includes April 11, 1984, the provisions generally do not apply until 1988.

C. Detailed Analysis

1. In General

The more restrictive definition of an affiliated group enacted by the TRA will apply for all purposes of the Internal Revenue Code.[19] This represents a change from the House and Senate versions of the revision of the affiliated group definition, which would have applied only for purposes of filing consolidated returns. Thus, not only will the eligibility to file consolidated returns be affected, but also eligibility to elect the 100 percent dividends-received deduc-

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tion of §243(b) will be governed by the new, more restrictive rules.

The new definition will have an impact for other purposes of the Code as well since the status of corporations as an affiliated group is important in other areas besides consolidated returns and the dividends-received deduction.[20] For example, under §337, relating to nonrecognition of gain or loss on sales or exchanges in connection with 12-month liquidations, the subsidiaries in a "chain of includible corporations" for purposes of §1504(a) (but determined without regard to the exclusions of §1504(b)) may be liquidated under the provisions of §337, provided the common parent is also liquidated under §337. In addition, under §404(a)(3), members of an affiliated group may make deductible contributions to a profit-sharing or stock bonus plan on behalf of another member of the group precluded from making a contribution because it does not have a sufficient amount of current or accumulated earnings and profits, taking into account the combined earnings and profits of the group.

Comment: By restricting the definition of an affiliated group, the TRA generally has an adverse effect on the ability to use the special tax benefits conferred on members of an affiliated group. However, in one area, Subchapter S, the new definition indirectly effects a liberalization of the qualification requirements. Under §1361(b)(2), a corporation that is a member of an affiliated group is excluded from the definition of a "small business corporation", and only a "small business corporation" is eligible to elect or to continue Subchapter S status. Since the TRA limits the definition of an affiliated group by raising the requisite stock ownership, an otherwise qualifying small business corporation can potentially own more stock of another corporation without losing its Subchapter S eligibility. Of course, under §1361(b)(1)(D), a corporation that has another corporation as a shareholder cannot qualify as a small business corporation, which means that the subsidiary of a small business corporation must be treated as a regular corporation. Therefore, the practical effect of this indirect liberalization of the Subchapter S rules is probably limited.

Two other variances between the House and Senate versions and the definition of an affiliated group adopted in the final bill deserve mention. Under the House and Senate definitions, a corporation would not have been eligible to file consolidated returns as a member of an affiliated group unless it met the new, more restrictive stock ownership requirements at the beginning of the taxable year for which the return would have been filed. Under this approach, a corporation that became an affiliated group member in the middle of the year would not be included in the consolidated return for that year. Similarly, a corporation ceasing to be a member in the middle of the year would be excluded from the consolidated return for that year. By deleting the requirement that a corporation be affiliated at the beginning of the year, the version adopted in Conference continues the present law treatment of including a corporation within an affiliated group of consolidated return purposes from the date it joins the group to the date it ceases to be a member.[21]

A second change made in Conference was to eliminate the authority granted to the Treasury Department under the House and Senate versions to nullify status as an affiliated group if a plan existed at the time of consolidation to reduce ownership of the value of all outstanding stock of another corporation below 80 percent. The Conference Report gives no reason for the deletion of this rule.

Comment: The Conference Committee's action may stem from the recognition that the other restrictive measures provided under the new definition should be more than adequate to prevent an unwarranted affiliation. However, it is conceivable this rule could reappear in regulations adopted to implement the revised definition. Section 1504(a)(5) authorizes the issuance of regulations "as may be necessary or appropriate to carry out the purposes of this subsection . . ." This provision then sets forth a nonexclusive list of areas in which regulations should be prescribed. It was from this list that the rule concerning planned disaffiliations was stricken. However, the list is not exclusive, and the grant of regulatory authority is broad. Hence, it would not be entirely surprising if regulations came out with this rule, or some variation thereof, under a Treasury Department interpretation of the deletion as making the issuance of the rule discretionary rather than mandatory.

2. New Definition of Affiliated Group

a. New 80 Percent Test

As enacted by the TRA, §1504(a)(1) provides that an "affiliated group" is one or more chains of includible corporations connected through stock ownership to a common parent corporation that is an includible corporation if (i) the common parent owns directly stock meeting the requirements of §1504(a)(2) in at least one of the other includible corporations, and (ii) stock meeting the §1504(a)(2) requirements in each of the includible corporations (excluding the common parent) is owned directly by one or more of the other includible corporations.

Note: Section 1504(a)(1) continues the requirement of current law that the stock owned in members of the group be owned "directly." Direct ownership under current law has been interpreted to mean beneficial ownership.[22] Thus, in Rev. Rul. 84-79, *see* footnote 22, although a parent corporation did not hold legal title to a subsidiary's stock which the parent had placed in a revocable voting trust, it was held that the parent possessed beneficial, and therefore "direct", ownership of the stock because dividends would be paid the parent. As a result, the trustee could not sell the stock without the parent's consent, and the parent could regain legal title by revoking the trust. Presumably, rulings such as Rev. Rul. 84-79 and Rev. Rul. 70-649, 1970-2 C.B. 179, holding that stock held by a nominee was "directly" owned, will be followed under the new law.

Section 1504(a)(2), in turn, provides the following two stock ownership requirements. First, there must be ownership of stock possessing at least 80 percent of the total voting power of the stock of the includible corporation. Second, there must be ownership of stock of the includible corporation having a value at least equal to 80 percent of the total value of the stock of such corporation.

Recognizing that the determination of stock value as required by §1504(a)(2)(B) is not completely objective and can be subject to forces out of the control of the affiliated group, ameliorative provisions are included by the TRA in

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§1504(a)(5). One provision, §1504(a)(5)(C), requires the Treasury to issue regulations providing that the value requirement should be treated as met if the affiliated group, in reliance on a good faith determination of value, has treated such requirements as met.

Observation: The Ways and Means Committee Report [23] notes that the Service will not ordinarily issue rulings as to the value of a stock interest but that the Service has issued rulings describing various valuation methodologies. The Report further states that the Committee contemplates that the Service will continue to issue such rulings. At present, the principal valuation ruling, covering situations where stock of a corporation is closely-held or where market quotations for the stock are otherwise unavailable or of such scarcity that they do not reflect fair market value, is Rev. Rul. 59-60, 1959-1 C.B. 237. Although Rev. Rul. 59-60 was initially to be used only in connection with valuations for estate and gift tax purposes, Rev. Rul. 68-609, 1968-2 C.B. 327, extended it to valuation for income tax and other tax matters. Revenue Ruling 59-60 has been modified or amplified on several occasions.[24] For example, Rev. Rul. 80-123 deals with the valuation of stapled entities. As will be discussed in Part III, *infra*, stapled entities have been dealt with legislatively by the TRA. Revenue Ruling 59-60, and all subsequent modifications and amplifications of the ruling, are reproduced in the Worksheets of 221 T.M., *Valuation of Shares of Closely-Held Corporations*.

The second relief measure, §1504(a)(5)(D), provides for the issuance of regulations under which an inadvertent ceasing to meet the 80-percent value requirements of §1504(a)(2)(B) because of changes in relative values of different classes of stock will be disregarded in determining whether a corporation remains a member of a affiliated group. According to the Conference Report,[25] the regulations will apply to changes in relative value that are "not intentionally generated" and "are not large" since, in such circumstances, it is believed that disaffiliation is inappropriate.

Comment: The condition that the swing in relative values not be "large" is contained only in the Conference Report; it is not set out in the statute. Presumably, the Regulations will reflect the Conference Committee's condition that the changes not be "large". The Conference Report provides no guidance as to what is meant by large changes, and unless the General Explanation of the TRA, when issued, provides some guidelines, the meaning of "large" will be uncertain until the Regulations are issued. It is unforunate that the Conference Report imposed this further qualification that the change not be large in view of the wide fluctuations in value to which different classes of stock in the same corporation can be subject. For example, preferred stock receiving a fixed dividend rate that is convertible into common stock but only at a conversion price well in excess of the current price of the common stock will likely be far more susceptible to interest rate fluctuations than the common stock. This is because, until the common stock appreciates to a point where it is near the conversion price, an investor will value the preferred stock primarily on a comparison of the dividend rate of the stock with prevailing interest rates. Although interest rates may also affect common stock value, they will not have as significant an impact if the earnings on the common can be maintained at a rate comparable to prevailing interest rates. In view of the volatile swings in interest rates in recent years, it would not be surprising in the foregoing circumstances for the preferred stock to show a "large" fluctuation in value relative to the fluctuation in the common stock. In such an event, it would seem unfair to penalize a corporation through loss of affiliation by reason of external market forces, but this result could obtain unless some flexibility is built into the definition of "large" by the Regulations.

b. Stock Considered in Testing for Affiliated Status

As noted in the description of present law, stock that is "limited and preferred as to dividends," and employer stock held in a tax credit ESOP or qualified stock in a leveraged ESOP is not counted in determining whether corporations are affiliated. Under the TRA, stock held in the foregoing types of ESOPs will no longer be disregarded as testing for stock ownership. The exclusion of stock held in ESOPs for testing purposes was a Senate-initiated change for which no reason was stated. However, it may reflect a perception that ESOPs can be utilized by a corporation as a means of reestablishing affiliation that had previously been severed. For example, if ESOP-held stock were disregarded, a corporation that was previously affiliated with a second corporation through ownership of more than 80 percent of that second corporation's stock, that had broken the affiliation chain by selling 30 percent of the stock in a public offering but still retained effective control of that second corporation, and that sought to reaffiliate with the second corporation, could direct the second corporation to establish an ESOP, which would publicly tender for sufficient shares of the second corporation to increase the first corporation's stock ownership in the second to the requisite 80 percent by reducing the total stock considered.

Under §1504(a)(4), as added by the TRA, the type of preferred stock that will not be considered in testing for affiliated group status has been greatly restricted. Only if the stock (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation rights not exceeding the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and (iv) is not convertible, will the stock be disregarded. The Conference Report [26] gives as an example of stock that fails to meet these requirements preferred stock carrying a dividend rate materially in excess of a market rate when issued. No legislative history exists, however, as to what constitutes a "reasonable redemption premium". Presumably, the right to satisfaction of dividend arrearages on cumulative preferred stock (assuming the dividends are at market rates) at redemption or liquidation will not disqualify the stock under §1504(a)(4) or be considered a redemption premium since the shareholder of such stock would only be receiving payment to which the shareholder was otherwise entitled.

In order to prevent abuse of the consolidated return provisions through the use of convertible securities or options, §1504(a)(5)(A)(B) provides for the issuance of regulations under which warrants, obligations convertible to stock, and similar interest will be treated as stock and

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options to acquire or sell stock as having been exercised. In addition, certain stock, such as putable stock,[27] will not be treated as stock. The Conference Report illustrates these rules with the following example:[28]

> *Example*: Corporation A has common stock worth $40 a share. Corporation B, the owner of all of A's common stock, grants Corporation C an option to acquire A's stock for $20 a share that is exercisable three years from the date of the grant. A and C are likely to be loss corporations but B is expected to be profitable. If it can be reasonably expected that C will exercise the option, the regulations may treat the option as having been exercised and, if so treated, A will not be affiliated with B and will therefore be ineligible to file a consolidated return with B.

Query: In the foregoing example, C will be deemed to own all the stock of A actually owned by B by reason of the deemed exercise of the option. A question left unanswered by the committee reports is whether C and A, although loss corporations, will be regarded as affiliated by reason of the deemed ownership and therefore eligible to file a consolidated return.

Comment: Although warrants and options are similar instruments—warrants are also generally options to acquire stock but remain outstanding for a considerablly longer period of time and therefore have a greater intrinsic value—§1504(a)(5)(A) provides for the treatment of warrants, as well as obligations convertible into stock, "as stock", whereas §1504(a)(5)(B) provides for the treatment of options "as having been exercised." It is unclear whether any significance should be attached to this difference in language. In the Ways and Means Report,[29] no distinction is made; the Report states that options, warrants, and convertible securities of a corporation are all to be treated as having been exercised or converted. The statutory language relating to options, warrants, and convertible securities in the House bill was the same as that finally enacted in the TRA. However, the Conference Report[30] does not reiterate the Ways and Means Report language but rather tracks the distinction made in the statutory language. If the distinction is to be observed, it is entirely possible that convertible securities such as convertible debentures will be directly treated as stock rather than as stock into which it can be converted. For example, assume that a convertible debenture worth $200 is convertible into two shares of common stock at a conversion price of $50 per share when the common stock is selling at a price of $80 per share. If the debenture is treated as having been converted into the two shares of common stock, it will presumably be valued at $160 (2 shares X $80) for purposes of the 80 percent value test of §1504(a)(2)(B). On the other hand, if the convertible debenture is itself treated as stock, then presumably under the value test it will be taken into account at its present fair market value of $200. This latter approach is obviously less favorable from a value standpoint than treating the debenture as having been converted.

The treatment of voting power under this approach for purposes of the voting stock test is less certain. The debenture itself has no voting power, but presumably the regulations could require the attribution of any voting power that would be held by the common stock shares into which the debenture is convertible.

c. Deconsolidation and Reconsolidation

Under the House and Senate versions of the new provisions, a member that was part of an affiliated group filing consolidated returns would not have ceased to be a member unless the group's stock ownership in that member fell below 80 percent of the voting power of all classes of voting stock or became 50 percent or less of the fair market value of all outstanding stock in that member. However, this provision was dropped in the Conference Committee because the Committee believed that such a rule would permit the common parent to dispose of too much of the value of stock of a member without requiring deconsolidation. Consequently, a corporation's status as a member of an affiliated group will continue only so long as the 80 percent voting power and fair market value tests of §1504(a)(2) continue to be met.

Note: After describing the foregoing rule, the Conference Report states that nothing in the bill is intended to overturn Rev. Rul. 78-119, 1978-1 C.B. 277. That ruling holds that a parent's temporary loss of the right to vote a subsidiary's stock because the stock has been placed in a court's custody during the pendency of litigation does not cause deconsolidation.

As previously discussed, under §1504(a)(5)(D), an inadvertent ceasing to meet the fair market value test by reason of changes in relative values of different classes of stock will not terminate a corporation's status as a member of an affiliated group under regulations to be issued. Section 1504(a)(5)(E) and (F) sets forth two additional situations under which regulations are to be issued that will prevent a disaffiliation. In one case, regulations are to be issued providing that transfers of stock within the group shall not be taken into account in determining whether a corporation ceases to be a member of an affiliated group. The Conference Report illustrates the anticipated operation of this rule as follows:[31]

> *Example*: Corporation A owns 100 percent of Corporation B's only class of stock, and B owns 100 percent of the only class of stock of Corporation C. The Report states that it is contemplated that the transfer by A of 30 percent of the stock of B to C will not break the status of A, B, and C as an affiliated group.

The second situation to be addressed by Regulations is where changes in voting power occur that are disproportionate to related changes in value. In such case, Regulations can disregard changes in voting power to the extent that such changes are disproportionate to the related changes in value.

> *Example*: Assume that Corporation A owns all the Class A common stock of Corporation C, and that such Class A stock represents 95 percent of the voting power and 90 percent of the value of all the common stock of C. Assume further that Corporation B owns 100 percent of the Class B common stock of Corporation C and that this Class B stock represents the remaining 5 percent of the voting power and 10 percent of the value of all of C's stock. If C's corporate charter is amended to reduce the voting power of the Class A stock from 95 percent of total voting power to 75 percent of total voting power, and such change has the effect of reducing the value of the Class A stock to 80 percent of the

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value of all outstanding stock, the regulations can presumably provide that the Class A stock continues to have at least 80 percent of the voting power and that A and C have not become disaffiliated.[32]

Under a new provision enacted by the TRA in §1504(a)(3), if a corporation is included in a consolidated return for a taxable year that includes any period after December 31, 1984, and if a corporation ceases to be a member of that consolidated return group in a taxable year beginning after December 31, 1984, then that corporation (and any successor of such corporation) may not be included in any consolidated return filed by that group or by another affiliated group with the same common parent or a successor of such common parent before the 61st month beginning after its first taxable year in which it ceased to be a member of such group.

Example: Assume that Corporation A is a member of an affiliated group that files consolidated returns on a calendar year, assume that A was included in the consolidated return filed by the group for the year ending December 31, 1985, and assume that A ceases to be a member of this group on November 30, 1986. As a result of the deconsolidation, the income or loss of A through November 30, 1985 must be reflected in the group's 1986 consolidated return, and A must file a separate return (assuming it does not become a member of an unrelated affiliated group) that will reflect the results of its December 1986 operations.[33] Hence, the taxable year in which A ceases to be a member of this affiliated group is its year ending November 30, 1985, and assuming it subsequently reaffiliates with this group, it cannot be included in a consolidated return with this group until December 1, 1991, which is the 61st month after the year in which disaffiliation occurred. Presumably, the Regulations that will implement this reconsolidation rule will permit A's income and loss for the December 1991 period to be included in the group's 1991 consolidated return although this is not entirely clear from the statute.

Under §1504(a)(3)(B), the Treasury is authorized to waive the application of the 60-month waiting period for any corporation that disaffiliates subject to such conditions as the Treasury may prescribe. The Conference Report notes that the rule prohibiting consolidation after deconsolidation is an anti-abuse rule and that the Treasury is expected to so apply it. The Conference Report [34] provides the following example of a situation in which the rule should not be applied:[35]

Example: Assume that Corporation A owns all the stock of Corporation X and that the two file a consolidated return. On July 1, 1986, A merges into unrelated Corporation B in a statutory merger qualifying under §368(a)(1)(A). It is assumed that all the corporations are operating corporations and that the merger is not a reverse acquisition.[36] According to the Conference Report, absent other factors, X should be able to join in filing a consolidated return with the group of which B is the common parent for the period beginning July 1, 1986.

Note: As previously mentioned, a successor to a corporation that deconsolidates, as well as the corporation itself, is generally precluded from joining in a consolidated return with that same affiliated group (or with another affiliated group with the same common parent or a successor of such common parent) for a 60-month period. However, neither the statute nor the legislative history provides any indication of what is meant by a "successor". The definition of a "successor" for these purposes presumably will be addressed in Regulations. Under the present consolidated return Regulations, no references exist to successor corporations. However, for purposes of defining a "separate return limitation year" of an affiliated group member in Regs. §1.1502-1(f)(1), reference is made to the "predecessor" of that member, and a predecessor is described as "transferor or distributor of assets to a member in a transaction to which section 381(a) applies." Section 381(a) applies to §332 liquidations of subsidiaries and certain nontaxable reorganizations. In view of this definition of "predecessor" in the current regulations, it would not be surprising if a "successor" were similarly defined as the transferee of a transferor corporation in a §381(a) transaction.[37]

3. Implications of More Stringent Definition

Many of the major consequences of the new definition of an affiliated group have already been described. As pointed out, it will become more difficult for related corporations to be treated as an affiliated group and to take advantage, therefore, of the consolidated return election and the §243(b) 100 percent dividends-received election. On the other hand, as previously described, the more stringent definition indirectly liberalizes the requirements that a corporation must satisfy in order to be considered a small business corporation for purposes of Subchapter S.

One change left unanswered by the statute and legislative history is whether the new provisions might be applied for the benefit of a taxpayer. For example, in PLR 8035031 (May 30, 1980) a Technical Advice Memorandum, a parent corporation held the 95 shares of nonvoting convertible stock in each of two subsidiaries. A tax-exempt organization held the only other shares of stock outstanding, 5 shares of voting common stock. Moreover, the by-laws of the two subsidiaries provided that only officers and directors of the parent could be elected as officers of the subsidiaries. Applying the rule under existing law that only presently outstanding voting power is considered for purposes of the affiliated group provisions,[38] thus disregarding the convertibility feature, the Service ruled that the two subsidiaries could not be included in an affiliated group with the parent. Under the new rules, as previously described, stock that is limited and preferred as dividends is no longer excluded for purposes of determining affiliated status under 1504(a), if the stock is convertible into voting stock.[39] It is less clear whether such convertible preferred stock should be treated as voting stock for purposes of 1504(a) test, but under the authority in 1504(a)(5) to issue all necessary and appropriate regulations, the Treasury could presumably permit convertible preferred stock to be treated as voting stock. In such case, a favorable result might be reached in circumstances such as PLR 8035031, where an adverse result had previously obtained.

Comment: Since the new provisions are more stringent and are designed to prevent abuses that were preceived to arise under present law, the likelihood that they will be

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applied in a manner that will ever benefit a taxpayer is not great. Certainly, a taxpayer should not arrange a corporate structure in the expectation that any favorable rules will be issued in the Regulations.

In the consolidated return area, it is likely that the separate return limitation year rules (SRLY) will be amended to provide that if a former member of an affiliated group filing a consolidated return again becomes an affiliate of that group within the 60-month period during which it is prohibited from joining in the consolidated return of the group, any years falling within that 60-month period will be treated as separate return years subject to the SRLY limitations. Otherwise, if not subject to the SRLY rules, the former member's losses and credits arising in the period commencing with reaffiliation and ending with the time it becomes eligible to rejoin in the group's consolidated returns may be available to the group under the consolidated return loss and credit carryover provisions.[40]

Also in the consolidated return area, it is possible that the investment adjustment rules of Regs. §1.1502-32 will be clarified to provide that negative adjustments must be made to the basis of all stock in the subsidiary to reflect the losses generated by that subsidiary except stock described in §1504(a)(4), relating to stock excluded from affiliated group computations where it is nonvoting, nonconvertible, nonparticipating, and limited and preferred as to dividends. Such a clarification will prevent taxpayers in the future from taking the position that a negative adjustment need not be made to voting preferred stock.[41]

Finally, it can be anticipated in view of the more stringent affiliated group requirements that corporations entering into a new venture that will generate tax benefits they will be unable to utilize will enter into partnership arrangements with corporations that can utilize such benefits. Under §704(b)(2) and Prop. Regs. §1.704-1(b), it is possible to make special allocations of tax benefits to a profitable corporate partner in the partnership agreement provided that the special allocations have "substantial economic effect."

Comment: Although partnership allocations furnish one possible avenue for avoiding the impact of the more stringent affiliated group rules, it should be noted that new §168(j)(9) may significantly affect the use of special allocations where the corporate partner is unable to use the tax benefits because it is a "tax-exempt entity" (and for this purpose, a foreign entity is considered "tax-exempt entity"). Under this provision, allocations of tax items to a tax-exempt partner must be consistent with the partner's interest in the partnership and must remain the same during the entire period that the tax-exempt partner remains in the partnership. These requirements are in addition to the rule that the allocation have "substantial economic affect" within the meaning of §704(b)(2). If the allocations to the tax-exempt partner do not meet these standards, then a portion of the partnership's property will be characterized as "tax-exempt use property". Property so reclassified is generally ineligible for the investment credit, and ACRS deductions must be taken over an extended period under the straight-line method. For a complete analysis of the new tax-exempt entity leasing rules, *see* Chapter 18 of this Portfolio.

4. Effective Dates

In general, the new amendments to the affiliated group definition are effective for taxable years beginning after December 31, 1984.[42] However, the revised definition does not apply to a corporation that on June 22, 1984, is a member of an affiliated group filing a consolidated return for such corporation's taxable year that includes June 22, 1984, until the taxable year beginning after December 31, 1987.[43] However, if (i) at any time after June 22, 1984, more than a *de minimis* amount of stock of any corporation affiliated on June 22, 1984, is sold or exchanged (including by redemption) or is issued other than in the ordinary course of business), and (ii) the requirements of new §1504(a) are no longer satisified after such sale, exchange, or issuance, then the provision will apply to such corporation for its taxable year beginning after December 31, 1984, or if later, the date such stock is sold, exchanged, or issued, as the case may be. The Conference Report states that for purposes of this rule, stock issued to ESOPs, stock issued upon the exercise of employee stock options, and similar issuances of stock are generally to be treated as issuance in the ordinary course of the corporation's business.[44] The Conference Report further provides an illustration of the foregoing effective date rules:[45]

> *Example*: Corporation B has 300 shares of Class A common stock and 100 share of Class B common stock outstanding. The shares of each class are identical except that each share of Class A common stock has three votes for every one vote of the Class B common stock. Corporation A owns all the Class A common stock, representing 90 percent of the voting stock and 75 percent of the value of all the stock of B at all times during 1984. A and B file a consolidated return for calendar year 1984. On June 30, 1985, A sells 20 shares of the Class A common stock of B to an unrelated party. After the sale, A owns 84 percent of B's voting stock and 70 percent of the value of all B's stock. B would be disaffiliated under the new provisions as a result of the sale. Under a special exception of the foregoing "sell-down" rule,[46] a corporation that issues or sells stock after June 22, 1984, pursuant to a registration statement filed with the Securities and Exchange Commission on or before June 22, 1984, will not be precluded from using the January 1, 1988, effective date but only if the requirements of §1504(a) are satisfied immediately after issuance or sale (but substituting a "more than 50 percent" test for the "at least 80 percent" test in §1504(a)(2)(B), relating to 80 percent ownership of the value of all outstanding stock and at all times thereafter until the first day of the first taxable year beginning after December 31, 1987.

Lastly, a special exception is provided for Native Corporations established under the Alaska Native Claims Settlement Act during any taxable year beginning before 1992.[47]

II. Graduated Rate Phaseout for Large Corporations

A. Background

Under §11(b), the first $100,000 of a corporation's taxable income is subject to taxation at graduated rates. A 15 percent rate is applied to the first $25,000 of taxable

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income. The second $25,000 of income is subject to tax at a rate of 18 percent. Taxable income in excess of $50,000 up to $75,000 is taxed at a rate 30 percent, and taxable exceeding $75,000 up to $100,000 is taxed at a 40 percent rate. The maximum corporate tax rate, imposed on income in excess of $100,000, is 46 percent. The tax savings yielded by having the first $100,000 of corporate taxable income taxed under these graduated rates, rather than at the 46 percent maximum rate, is $20,250.

The graduated rates are generally available to any corporation subject to the §11 corporate tax, unless the corporation is a "component member of a controlled group of corporations" within the meaning of §1563. Under §1561(a), component members of a controlled group are limited to a single application of the graduated rates. Section 1561(a) provides that the $25,000 amount in each rate bracket is to be divided equally among the component members of the group unless the component members agree to allocate each $25,000 amount unequally pursuant to an apportionment plan.[48] In general, a controlled group of corporations is either (i) a parent-subsidiary group of corporations connected to each other through stock ownership possessing at least 80 percent of total voting power or at least 80 percent of the total value of all stock or (ii) a brother-sister group consisting of two or more corporations in which 5 or fewer individuals, estates, or trusts own at least 80 percent of the voting power or at least 80 percent of the total value of the stock of each corporation, and more than 50 percent of such ownership is identical with respect to each corporation in the brother-sister group. A controlled group can also consist of a combination of parent-subsidiary groups and brother-sister groups. Under §1563(b), a component member of the group is generally any member of the group as of a particular December 31 except one excluded under §1563(b)(2), such as an exempt organization or foreign corporation.

B. Analysis of New Provisions

1. In General

The TRA amends §11(b) to recapture the tax savings yielded by the graduated rate structure for large corporations earning in excess of $1,000,000 of taxable income. This is accomplished by imposing a surtax on corporate taxable income in excess of $1,000,000 equal to the lesser (i) 5 percent of such excess, or (ii) $20,250. Thus, corporate taxable income in excess of $1,000,000 up to $1,405,000 (5% X $400,000 = $20,250) will be subject to the 5 percent surtax.

The reason for this change is succinctly stated in the Senate Finance Report accompanying the TRA:[49]

> "The graduated corporate tax rates were added in 1978 to ease the tax burden on small business. However, large corporations, as well as small corporations, are entitled to these benefits. The Committee believes that large corporations should not be able to take advantage of the small business provision."

2. Controlled Groups

In a conforming change,[50] §1561(a) has been amended to treat a controlled group of corporations as one corporation for purposes of this 5 percent surtax. As amended, §1561(a) in essence provides that in applying the 5 percent surtax on income in excess of $1,000,000 to component members of a controlled group, the taxable income of all such members is taken into account and any tax increase due to the surtax shall be divided among the component members in the same manner as the $25,000 rate bracket amounts are allocated among the members. As noted above, each $25,000 rate bracket amount is divided equally among the component members unless they have an apportionment plan in effect specifying an unequal allocation.

> *Example*: Assume that four corporations constituting component members of a controlled group of corporations collectively report taxable income of $2,000,000 for their taxable years ending in 1986. Assume further that the controlled group did not have an apportionment plan in effect so that the $25,000 rate bracket amounts were divided equally among the four component members. The $20,250 surtax computed on the controlled group's collective taxable income falling between $1,000,000 and $1,405,000 will be divided equally among the members. Thus, each member must pick up $5,062.50 ($20,250/4) of the surtax for their taxable years ending in 1986.

The allocation of the 5 percent surtax is not quite as clear if the graduated rate bracket amounts have been allocated unequally among the component members rather than equally as in the previous example. If the bracket amounts have been allocated entirely to one member, then logically the entire 5 percent surtax amount should be allocated to that member. If, however, the bracket amounts are allocated in some other disproportionate manner among the members, two alternatives exist for allocating the 5 percent surtax, one based on the percentage of benefit each member obtained from the graduated rates and the second based on a first-in first-out (FIFO) ordering principle, as illustrated below.

> *Example*: Assume that Corporations A and B, component members of a controlled group, pursuant to an apportionment plan, allocated the first two $25,000 bracket amounts (the 15 percent and 18 percent brackets) to Corporation A and the remaining two $25,000 bracket amounts to Corporation B (the 30 percent and 40 percent brackets).[51] The tax benefit derived by allocating the first two bracket amounts to Corporation A is $14,750 (the difference between having $50,000 taxed at the maximum 46 percent and having that $50,000 taxed at the 15 and 18 percent rates); the savings derived by B is $5,500 (the difference between having $50,000 taxed at the maximum 46 percent rate and having that $50,000 taxed at the 30 and 40 percent rates under the graduated rates schedule). Further assume that the aggregate taxable income of A and B is $1,200,000 so that the 5 percent surtax on the $200,000 in excess of $1,000,000 of taxable income is $10,000. Under a FIFO ordering rule, it would be assumed that the first dollars recaptured by the surtax would be allocated to the first bracket amount until the savings produced by that bracket amount had been recaptured. Since A was entirely allocated the first two $25,000 bracket amounts and derived a tax savings in excess of the $10,000 recaptured by the surtax, that $10,000 would be entirely allocated to A. Alternatively, if the 5 percent recapture tax is allocated according to the

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percentage benefit each component member has derived from the graduated rates, A would be allocated 72.84 percent ($14,750 tax savings/$20,250 total tax benefit from graduated rates) or $7,284 of the $10,000 surtax, and B would be allocated the remaining $2,716 of the surtax based on its percentage benefit from the graduated rates.

Of course, if the full $20,250 tax benefit yielded by the graduated rates is recaptured by the surtax, the allocation of that amount among the component members should be the same regardless of whether a FIFO or percentage method is employed.

C. *Effective Dates*

The 5 percent surtax is effective for taxable years beginning after December 31, 1983.[52] It is not treated as a change in rates under §15[53] and, consequently, a fiscal year corporation will not be affected until its first taxable year beginning in 1984.

Observation: The impact of the surtax on a large corporation's estimated taxes should not be overlooked. Any corporation or controlled group of corporations that is subject to the surtax will be treated as a "large corporation" for purposes of the estimated tax penalty under §6655.[54] Since the §6655(d)(1) and (2) exceptions to the penalty (based on prior year's tax liability or income) are unavailable to a large corporation, such a corporation is generally required to pay at least 90 percent of its prospective tax liability for the year in estimated tax installments. To avoid any penalty, a large corporation should review whether the surtax requires any augmentation in its estimated payments for its first taxable year beginning after 1983.

Comment: The determination of whether corporations constitute a controlled group of corporations is made as of a particular December 31, as mentioned above, regardless of whether their taxable years correspond. If a controlled group consists of, for example, both calendar and fiscal year corporations, it is not entirely clear how their incomes should be aggregated to determine whether they are subject to the surtax for the first year the surtax is effective. Presumably, a controlled group of corporations should wait until all fiscal years have closed in 1985 before making a final determination as to whether the controlled group, including the calendar year component members, is subject to the surtax.

III. Treatment of Stapled Entities [Act §136]

A. *Introduction*

The ownership and control of one entity by another has in many cases a significant impact on the tax liability of one or both such entities. For example, a corporation may be a "foreign personal holding company" if, assuming certain gross income requirements are met, more than 50 percent in value of the outstanding stock of the foreign corporation is owned directly or indirectly by or for not more than five persons who are citizens or residents of the United States (the "United States Group").[55] A United States shareholder of a foreign personal holding company is required to include in income his proportionate share of the corporation's "undistributed foreign personal holding company income".[56]

Similarly, a corporation may be a "controlled foreign corporation" if more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned, actually or constructively, by United States shareholders on any day during the taxable year of the foreign corporation.[57] A "United States shareholder" is a United States person, including a corporation, which owns, directly or indirectly, ten percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.[58] Every United States shareholder of a controlled foreign corporation must include in his gross income his proportionate share of the corporation's "subpart F" income for the year, as well as his proportionate share of certain other types of income designated in §951(a). Although §957 speaks only of voting power, the regulations promulgated under that section[59] provide that, in determining whether the U.S. shareholders own the requisite percentage of voting power, consideration must be given to all the "facts and circumstances" of each case. The regulations also provide that any arrangement to shift formal voting power away from the United States shareholders will not be given effect if "in reality" those shareholders retain control.[60] The courts have, in general, interpreted this provision to prohibit attempts to dilute U.S. share ownership through the nominal transfer of 50 percent of the voting power of a foreign corporation to non-U.S. shareholders in those cases where the new foreign shareholders were in fact, if not formally, under the control of the U.S. owners.[61]

One technique for avoiding control limitations where the stock of a foreign corporation is wholly-owned by a widely-held domestic (U.S.) corporation, is to distribute the stock of the foreign subsidiary pro rata to the shareholders of the U.S. parent while pairing, or "stapling" the stock of the two separate entities by restricting the transfer of the stock of one without transferring the stock of the other. In some cases, the stock certificates of the stapled entities are printed on both sides of a single document. If the stock ownership of the domestic U.S. parent corporation is sufficiently widely-held, then the pro rata distribution of the stock of the foreign subsidiary to the shareholders of the U.S. parent will in most cases avoid the concentration of control in a few U.S. shareholders which is necessary for the corporation to be treated as a foreign personal holding company or controlled foreign corporation.

In the domestic context, stapled stock is used to enable those entities such as real estate investment trusts (REITs) and regulated investment companies (RICs), which are limited by statute to passive investments (in real property and securities respectively), to diversify their investments by pairing the stock of the REIT or RIC with the stock of another company which engages in a business which could not be carried on by the REIT or RIC.[62] In the case of a REIT (although not a RIC), which is prohibited from owning more than ten percent of the stock of another corporation,[63] it also cannot carry on the prohibited business in subsidiary form. To avoid these limitations, the stock of a newly formed subsidiary is distributed pro rata to the shareholders of the REIT or RIC in the same manner as the stock of a controlled foreign subsidiary would be distributed to the stockholders of its domestic parent.

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The IRS approved this type of pairing transaction when undertaken by a REIT in a private letter ruling issued in 1979.[64] The distribution of the stock of the subsidiary to the REIT's shareholders, however, is taxable as a dividend to those shareholders since a REIT, by its nature, cannot satisfy the active trade or business requirement of §355 of the Code.[65] In many such paired stock split-offs, the "business purpose" requirement also will not be satisfied. In Rev. Proc. 81-4,[66] however, the IRS announced that it will not rule on the validity of a paired stock transaction where the activities of the REIT and the stapled corporation continue to be "integrated".

A third situation arises in the area of multiple surtax exemptions and multiple accumulated earnings tax credits. Sections 1561 and 1563 limit the ability of component members of a controlled group of corporations to accumulate multiple tax benefits in cases where one or more corporations are under common control. While the parent-subsidiary controlled group is the most obvious control situation, §1563 also covers brother-sister control groups in certain cases. Section 1563 covers corporations in which five or fewer persons own directly or indirectly at least 80 percent of the total combined voting power or at least 80 percent of the total value of shares of all classes of stock of each corporation or more than 50 percent of the voting power and 50 percent of the value of the stock of each corporation. This takes into account the stock ownership of each person to the extent that it is identical with respect to each corporation.[67] The statute arguably may not cover, however, the widely-held paired stock arrangement described above.

B. Overview

1. Statutory Changes

Section 136 of the Act adds §269B ("Stapled Entities"). Subsection (a) of §269B sets forth the general rules to be applied in the taxation of domestic and foreign stapled entities. First, if a domestic and foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation.[68] Next, §269B treats stock of a second corporation which is stapled to a first corporation as owned by the first corporation for purposes of §1563.[69] Finally, §269B provides that, in determining whether any stapled entity is a REIT or a RIC, all entities which are stapled with respect to each other shall be treated as one entity. The statute also contains a broad directive to the Secretary to prescribe regulations necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities, including regulations providing the extent to which one of such entities shall be treated as owning the other entity.[70]

The term "entity" includes, in addition to corporations, partnerships, trusts, associations, estates or any other form of carrying on a business or activity.[71] A "stapled entity" is any group of two or more entities if more than 50 percent in *value* of the beneficial ownership in each consists of stapled interests.[72] An interest is considered to be stapled if "by reason of form of ownership, the restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other interests are also transferred or required to be transferred".[73]

In general no treaty or any other provision of the law shall be construed as permitting an exemption from the requirements of §269B. This provision, however, like many other provisions of the section is substantially modified by the effective dates summarized below.

2. Effective Dates

Section 269B is effective in general on the date of enactment of the Act (June 18, 1984). There are, however, six exceptions to the effective date which are designed to except from or substantially modify the result of the application of §269B to certain stapled entities in existence prior to the effective date.[74]

First, the Act provides that with respect to entities which were stapled on June 30, 1983, §269B shall take effect on January 1, 1985, or January 1, 1987 in the case of stapled interests in a foreign corporation. Next, the Act provides that it shall not apply to those REITs which were part of a group of stapled entities where all members of the group were stapled as of June 30, 1983 and, as of June 30, 1983 such group included one or more REITs. Third, the provisions applicable to stapled domestic and foreign corporations shall not apply to a "qualified Puerto Rican corporation" and a domestic corporation which were stapled on June 30, 1983. For this purpose, a "qualified Puerto Rican corporation" is a corporation which is described in §957(c) of the Code, so long as that corporation does not own any stock of a corporation which is not described in §957(c).[75] Fourth, the Act provides an exception for entities which were stapled as of June 30, 1983 and enjoyed a treaty benefit as of such date so that §269B of the Code shall not override such benefit. Fifth, there is a relief provision for those foreign and domestic corporations which, as of June 30, 1983, were stapled entities. Under this exception, the domestic corporation may treat the stapled foreign entity as a subsidiary to the extent of the stapled interests if such election is made not more than 180 days after the date of enactment in a manner to be prescribed by the Secretary of the Treasury or his delegate. The election thereafter may be revoked only by the Secretary or his delegate. Lastly, the Act provides that §269B(a) shall not apply to a "qualified real estate investment trust" which is part of a group of stapled entities created pursuant to a written board of directors resolution adopted before April 15, 1984 where all members of such group were stapled entities as of June 16, 1985. For this purpose a "qualified real estate investment trust" means any REIT, at least 75 percent of the gross income of which is derived from interest on obligations secured by mortgages on real property. Such interest must be at an arm's-length rate or a rate not more than one percent greater than the associated borrowing cost of the trust, and any real property held by the trust is not used in the trade or business of any other member of the stapled group.

C. Detailed Analysis

1. General Rules

Section 269B of the Code was designed to limit the abuse of the tax system and its special tax benefits (such as those granted to REITs) which result from the formal separation of control arising from the stapling of related entities.[76] In addition to the concerns illustrated by the

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examples in the Introduction, the Ways and Means Committee was concerned that the stapling of a taxable entity to a nontaxable entity or an entity subject to tax at a considerably lower rate might result in the opportunity to shift profits away from the taxable entity through improper transfer prices or other means which, while subject to correction under §482 have proven difficult to correct in practice.[77]

Section 269B(a)(1) treats stapled domestic and foreign corporations as two domestic corporations. Since the result of this would be to subject the stapled foreign corporation to U.S. tax on its worldwide income, the Act provides an exception in the effective date provisions for those foreign and domestic corporations which were stapled entities on June 30, 1983. The U.S. corporation in that case may elect to treat all of the stapled interests in the foreign corporation as owned by the U.S. corporation. In many cases this will result in the stapled foreign corporation being treated as a controlled foreign corporation or a foreign personal holding company.[78] The U.S. corporation therefore would be subject to tax on the undistributed foreign personal holding company income or subpart F income attributable to the stapled stock. Since the U.S. corporation would not be taxable on any of the earnings attributable to stock held by non-U.S. shareholders, this election generally would result in a smaller tax on the income of the stapled foreign entity than would be imposed if it were treated as a domestic corporation under §269B(a)(1).

Since all stapled entities will be treated as one in determining whether any corporation is a REIT or a RIC, §269B(a)(2) will reduce significantly the abuse of the tax benefits provided to those corporations, most of which will have to choose between abandoning their favorable tax status or decontrolling their stapled entities. A similar result will obtain where, for purposes of §1563 two stapled corporations are treated as one. These corporations, if they retain their stapled status, will lose the benefit of any multiple surtax exemptions and the denial of multiple accumulated earnings tax credits.[79] The House Committee Report notes, in addition, that under the standard rules governing consolidated returns, neither stapled U.S. corporations nor stapled U.S. and foreign corporations will be eligible to file consolidated returns. A contiguous country stapled corporation might, however, be eligible to consolidate under the rules described in §1504(d) if the election to treat the stapled entity as a subsidiary to the extent of the stapled interest is in effect.[80]

As noted above, two or more interests will be considered stapled if "by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferrred or required to be transferred."[81] The House Committee Report gives two examples of situations in which the terms and conditions of ownership will not result in the interests of two corporations being considered stapled. In the first, under a standard death redemption agreement, two U.S. citizens, each of whom own 50 percent of a U.S. corporation and a foreign corporation, have obligated their estates to sell all of the shares of the first shareholder to die, while each corporation has agreed to buy those shares. The Report notes that these shares are not stapled so long as each shareholder may trade shares of the two corporations freely before death.[82] A similar result would obtain where, instead of a death redemption agreement, the shares were subject to a right of first refusal in the corporation or the other shareholder at a certain price. In this case the shares would not be considered stapled so long as either shareholder might dispose of his interest in one corporation without disposing of his interest in the other.[83]

Since the Act defines "stapled entities" to mean any group of two or more entities where more than 50 percent in *value* of the beneficial ownership of each consists of stapled interests, it is conceivable that, in order to avoid §269B, U.S. corporations may attempt to formally "destaple" 50 percent of the beneficial ownership in the related entity, much in the same way as, in the controlled foreign corporation situation, there have been attempts to "decontrol" a foreign subsidiary through the formal transfer of voting rights to foreign interests. It may be anticipated that litigation, similar to that which has arisen under the controlled foreign corporation provisions, may arise concerning the extent to which 50 percent in value of an entity is in fact stapled to another such entity. Regulations to be promulgated under the directive of §269B(b) might effectively deal with this situation.

2. Exceptions

The effective date provisions provide a number of exceptions, outlined above, to the general provisions of Code §269B. One of these, the election to treat a stapled foreign entity as a subsidiary, has been discussed above. The general rule, that the stapled stock provisions will override treaties, will not restrict the availability of treaty benefits for entities stapled on June 30, 1983, so long as the treaty is not renegotiated.[84] The exception for U.S. corporations stapled to pre-existing Puerto Rican corporations was inserted because, under the possessions corporation rules (Code §936), tax benefits comparable to those of stapling are accorded to certain Puerto Rican corporations.[85] Finally, the Committee has indicated that the exception for pre-existing stapled REITs was inserted because the Internal Revenue Service, in private letter rulings, has explicitly sanctioned the stapling of REITs in the past.[86]

The Act provides all corporations, both foreign and domestic, which were stapled as of June 30, 1983 with a period of time in which to "destaple" their interests. Domestic corporations have until January 1, 1985 to destaple while domestic corporations which are stapled to foreign corporations have until January 1, 1987.

IV. Loss Deferrals Under §267 for Controlled Group Transactions

Expense and interest deductions for amounts owing from an accrual-basis entity to a cash-basis entity, which were formerly disallowed, are now, as a result of TRA §174, merely deferred until the expense or interest is actually paid and the cash-basis entity recognizes income. The former grace period for expenses or interest paid during the 2½ months following the close of the taxable year, during which time payments were not subject to disallowance under §267(a)(2), has been repealed. Now, any delay in payment by an accrual-basis taxpayer to a related cash-basis taxpayer will result in postponement of

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the deduction for the expense or interest until actual payment.

The Act amends §267(b) to broaden the relationship rules. The extension of the relationship rules will apply to both the disallowance of loss on a sale or exchange of property between related parties and to the deferral of deductions for unpaid expenses and interests owed by an accrual-basis taxpayer to a cash-basis taxpayer. Section 267 will now apply to transactions between a partnership and a corporation which are commonly controlled, and to transactions between an S corporation and a C corporation which are commonly controlled (whether by one individual, as under prior law, or by more than one person). The Act also extends §267 to transactions between groups of controlled corporations. Corporations will be treated as members of a controlled group if they satisfy the tests of §1563(a), except that a 50 percent control test will be substituted for the 80 percent control test of §1563(a). In the case of a transaction between members of a controlled group of corporations, the disallowance of a loss on the sale or exchange of property under §267(a)(1) will not apply. Instead, losses will be deferred until the property is disposed of to an unrelated third party in a transaction which results in recognition of gain or loss under consolidated return principals. Loss on a transfer to a DISC or on certain sales of inventory to a foreign member of the same controlled group, and certain foreign currency losses, will not be subject either to disallowance or deferral.

V. Amendments to the Accumulated Earnings Tax

A. Introduction

1. Background

Part 1, subchapter G of the Code imposes, as a penalty tax, an accumulated earnings tax on corporations that are formed or availed of to avoid shareholder-level taxation by accumulating earnings. Under §531, the tax is equal to the sum of 27½ percent of the first $100,000 of "accumulated taxable income," plus 38½ percent of any additional accumulated taxable income. The term "accumulated taxable income" means the taxable income of the corporation, with adjustments provided in §535(b), reduced by the sum of the §561 deduction for dividends paid and the accumulated earnings credit (generally, a minimum of $250,000). For this purpose, adjustments to taxable income currently permitted include, *inter alia,* (a) deductions for capital losses in excess of capital gains (*i.e.*, losses disallowed under §1211(a)), and (b) net §1201 gain, determined without regard to the capital loss carryback or carryover and reduced by taxes attributable to such gain (computed by taking any capital loss carryback or carryover into account).

The accumulated earnings tax applies to every corporation (other than a personal holding company, a foreign personal holding company, or an exempt organization) having the requisite tax-avoidance purpose. There has been some dispute as to whether the accumulated earnings tax applies to corporations the stock of which is widely held. The Service has taken the position that a publicly-held corporation is not immune to the tax,[87] but the case law on the point is conflicting.[88] The question has arisen because of the perceived difficulty in making a "formed or availed of" determination when no shareholder or limited group of shareholders is in a position to control corporate affairs.

2. Outline and Purpose of New Provisions

Section 58 of the Act amends §532 (describing corporations subject to the accumulated earnings tax) by adding subsection (c). Subsection 532(c) clarifies that the application of the accumulated earnings tax shall be determined without regard to the number of shareholders.

The Act also substantially modifies the definition of accumulated taxable income so as to reduce the amount of capital gain and loss deductions currently permitted as adjustments under §535(b). In the case of a holding or investment company, the deduction for capital losses is completely disallowed.

These modifications reflect the legislative determination that there is no longer any justification for permitting accumulations to offset business losses (since most business losses are treated as ordinary losses), especially in the case of a holding or investment company. According to the House Report, certain investment companies formed to accumulate dividend income have been able to utilize the deductions for capital gains and losses to avoid both the accumulated earnings tax and the regular tax on capital gains by carefully allocating capital gains and losses over the years and, in effect, double-counting capital losses for purposes of the accumulated earnings tax computation.[89]

3. Effective Date

The accumulated earnings tax amendments will apply to taxable years beginning after July 18, 1984, the date of enactment of the Act.

B. Detailed Analysis

1. Clarification as to Publicly-Held Corporations

Subsection 532(c) provides that the number of shareholders of a corporation is irrelevant for purposes of determining the application of the accumulated earnings tax. Despite this clarification, the Service may have difficulty establishing the proscribed purpose with respect to a widely-held company that is not controlled by an individual or a small group of shareholders, when the statutory presumption under §533 (relating to accumulations beyond the reasonable needs of the business) is not available.

2. Treatment of Capital Gains and Losses

The Act retains the adjustment to taxable income for net capital gains, less taxes attributable to such gain. However, the adjustment must be computed by taking into account, as short-term capital losses, any net capital losses incurred during the preceding taxable year. The effect of this revision may be to reduce the capital gain adjustment that would have been available under prior law.

> *Example*: A Corp. has taxable income of $110,000 for the taxable year ended December 31, 1986, of which $10,000 is the excess of net long-term capital gain of $20,000 over a net short-term loss of $10,000. Such loss includes a capital loss carryover from the preceding taxable year of $8,000. Under prior law, the capital gain adjustment for A Corp. would have been $15,200 ($20,000 net long-term capital less $2,000 net short-term capital loss computed without regard to the

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$8,000 carryover, less taxes of $2,800 attributable to the net capital gain of $10,000 (computed with regard to the $8,000 carryover)). Under the new rules, the adjustment is only $7,200 (the $8,000 carryover being subtracted from $15,200).

The Act also retains, but reduces, the adjustment for capital losses. The adjustment is in an amount equal to the net capital loss of the corporation (without regard to carryovers),[90] reduced by the lesser of "nonrecaptured capital gains deductions" or the corporation's accumulated earnings and profits account as of the close of the preceding taxable year.[91] "Nonrecaptured capital gains deductions" is the aggregate amount of allowable net capital gain adjustments for the prior taxable years beginning after December 31, 1984, that were not used to reduce the net capital loss adjustment in those years.[92]

Example: A Corp. has $40,000 net capital loss for the taxable year ended December 31, 1987. For the taxable years 1985 and 1986, A Corp. had $20,000 in allowable net capital gains adjustments, of which $10,000 was used to reduce the net capital loss adjustment for taxable year ended December 31, 1986. A Corp.'s net capital loss deduction for 1987 is $30,000 ($40,000 minus ($20,000 minus $10,000)). The Conference Report makes clear that the same net capital gain adjustment (less taxes attributable thereto) will not be used to reduce the adjustment for net capital losses more than once.[93]

The requirement that net capital loss carryovers be included in computing the net capital gains adjustment effectively prevents a corporation from counting capital losses twice in computing accumulated taxable income. Similarly, reductions to the capital loss adjustment for previously unrecaptured capital gains adjustments will prevent adjustment for both net capital losses and net capital gains in any taxable year.

The Act also adds subsection 535(b)(8), containing special rules applicable to mere holding and investment companies. First, the capital loss adjustment will no longer be available to such companies.[94] Second, however, the net capital gains adjustment will be available, but only to the extent the gain does not exceed §1212 capital loss carryovers to the taxable year.[95] Finally, for all purposes of subchapter (c), the accumulated earnings and profits of a holding or investment company, at any time, shall not be less than they would have been had §535(b), as amended by the Act, applied to all taxable years beginning after the date of enactment.

VI. Increase in Corporate Preference Reduction and Technical Changes [Act §§68 and 712(a)]

A. Introduction

TEFRA added §291 to the Code, providing for a 15 percent cutback in certain corporate tax preferences. Section 57(b) of the Code makes adjustments to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference.[96]

Section 291 reduced the excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property by 15 percent.[97] However, only 71.6 percent of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the property was treated as a corporate tax preference under the minimum tax.[98]

The bad debt reserve deduction (under §§585 or 593) was reduced by 15 percent of the amount by which the otherwise allowable deduction exceeds the amount that would have been allowable on the basis of actual experience.[99] Only 71.6 percent of the excess of the allowable deduction over what would be allowable based on actual experience was treated as an item of tax preference under the minimum tax.[100]

In the case of a financial institution, 15 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 was disallowed.[101]

The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder (under §995(b)(1)(F)(i)) was increased by 15 percent to 57 1/2 percent of certain taxable income.[102]

The amount treated as ordinary income on the sale or other disposition (including certain nonrecognition transactions) of §1250 property by a corporation was increased by 15 percent of the additional amount which would be treated as ordinary income if the property were subject to recapture under §1245.[103] The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under §1245 was reduced by 28.4 percent (*i.e.*, 71.6 percent of the remaining 85 percent of the §1250 preference would be treated as a preference for puposes of the corporate minimum tax).[104]

Fifteen percent of the basis of pollution control facilities to which an election under §169 applies was treated as if the election did not apply.[105] The minimum tax preference for the remaining property for which five-year amortization was elected was reduced by 28.4 percent.[106]

In the case of an integrated oil company, 15 percent of the amount otherwise allowable for intangible drilling costs under §263(c) was capitalized to the oil, gas, or geothermal property and deducted ratably over a 36-month period beginning with the month the costs were paid or incurred.[107]

Fifteen percent of the amounts otherwise allowable as deductions under §§616 and 617 to a corporation were capitalized and treated as if they were used to acquire recovery property assigned to the five-year class. ACRS deductions were allowed beginning with the year the expenses were incurred, and the investment tax credit was available in the year the expenses were paid or incurred.[108]

B. Overview

1. Increase in Corporate Preference Reduction

The 1984 Deficit Reduction Act generally increases the 15-percent preference cutback to 20 percent. The benefits of the new FSC legislation in the Act will be reduced by 6 ¼ percent in the case of a corporate FSC shareholder. The cutback in the depletion allowance for coal and iron ore remains unchanged. The 71.6 percent preference inclusion rule for the add-on minimum tax will be decreased to 59 5/6 percent. In addition, certain technical changes are made in order to clarify TEFRA.

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2. Effective Dates

The amendments to §§291 and 57 are generally applicable to taxable years beginning after December 31, 1984. The amendments to §291(a)(1) (affecting sales and other dispositions of §1250 property) will apply to sales or other dispositions after December 31, 1984, in taxable years ending after that date. The amendments made to §291(a)(5) (affecting pollution control facilities) will apply to property placed in service after December 31, 1984, in taxable years ending after that date. The amendments made to §291(b) (affecting drilling and mining costs) will apply to expenditures after December 31, 1984, in taxable years ending after that date. The technical changes made by Act §712(a) are retroactive to the TEFRA effective dates (generally, for taxable years beginning after December 31, 1982).

C. Detailed Analysis

1. Twenty Percent Cutback in Corporate Tax Preferences

a. Depletion for Coal and Iron Ore

The excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property is reduced by 15 percent, as under prior law.[109] Also as under prior law, 71.6 percent of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the property is treated as a corporate tax preference under the minimum tax.[110]

b. Bad Debt Reserves

The bad debt reserve deduction (under §585 or §593) is now reduced by 20 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience.[111] Only 59 5/6 percent of the excess of the allowable deduction over what would be allowable based on actual experience is treated as an item of tax preference under the minimum tax.[112]

c. Tax Exempt Interest

In the case of a financial institution, 20 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 is disallowed.[113]

d. Exempt Foreign Trade Income of a FSC

The Act reduces the benefits to corporate shareholders of the new foreign sales corporation (FSC) provision, also added by the Act. The amount of exempt foreign trade income on which tax may be deferred under §923(a)(2) is reduced from 32 percent to 30 percent, a reduction of 6 ¼ percent.[114] Alternatively, the amount of exempt foreign trade income on which tax may be deferred under §923(a)(3) is reduced from 16/23 to 15/23, also a reduction of 6 ¼ percent. Thus, the Act reduces the tax benefits available under the new FSC provision by 6 ¼ percent.

e. Section 1250 Property

The amount treated as ordinary income on the sale or other disposition (including certain nonrecognition transactions) of §1250 property by a corporation will be increased by 20 percent of the additional amount which would be treated as ordinary income if the property were subject to recapture under §1245 instead of §1250.[115] The minimum tax preference for the remaining 80 percent of the capital gain which would have been ordinary income under §1245 is reduced by 40 1/6 percent. In other words, 59 5/6 percent of the remaining 80 percent of the §1250 preference enters into the corporate minimum tax computation.[116]

f. Pollution Control Facilities

Twenty percent of the basis of pollution control facilities to which an election under §169 would otherwise apply will be treated as if the election did not apply.[117] The minimum tax preference for the remaining property for which five-year amortization is elected will be reduced by 40 1/6 percent. Thus, 59 5/6 percent of the remaining 80 percent of the §169 preference will be treated as a preference for purposes of the corporate minimum tax.[118]

g. Intangible Drilling Costs

In the case of an integrated oil company, 20 percent of the amount otherwise allowable for intangible drilling costs under §263(c) will be capitalized to the oil, gas, or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred.[119]

h. Mineral Exploration and Development Costs

Twenty percent of the amounts otherwise allowable as deductions under §§616 and 617 to a corporation will be capitalized and treated as if they are used to acquire recovery property assigned to the five-year class. ACRS deductions are allowed beginning with the year expenses are paid or incurred, and the investment tax credit is available in the year the expenses are paid or incurred.[120]

2. Technical Changes

The Act provides that the additional gain recognized as ordinary income on the disposition of §1250 property by reason of §291 is treated, for all purposes of the Code (such as §§170, 341, 453B, and 751), in the same manner as other §1250 gain.[121]

Since the investment tax credit is generally not allowed for property used outside the United States, the Act provides that no investment credit is allowed for mineral exploration and development costs with respect to mineral deposits located outside the United States.[122]

The Act clarifies that, for purposes of applying the preference cutback of §291 with respect to interest of financial institutions used to carry tax-exempt bonds, amounts paid in respect of deposits, investment certificates, or withdrawable or repurchased shares are treated as interest, whether or not designated as interest.[123]

The Act clarifies the language providing for coordination of the 36-month amortization of drilling and mining costs (which are otherwise disallowed by §291(b)(1)) with cost depletion under §611. The portion of the adjusted basis of any property which is attributable to amounts disallowed by §291(b)(1) will not be taken into account for purposes of determining depletion under §611.[124]

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VII. Nonrecognition of Gain or Loss on Stock Warrants by Issuers

A. *Background*

A corporation may, for any number of reasons, issue options to purchase shares of its stock. These are generally termed stock warrants. Typically, they have expiration dates substantially in excess of exchange traded stock options or those written off the exchange by third parties. At one time, it was generally assumed that amounts received by a corporation in exchange for such warrants should be credited to paid-in capital. If and when the warrants were exercised, the exercise price plus the amounts previously credited would be credited to stockholder equity. In other words, any consideration received for the issuing of warrants should be treated the same as amounts received in exchange for stock of the issuer.[125]

The IRS, however, in 1972, announced the position that amounts received by a corporation in exchange for warrants issued by it should be treated the same as premiums received by the grantor of stock option, *i.e.* should be treated as income if the warrants expire unexercised. From this, it also followed that if the warrants were repurchased by the issuer, gain or loss should be recognized as in the case of a closing transaction under §1234(b).[126] In Rev. Rul. 72-198, 1972-1 C.B. 223, the IRS ruled that where corporation X issued warrants on its stock to the shareholders of corporation Y in exchange for Y stock, and where the warrants expired unexercised, corporation X realized ordinary income in the amount of the fair market value of the Y stock at the time of the exchange.[127] This ruling generated immediate protests, and its application was delayed and made prospective.[128] While the American Bar Association, Section of Taxation, recommended to Congress that it take action to overrule Rev. Rul. 72-198, no such action was taken in the 1976 TRA. In the committee report relating to §1234(b), it was stated that this issue was open to question, but was not considered by Congress in connection with the revision of §1234. The report concluded "[N]o inference is intended (for the past or for the future) with respect to whether the expiration of warrants issued by a corporation should, or should not, result in recognition of taxable income to the corporation." [129] This problem was, therefore, left as unfinished legislative business.

B. *Overview*

Section 57(a) of the Act amends §1032 (relating to the exchange of stock for property) by adding at the end of the section the following sentence: "No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including Treasury stock)."

This amendment is effective as to options acquired or lapsed after July 18, 1984, the date of enactment, in taxable years ending after that date.[130]

C. *Detailed Analysis*

Under the statute, no *gain* or *loss* is recognized by a corporation from the *expiration* or the *acquisition* of an option to *purchase* or *sell* its own stock. In other words, the corporate grantor of such options is not treated as is the grantor of an option to buy or sell the stock of some third party under §1234(b). While it has long been settled that no income is recognized from the receipt of a premium for the writing or granting of an option to purchase stock or securities, since prior to the time the option either lapses or is exercised there is no closed transaction, the tax consequences of such lapse or exercise was for a long time somewhat unclear. In the case of the grantor of an option with respect to the stock of a third party, this was settled by the enactment of §1234(b). The committee's comments quoted above, show that it was unclear whether this rule applied to warrants. The amendment to §1032 makes it clear that not only is no gain recognized upon the lapse of a call or put options granted with respect to the grantor's own stock, but that no gain or loss is recognized where the option is "repurchased," *i.e.* the grantor makes payment to the option holder for the cancellation of the grantor's obligation under the option.

Of course, where options of this kind are granted in exchange for property or for services, the transaction should be treated the same as transactions involving the grantor's stock. Section 1032 has no effect on this aspect of such transaction. Valuation problems will always be present where the warrants (or put options) are untraded, as has been experienced in cases where warrants are issued as part of an investment unit.[131]

Comment: Under the effective date provision of Act §57(b), amended §1032 applies only to options acquired or lapsed after the date of enactment (July 18, 1984) in taxable years ending after that date. This leaves open the question of the validity of Rev. Rul. 72-198 with respect to acquisitions and lapses occurring before such effective date. It may be considered unfortunate by some that this effective date was not made retroactive to put an end to potential litigation concerning this matter. The IRS, position it is submitted, is a weak one at best and, if a court can be persuaded to hold it valid, would be unfair to many corporate issuers who, prior to 1972, reasonably relied on the prevailing view that amounts received for warrants (premiums as well as the exercise price when exercised) should be treated for all purposes as amounts received for stock. On the other hand, those taxpayers who claimed and were allowed loss deductions where outstanding warrants were repurchased or redeemed are protected against deficiencies for years still open.

Finally, the new provisions are effective even though the warrant issued or granted by the corporation relates to specific shares of treasury stock held by the issuer.

VIII. Repeal of Stock for Debt Exception for Cancellation of Debt Income

A. *Introduction*

For more than fifty years, it has been clear that a creditor's cancellation or extinguishment of a debtor's indebtedness generates taxable income to the debtor to the extent that the face amount of the debt extinguished exceeds the fair market value of any property received in consideration for the extinguishment, even though the debtor receives no cash or other property at the time.[132] However, where the debtor is a corporation that transfers its own stock to the creditor as consideration for the extinguish-

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ment, the courts and the IRS have traditionally taken the position that no taxable income arises even if the fair market value of the stock issued is less than the face amount of the debt cancelled, on the theory that the creditor has simply changed the form that its claim against the debtor corporation has taken.[133]

The rule that the issuance of stock in satisfaction of debt did not result in cancellation of indebtedness income was nearly eliminated, and was modified somewhat, by the Bankruptcy Tax Act of 1980.[134] Section 2(a) of H.R. 5043, passed by the House of Representatives in March 1980, would have taxed as gross income the difference between the face amount of any corporate debt — other than a debt that constituted a security within the meaning of section 166 of the Code — and the fair market value of stock issued in consideration for the cancellation of such debt. However, that provision was dropped by the conference committee considering the Bankruptcy Tax Act.

Two modifications of the stock-for-debt exception were enacted in the Bankruptcy Tax Act of 1980. First, Code §108(e)(8)(A) was added, making the exception inapplicable where only a "nominal or token" amount of stock was issued in exchange for extinguishment of any debt, including securities. The legislative history of this provision indicated that the determination of when only a "nominal or token" amount of stock had been issued would be based upon all facts and circumstances considering whether the former creditor received a real equity interest in the former debtor.[135] The second exception added §108(e)(8)(B), making the stock-for-debt exception inapplicable where an unsecured creditor received a disproportionate amount of stock in a workout. This would involve stock having a fair market value in relation to the face amount of a debt extinguished of less than fifty percent as great as the ratio of stock received by all participating unsecured creditors in the workout to the total face amount of unsecured debt extinguished.

Where either of these exceptions to the stock-for-debt exception applies, the debtor corporation realizes gross income equal to the difference between the face amount of the debt extinguished and the fair market value of the stock issued. However, under §§108(a)(1)(C), 108(c) and 108(d)(4), the former debtor corporation may elect to reduce the basis of its depreciable assets, which are deemed to include real property held for sale to customers in the ordinary course of business and interests in partnerships holding depreciable property, in lieu of an immediate recognition of income.[136]

B. Detailed Analysis

1. Legislative History

Section 59 of H.R. 4170, as passed by the House of Representatives, provided for the repeal of the stock-for-debt exception effective for transfers of stock after the date of enactment. The bill provided for exceptions where the debt extinguishment occurred in a "title 11 case" — *i.e.*, pursuant to a bankruptcy or insolvency proceeding filed under title 11 of the United States Code — or where the debtor corporation was insolvent. The House Ways and Means Committee report accompanying H.R. 4170 gave two reasons for eliminating the exception. First, the report noted the inequity of a nonrealization rule where stock is issued in consideration for the extinguishment of debt, as compared to the rule that income is realized when a debtor corporation uses the proceeds of stock issued to third parties to extinguish a debt at less than its face amount. In this latter situation, the debtor corporation would realize cancellation of indebtedness income because no stock would be issued directly in consideration for extinguishment of the debt. Second, the report noted somewhat spuriously that retirement of a debt without tax permits a debtor corporation to issue new debt having the same debt service obligation but at a higher interest rate so that a greater portion of its payments would be deductible interest. However, it would not appear that extinguishing old debt and issuing new debt in a lower face amount but carrying a greater interest rate would be in the interest of any debtor corporation because the corporation would thereby have the use of less money. Barring the right to call its obligations a profitable debtor corporation would probably not be permitted to extinguish its debt at a discount while an unprofitable corporation would have no advantage in obtaining larger interest deductions.

S. 2130, as passed by the Senate, contained no provision concerning the stock-for-debt exception to cancellation of indebtedness income. The Conference Committee retained the House version, including the exceptions for title 11 cases and insolvent debtors, and added one permanent and four transitional exceptions to the new rules.[137]

2. Analysis of New Rules

a. Elimination of Stock-for-Debt Exception

Section 59(a) of the 1984 TRA added §108(e)(10)(A) providing that, where a debtor corporation issues stock in exchange for the extinguishment of any of its debt, the debtor corporation is treated as having satisfied the debt with an amount of cash equal to the fair market value of the stock issued. In other words, the difference between the face amount of the debt so extinguished less the fair market value of the stock issued therefor constitutes gross income realized.

Because any debt so satisfied is by definition debt issued by a corporation, it will be "qualified business indebtedness" within the meaning of §108 and thus the debtor corporation may elect to reduce the basis of its depreciable assets, defined to include real property held for sale to customers in the ordinary course of business and interests in partnerships holding depreciable property, rather than take the forgiven debt into income.[138]

Two other preexisting exceptions to recognition of cancellation of indebtedness income are also potentially available to many corporations satisfying debts at a discount with stock. First, §108(e)(2) would preclude realization of income by a cash basis debtor corporation that issues stock in exchange of debts the payment of which would have given rise to deductions. Thus, for example, if a cash method corporation promises to pay $100 for ordinary services to an employee or independent contractor and satisfies such debt with $80 worth of stock, the corporation would recognize no income even though the face amount of the debt exceeded the fair market value of the stock issued by $20.

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Second, §108(e)(5) provides that the satisfaction of purchase money indebtedness at a discount results in a purchase price adjustment rather than income recognition. Thus, where a corporation satisfies its debt to a purchase money creditor with stock having a fair market value less than the amount of the debt extinguished, the debtor corporation would not realize any income but would reduce its basis in the property purchased.[139]

Example: Corp. D, an accrual method real estate dealer which is neither insolvent nor involved in a title 11 case and which owns property held for sale to customers having a basis of $500, owes C $100 for services rendered. On March 1, 1985, Corp. D issues its own stock having a fair market value of $60 to C in satisfaction of the debt. Corp. D realizes $40 of income but may elect to reduce to $460 the basis of its property held for sale to customers in the ordinary course of business. If Corp. D were a cash method taxpayer, it would realize no income on the transfer of stock in exchange for extinguishment of the debt because the payment of $100 to C would have been deductible. If Corp. D's debt to C were a purchase money debt, Corp. D would realize no income and would have to reduce the basis of the property purchased by $40.

Unlike §2(a) of H.R. 5043 that was passed by the House of Representatives in 1980, §108(e)(10) does not contain an exception to the income recognition rules for stock issued in consideration for the surrender of a security. Moreover, although §1032 was not amended by the 1984 TRA, the conference report on the act states that §1032 does not override the new rules governing stock issued for debt.[140] Therefore, it appears that corporations converting bonds into stock in otherwise tax free recapitalizations under §368(a)(1)(E) [141] must be aware of the possibility of income recognition to the extent that the face amount of each bond surrendered exceeds the fair market value of stock issued therefor. This problem will always be present where the fair market value of the bonds so exchanged is less than their face value.

The same possibility may arise whenever an acquiring corporation in a merger or otherwise tax free reorganization was indebted to the acquired corporation and the debt is extinguished in the reorganization. Although the risk is not great where a premium is paid by the acquiring corporation for the assets acquired and although it is not clear how the stock issued in the reorganization would be allocated to the indebtedness extinguished, this risk would be present where the face amount of indebtedness extinguished exceeded its fair market value. The problem would not be present in a reorganization where the acquired corporation survived the reorganization, as in a (B) reorganization, and continued to hold the outstanding indebtedness.

Example: Corp. T has assets worth $200, including $20 worth of Corp. A bonds having a face value totalling $30. In a merger qualifying under §368(a)(1)(A), Corp. T merges with and into Corp. A, with the shareholders of Corp. T receiving $200 worth of Corp. A voting common stock. Because the bonds would be extinguished as a matter of law, it would appear that Corp. A would realize $10 worth of gross income as the result of extinguishment of the bonds in the reorganization. Had Corp. A acquired all of the stock of Corp. T in a (B) reorganization and had the bonds remained outstanding in Corp. T's hands, no discharge of indebtedness income would have arisen.

b. Exception for Title 11 Cases and Insolvent Debtors

Code §108(e)(10)(B) provides that gross income does not include any difference between the face amount of debt extinguished and the fair market value of stock issued in exchange therefor if the issuance of stock is pursuant to a federal bankruptcy proceeding or to the extent that the debtor corporation is insolvent. Because the prior stock-for-debt exception to income realization applies in those cases, the debtor corporation in such cases need not reduce its tax attributes — which is the price other insolvent corporations or corporations undergoing title 11 proceedings pay for nonrecognition of cancellation of indebtedness income. However, the stock-for-debt exception as applied to insolvency cases outside of federal bankruptcy proceedings prevents income realization only to the extent of insolvency.

Example: Corp. D has liabilities exceeding the fair market value of its assets by $30. On January 1, 1985, it issues stock having a fair market value of $60 in satisfaction of a liability having a face amount of $100. Corp. D realizes no income with respect to $30 of the difference between the face amount of the debt and the fair market value of the stock and need not reduce any of its tax attributes with respect to that $30. Corp. D would realize $10 income on the transaction but could elect to reduce the basis of its depreciable assets by that amount in lieu of recognizing the income. Had Corp. D paid $60 cash for the extinguishment of the liability, it would have had to reduce its net operating loss carryovers or certain other tax attributes by $30 and would have had the election of reducing the basis of its depreciable assets by $10 or of recognizing $10 of income.

1984 TRA does not eliminate the two pre-existing exceptions to the stock-for-debt exception to cancellation of indebtedness income — for nominal stock issuance and for disproportionately low amounts of stock given to certain unsecured creditors in a workout. Presumably, these exceptions continue to apply to the issuance of stock in consideration for the extinguishment of debt in title 11 cases and by insolvent corporations. Thus, where an insolvent corporation or a corporation involved in a federal bankruptcy case satisfies debts with unusually small amounts of stock, tax attributes may be reduced. In the case of an insolvent corporation, to the extent that the cancellation of indebtedness income exceeds the amount of insolvency, the corporation may have to either reduce the basis of its depreciable assets or recognize cancellation of indebtedness income.

3. Exception for Post-1985 Qualified Workouts

The first §59(b)(1) of the 1984 TRA [142] adds §108(e)(10)(C), providing that the general rules of §108(e)(10)(A) — that a corporate debtor's gross income includes the excess of the face amount of any debt extinguished over the fair market value of stock issued in exchange therefor — does not apply to stock issued in a "qualified workout". For this purpose, the term "qualified workout" is defined as a plan under which stock is transferred to creditors in satisfaction of indebtedness if (i) due to cash flow and credit problems the corporation transferring the stock will have difficulty meeting its liabilities

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coming due in the next twelve months to such an extent that there is a substantial threat of involuntary bankruptcy or insolvency proceedings, (ii) the debtor corporation reports to its shareholders this fact and the fact that it is undergoing a workout, (iii) the holders of that least fifty percent of the corporation's total debt approve such a plan, and (iv) at least 25 percent of the corporation's total indebtedness is extinguished by the plan. The Conference Committee Report relating to this exception indicates that it will apply only if the plan is reasonably related to avoiding an insolvency or bankruptcy proceeding.[143] Presumably this provision will not immunize from income realization under Code §108(e)(8)(B) transfers of stock in a workout to unsecured creditors who received less than fifty percent of the proportionate amount of stock issued to all unsecured creditors in the plan.

The effective date of this provision is tied to the effective date for implementation of the 1976 Tax Reform Act changes to Code §382. Implementation of those provisions is scheduled for January 1, 1986. Because of the already effective exceptions to the new stock-for-debt rule of income recognition in title 11 cases and for insolvent corporations, when this exception is effective, the prior law stock-for-debt exception to cancellation of indebtedness income will apply in most cases where a financially troubled corporation issues stock in satisfaction of its debt. However, the Conference Committee Report indicates that a broad review of the interaction of the rules of §§382 and 108(e)(10) is to occur before the qualified workout exception is to be effective.[144]

4. Effective Date and Transition Rules

Elimination of the stock-for-debt exception to cancellation of indebtedness income is generally effective for transfers of stock after July 18, 1984, the date of enactment of the 1984 TRA. However, there are four exceptions to this transition rule, one of which may apply indefinitely and the other three of which would apply only to pre-1985 transfers of stock. All of these exceptions were added by the Conference Committee.

a. Exercise of Pre-June 7, 1984 Options or Conversion Rights

The second of the two sections designated §59(b)(2) in the 1984 TRA contains an exception to the new stock-for-debt rules where stock is issued in consideration for the extinguishment of indebtedness pursuant to a pre-June 7, 1984 option. The Conference Committee Report makes clear that this exception applies to convertible debentures and similar instruments and immunizes the issuing corporation from income realization whenever the option is exercised or the conversion occurs.[145] Apparently, the option or conversion right need not be in writing for the exception to apply.

b. Pre-1984 Transfers

Section 59(b) of the 1984 TRA also contains three exceptions for certain pre-January 1, 1985 transfers of stock in consideration for the extinguishment of debt. The first of these is for stock transfers pursuant to a written contract binding at all times on and after June 7, 1984, but only if the transferee of the stock held the debt so extinguished at all times on June 7, 1984.[146] The second of these exceptions applies where a debtor corporation transfers stock to another corporation, which on June 7, 1984, owned at least 75 percent of the fair market value of the debtor corporation's stock if, immediately after the transfer, the transferee of the stock owns at least 80 percent of the fair market value of the transferor corporation's stock.[147] The third of these exceptions, which will no doubt have broad application, is for transfers of stock covered by a November 1983 debt restructure agreement which was specified in a registration statement filed with the Securities and Exchange Commission on March 7, 1984.[148]

IX. Preferred Stock Eligible for §1244 Treatment [Act §481]

A. Introduction

Under Code §1244, if an individual sustains a loss on stock that meets certain definitional criteria, referred to as "§1244 stock," and if the stock was issued to that individual or to a partnership of which that individual was a partner at the time of issuance, up to $50,000 of the loss (or $100,000 in the case of a husband and wife filing a joint return) will be treated as an ordinary loss.[149] The definitional criteria, generally speaking, have historically been as follows: (1) the stock must be common stock;[150] (2) it must be issued in exchange for money or property other than stock or securities;[151] (3) if the issuing corporation is not a new corporation, more than 50 percent of its income over its five most recent taxable years must have been derived from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock and securities;[152] and (4) the issuing corporation must have no more than $1,000,000 in equity capital at the time of issuance, including the stock in question.[153] Thus, preferred stock has historically been ineligible to be §1244 stock, and losses on preferred stock are ordinarily treated as capital losses.

B. Overview

The Act makes preferred stock as well as common stock eligible to be §1244 stock.

C. Detailed Analysis

Section 481 of the Act deletes from the definitional criteria of §1244 stock the requirement that such stock be common stock by deleting the word "common" where it prefaces the word "stock" in the definition of §1244 stock set forth in §1244(c)(1). In addition, the word "common" is deleted where it prefaces the word "stock" in §1244(d)(2), under which certain stock deriving its basis from §1244 stock can be treated as §1244 stock. The definition of §1244 stock is otherwise unaffected by the Act.

The legislative history of Act §481 [154] reflects Congress' desire, in modifying §1244, "to encourage new venture capital." The amendment is effective for stock issued after July 18, 1984, the date of enactment of the Act in taxable years ending after that date.[155]

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X. Tax Exemption for Federal Home Loan Mortgage Corporation Repealed

A. *Introduction*

The Federal Home Loan Mortgage Corporation, commonly called "Freddie Mac," was chartered in 1970 and is authorized to purchase or make commitments to purchase residential mortgages from the Federal Savings and Loan Insurance Corporation, Federal Home Loan Banks, any member of a Federal Home Loan Bank, or other financial institutions whose deposits or accounts are insured by an agency of the United States.[156] Freddie Mac may hold, sell, or otherwise dispose of such mortgages or interests in mortgages. Most of the funds raised by Freddie Mac come from sales of participating certificates, commonly called PCs, which represent pools of mortgages that Freddie Mac has purchased. Freddie Mac retains an interest in such pools, and guarantees payment on the certificates to purchasers.

Under a "non-Code" statute,[157] Freddie Mac was exempted from all federal, state, and local income taxation, although real property held by Freddie Mac was, and remains, subject to state and local taxation.[158] TRA 1984 repeals the federal income tax exemption, effective January 1, 1985,[159] and provides other technical changes arising from the imposition of the new tax.[160]

The apparent genesis of this proposal is the recommendation of the President's Private Sector Survey on Cost Control (the so-called "Grace Commission") to tax Freddie Mac. A Committee Print prepared by the staff of the Joint Committee on Taxation notes,

> "Effectively, [Freddie Mac] acts as a mortgage company. To the extent that [Freddie Mac] is able to maintain a strong financial position and to expand its services, it can be argued that [Freddie Mac] should not be treated differently than other mortgage companies that are not exempt from Federal income tax. It may be appropriate, however, to provide transitional rules if the exemption is repealed." [161]

B. *Overview*

The Federal Home Loan Mortgage Corporation becomes subject to Federal income tax on January 1, 1985. TRA 1984 also delineates rules that measure the cost basis of assets held on January 1, 1985, special net-operating loss rules (that parallel the rules of the Federal National Mortgage Corporation - "Fannie Mae"), as well as rules pertaining to the treatment of "participating certificates" and "replacement obligations". Special dividend received deduction rules are also provided for dividend income received by shareholders of Federal Home Loan banks that is attributable to dividend income of the Federal Home Loan Banks from Freddie Mac.

C. *Detailed Analysis*

1. *The Dividend Received Deduction*

The stock of Freddie Mac is owned by the 12 Federal Home Loan Banks (FHLB's), which are owned by federally chartered savings and loans. Under pre-TRA 1984 law, dividends received by savings institutions from a FHLB were non-deductible,[162] since FHLBs are tax-exempt.[163] Under the TRA 1984, dividends received from an FHLB out of its current year earnings and profits allocable to dividends from Freddie Mac, and dividends out of accumulated earnings and profits to the extent measured below, are "deductible"; that is, they are subject to the tax treatment of Code §§243-246.[164] For dividends paid out of current year earnings and profits, the amount "deductible" is computed as follows: [165]

1. *The Dividend Received Deduction*

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$$\frac{\text{Dividends Received by FHLB from Freddie Mac}}{\text{Total E + P of the FHLB for the year}}$$

If the dividends paid by the FHLB exceeds the bank's current year earnings and profits, the proportion of the dividends paid out of accumulated earnings and profits that is "deductible" is determined as follows: [166]

$$\frac{\text{Dividends received by the FHLB from Freddie Mac which are out of E + P of Freddie Mac for taxable years after December 31, 1984, and not taken into account in measuring the dividend out of the current year E + P}}{\text{Total accumulated earnings and profits of the FHLB as of the time such dividend is paid}}$$

For purposes of measuring the accumulated earnings and profits of an FHLB, the amount of accumulated earnings and profits on January 1, 1985, is the amount of retained earnings on that date.[167] The accumulated earnings and profits of Freddie Mac on January 1, 1985 is zero.[168]

2. *Net Operating Loss Carryovers of Freddie Mac*

In general, corporations can carry net operating losses back three years and forward fifteen years.[169] Net operating losses of the Federal National Mortgage Association, Fannie Mae, arising in 1982 or later years, to the extent that they exceed mortgage disposition losses, can be carried back ten years and forward for five years.[170] Fannie Mae mortgage disposition losses can be carried back three years or forward for fifteen.[171]

Under the TRA 1984, Freddie Mac is subject to the same carryover rules for net operating losses and mortgage disposition losses as Fannie Mae, for Freddie Mac losses occurring in taxable years beginning after December 31, 1984.[172] Net operating losses, capital losses and excess credits of Freddie Mac cannot be carried back and applied

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against income, etc., in years prior to 1985 since such years are nontaxable to Freddie Mac and such carryovers would thus provide no value to the corporation. Such amounts can be carried forward to other allowable years.[173]

3. Treatment of Participating Certificates

Under TRA 1984, income rights of Freddie Mac with regards to mortgage pool participation certificates, PCs, or similar interests in mortgages sold or issued by Freddie Mac before 1985 have no basis. Income of Freddie Mac from the sale or exchange of such certificates or interests in mortgages is taxable in the year the income is received, even if it is attributable to services, guarantees made, or other sources, before 1985.[174] Freddie Mac may not apply depreciation or amortization deductions with regards to income rights from participation certificates, collateralized mortgage obligations, or similar obligations sold or issued by Freddie Mac before January 1, 1985.[175] For purposes of determining the gain upon the sale of such income rights the basis is treated as zero.[176] Gain realized by Freddie Mac on the sale of income rights after March 15, 1984, and before January 1, 1985, are recognized on January 1, 1985.[177]

4. Treatment of Replacement Obligations

Freddie Mac may not apply deductions for interest accruing after December 31, 1984, for obligations created after March 15, 1984, that the Treasury Department determines to be a replacement for an equity or debt interest of a person, including a Federal Home Loan Bank, which existed on March 15, 1984.[178] This treatment, however, does not apply to any replacement obligation that was not created for tax avoidance purposes.[179]

D. Effective Date and Basis Rules for Assets Held by Freddie Mac on January 1, 1985

The effective date of provisions of 1984 TRA §177 is January 1, 1985, unless otherwise stated. Special basis rules for assets held on that date are noted below.

The TRA 1984 includes a set of basis rules that attempt to ensure that pre-1985 appreciation or decline in value of Freddie Mac assets are not taken into account for tax purposes. For purposes of determining gain on the sale of Freddie Mac assets — other than tangible depreciable property and any right to receive income under a mortgage PC or similar instrument — held on January 1, 1985, the basis on January 1, 1985, is the higher of the adjusted basis of the asset or the fair market value on that date.[180] For purposes of determining loss, the adjusted basis on January 1, 1985 is the lower of the two figures.[181] If the amount realized upon sale of such assets is between the adjusted basis and fair market value on January 1, 1985, no gain or loss is recognized.

For tangible depreciable property held by Freddie Mac on January 1, 1985, the adjusted basis of the property as of such date is the lower of its fair market or the adjusted basis.[182] This rule attempts to prevent Freddie Mac from claiming deductions based on pre-1985 depreciation.[183]

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[1] *See* §1504(c), permitting a life insurance companies to be treated as affiliated after it has been a member of the group for five years.

[2] Under §1504(d), an election is available to treat certain Canadian and Mexican corporations as domestic corporations and, therefore, includible corporations.

[3] §243(b)(5).

[4] §409A(l) has been redesignated by the TRA, Act §491(e), as §409(l).

[5] Rev. Rul. 79-21, 1979-1 C.B. 290.

[6] Rev. Rul. 71-83, 1971-1 C.B. 268. This ruling is contrary to *Pioneer Parachute Co. v. Comr.*, 6 T.C. 1246 (1946), aff'd, 162 F.2d 249 (2nd Cir. 1947), where the Service had successfully contended that preferred stock convertible into voting must be counted as voting stock.

[7] PLR 7938060 (June 21, 1979).

[8] Rev. Rul. 64-251, 1964-2 C.B. 338.

[9] Regs. §1.1502-76(b)(1).

[10] *Id.*

[11] H.R. Rep. No. 861, 98th Cong., 2d Sess. 831 (1984).

[12] H.R. Rep. No. 432, Part II, 98th Cong., 2d Sess. 1205-1206 (1984).

[13] In PLR 8030007 (April 14, 1980), a Technical Advice Memorandum, it was conceded that §269 did not apply to a situation in which a corporation had a substantial business purpose for acquiring managerial control (50 percent in this case) of two subsidiaries, even though two classes of common stock existed and voting rights were disproportionately allocated to one class for a period of years. The ruling concluded that because the parent corporation had a principal business purpose for acquiring managerial control, no further business purpose was required for the acquisition and ownership of the increment of voting power between managerial control (50 percent) and the 80 percent required for affiliation under §1504(a).

[14] *Id.*, at 1206.

[15] *Id.*

[16] Regs. §1.1502-32(e)(1).

[17] PLR 8022017 (February 23, 1980).

[18] Act §60, amending §1504(a).

[19] Revised §1504(a) begins, "For purposes of this subtitle . . .".

[20] Prior to the enactment of the "controlled group of corporations" definition in §1563 by the Tax Reform Act of 1969 (P.L. 91-172), the use of the affiliated group definition to fix related party status among corporations was more widespread in the Code than it is today. For example, under the investment credit provisions, whether related corporations could utilized separate $25,000 amounts in calculating the amount of taxes such credits could offset depended on the corporations' status as an affiliated group. *See* §46(a)(5), prior to amendment by the Tax Reform Act of 1969. Under present law, the availability of separate $25,000 amounts for investment credit purposes is determined under the controlled group rules of §1563(a). *See* former §46(a)(6) which has been incorporated by the TRA, Act §473, into the general business credit of §38(c)(3)(B). It should be noted that any group of corporations qualifying as an affiliated group under either the old or new versions of §1504(a) will generally constitute a controlled group of corporations under §1563(a).

[21] *See* Regs. §1.1502-76(b)(1).

[22] *Miami National Bank v. Comr.* 67 T.C. 793 (1977); Rev. Rul. 84-79, I.R.B. 1984-23, 52.

[23] H.R. Rep. No. 432, Part II, 98th Cong., 2d Sess. 1206 (1984).

[24] *See* Rev. Ruls. 65-193, 1965-2 C.B. 370, and 68-609, 1968-2 C.B. 327, modifying Rev. Rul. 59-60 and Rev. Ruls. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-213, 1980-2 C.B. 101, and Rev. Rul. 83-120, 1983-2 C.B. 170.

[25] H.R. Rep. No. 861, *supra*, 833 (1984).

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[26] *Id.*
[27] *Id.*, at 834.
[28] *Id.*
[29] H.R. Rep. No. 432, *supra*, at 1207.
[30] H.R. Rep. No. 861, *supra*, at 834.
[31] *Id.*
[32] Since the reduction in the Class A stock value was approximately 11.11% (90% - 80%/90% = 11.11%), an 11.11% reduction in the Class A voting power would leave the stock with 84.45% of the voting power.
[33] *See*, for example, Rev. Rul. 74-585, 1974-2 C.B. 143.
[34] H.R. Rep. No. 861, *supra*, at 833-834.
[35] *Id.*
[36] *See* Regs. §1.1502-75(d)(3), for the definition of a "reverse acquisition".
[37] The Subchapter S rules have a rule comparable to the one described above that bars a former Subchapter S corporation, or its successor, from filing a new Subchapter S election for the five-year period following a termination of the election. Regs. §1.1372-5(b) defines a successor corporation for Subchapter S purposes as any corporation (i) where at least 50 percent of the stock is owned directly or indirectly by the same persons who, at any time during the first taxable year for which the Subchapter S termination was effective, owned 50 percent or more of the stock of the corporation with respect to which the election was terminated, and (ii) which acquires a substantial portion of the assets of such corporation or a substantial portion of the assets which were assets of that corporation. The stock ownership portion of this definition of the successor corporation does not appear relevant in the consolidated return context because the reconsolidation question does not arise until the affiliated group reacquires stock having 80 percent of the voting power of the former affiliate's stock and 80 percent of the value of all outstanding stock of the former affiliate. This means that the focus in the definition on a "substantial portion of assets" may provide some further indication of the approach the consolidated return Regulations will take in defining a "successor".
[38] *See* Rev. Rul. 71-83, *supra*.
[39] §1504(a)(4).
[40] *See* Regs. §§1.1502-3(b) and (c) and 1.1502-21(b) and (c).
[41] *See* PLR 8022017 (February 22, 1980).
[42] Act §60(b)(1).
[43] Act §60(b)(3).
[44] H.R. Rep. No. 861, *supra*, at 834-835.
[45] *Id.* at 835
[46] Act §60(b)(4).
[47] *See* Act §60(b)(5).
[48] *See* 55 T.M., *Multiple Corporations*, for a full discussion of the allocation procedure.
[49] S. Rep. No. 169, 98th Cong., 2d Sess. 190 (1984).
[50] Act §66(b).
[51] This type of allocation is permitted under Temp Regs. §5.1561-1(d)(2).
[52] Act §66(c)(1).
[53] Act §474(b) has redesignated §21 as §15, effective for taxable years beginning after 1983.
[54] *See* §6655(i).
[55] §554(a)(1).
[56] §551.
[57] §957(a).
[58] §951(b).
[59] Regs. §1.957-1(b).
[60] Regs. §1.957-1(b)(2).
[61] Compare *Garlock, Inc. v. Comr.*, 58 T.C. 423 (1972), aff'd 489 F.2d 197 (2d Cir. 1973), cert. denied 417 U.S. 911 (1974) and *Krause v. Comr.*, 59 T.C. 681 (1973), aff'd 490 F.2d 898 (2d Cir. 1974), with *CCA, Inc. v. Comr.*, 64 T.C. 137 (1975), acq. 1976-2 C.B. 1, (withdrawn) nonacq. 1982-1 C.B. 1.
[62] *See* §§851(b) and 856(c).
[63] §856(c)(5)(B).
[64] PLR 8002026 (Oct. 16, 1979).
[65] PLR 8120107 (Feb. 20, 1981). *See also* Rev. Rul. 54-140, 1954-1 C.B. 116, in which the Service approved a paired stock arrangement which resulted from the distribution of the stock of a subsidiary by a national bank which, due to national banking regulations, could not hold the stock directly.
[66] 1981-1 C.B. 619.
[67] §1563(a)(2).
[68] §269B(a)(1).
[69] §269B(a)(2).
[70] §269B(b).
[71] §269B(c)(1).
[72] §269B(c)(2).
[73] §269B(c)(3).
[74] *See* Act §136(c), subsections (2) through (7).
[75] Act §136(c)(4). The term "qualified Puerto Rican corporation" also will mean any corporation organized in Puerto Rico if, while not described in §957(c), would be so described if any dividends it received from any other corporation described in such section were treated as gross income of the type described in such section.
[76] *See* H. Rep. No. 432 (Part 2), 98th Cong. 2d Sess. p. 1543 (March 5, 1984).
[77] *Id.* at p. 1544.
[78] Since a foreign corporation is a "stapled entity" within the meaning of new §269B(c)(2) only if 50 percent or more in *value* of its beneficial ownership is stapled, while the controlled foreign corporation rules provide that it is voting power rather than value which is determinative of CFC status, treating the stapled foreign entity as a subsidiary to the extent of the stapled interest may not always result in the treatment of that corporation as a controlled foreign corporation.
[79] H. Rep. No. 432 (Part 2), *supra*, p. 1546.
[80] *Id.*
[81] §269B(c)(3).
[82] H. Rep. No. 432 (Part 2), *supra*, at 1546.
[83] *Id.* at 1547.
[84] *Id.* at 1546.
[85] *Id.* at 1545.
[86] *Id.*
[87] Rev. Rul. 75-305, 1975-2 C.B. 228.
[88] Compare *Golconda Mining Corporation v. Comr.*, 507 F.2d 594 (9th Cir. 1974) with *Alphatype Corp. v. U.S.*, 76-2 USTC ¶9730.
[89] A "rather elaborate scheme" for achieving these results, employed by certain investment companies electing out of regulated investment company coverage, is described in H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), p. 1199.
[90] §535(b)(5)(A).
[91] §535(b)(5)(B).
[92] §535(b)(5)(C).
[93] H.R. Rep. No. 861, 98th Cong., 2d Sess. at 828.
[94] §535(b)(8)(A).
[95] §535(b)(8)(B).
[96] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 192 (1984).
[97] §291(a)(2). Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.
[98] §57(a)(8) and (b)(1)(B).
[99] §291(a)(3) and (e)(1)(A).
[100] §57(a)(7) and (b)(1)(A).
[101] §291(a)(3) and (e)(1)(B).
[102] §291(a)(4).
[103] §291(a)(1).
[104] §57(b)(2).
[105] §291(a)(5) and (c).
[106] §57(a)(4) and (b)(1)(A).
[107] §291(b)(2)(A).
[108] §291(b)(2)(B).
[109] §291(a)(2).
[110] §57(a) and (b)(1)(B).
[111] §291(a)(3) and (e)(1)(A).
[112] §57(a)(7) and (b)(1)(A).
[113] §291(a)(2) and (e)(1)(B).
[114] §291(a)(4). Act §68(b) was corrected by H. Con. Res. 328, Item 28 (1984).
[115] §291(a)(1).
[116] §57(b)(2).
[117] §291(a)(5) and (c).
[118] §57(a)(4) and (b)(1)(A).
[119] §291(b)(2)(A).
[120] §291(b)(2)(B).
[121] §291(a)(1); H. Rep. No. 432 (Part II), 98th Cong, 2d Sess. 1612-1613 (1984).
[122] §291(b)(2)(B)(ii); H. Rep. No. 432, 98th Cong., 2d Sess. 1613 (1984).
[123] §291(e)(1)(B)(iii); H. Rep. No. 432, 98th Cong., 2d Sess. 1613 (1984).
[124] §291(b)(6); H. Rep. No. 98-432, 98th Cong., 2d Sess. 1613 (1984).
[125] *See* Reiling, "Warrants in Bond-Warrant Units: A Survey and Assessment," 70 Mich. L. Rev. 1411, 1419 (1972). In the 1971 edition of Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶4.06, p. 4-27, it was stated that the issuer realizes no income from the expiration of a warrant. This was viewed as consistent with the

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exclusion of amounts received for the warrants by the corporate issuer under §118 or §1032. This statement was removed from later editions as the issue seemed unclear in view of the IRS position

[126] §1234(b) was enacted by the 1976 Tax Reform Act. Prior to that date, any gain or loss realized by the grantor of an option from the termination of his obligation thereunder was considered ordinary. *See* Rev. Rul. 78-182, 1978-1 C.B. 265. Such termination is termed a "closing transaction" by he statute.

[127] See preceding footnote.

[128] *See* Rev. Rul. 77-40, 1977-1 C.B. 228.

[129] General Explanation of the Tax Reform Act of 1976, Joint Committee on Taxation, at p. 678.

[130] Act §57(b).

[131] *See* Regs. §1.1232-3(b)(2)(ii).

[132] *United States v. Kirby Lumber Co.* 284 U.S. 1 (1931).

[133] *Comr. v. Motor Mart Trust*, 156 F. 2d 122 (1st Cir. 1946); Rev. Rul. 59-222, 1959-1 C.B. 80.

[134] P.L. 96-589.

[135] S. Rep. No. 1035, 96th Cong., 2d Sess. 17 (1980).

[136] §1017(b)(3).

[137] §59 of P.L. 96-369.

[138] §§108(c) and (d)(4) of the Code.

[139] If the property purchased with the purchase money debt so satisfied has been sold or exchanged prior to the satisfaction, presumably the corporation would have to increase the amount of gain, or reduce the amount of loss, realized on such sale or exchange by the amount of the debt forgiven.

[140] H.R. Rep. No. 861, 98th Cong., 2d Sess. 829 (1984).

[141] Regs. §1.368-2(e)(1).

[142] Due to an error in drafting, there are two provisions in the act designated as §59(b). The first §59(b), which contains the exception for "qualified workouts" discussed in the accompanying text, contains two paragraphs. The second §59(b), which concerns the effective date of the stock-for-debt provisions and transition rules, contains four paragraphs.

[143] H.R. Rep. No. 861, 98th Cong., 2d Sess. 830 (1984).

[144] H.R. Rep. No. 861, 98th Cong., 2d Sess. 830-31 (1984).

[145] H.R. Rep. No. 861, 98th Cong., 2d Sess. 830 (1984).

[146] §59(b)(2)(A) of the 1984 TRA.

[147] §59(b)(3) of the 1984 TRA.

[148] §59(b)(4) of the 1984 TRA.

[149] §1244(a) and (b).

[150] §1244(c)(1).

[151] §1244(c)(1)(B).

[152] §1244(c)(1)(C).

[153] §1244(c)(3).

[154] H. Rept. No. 98-432 (Part 2), 98th Cong., 2d Sess., p. 1581 (1984).

[155] §481(b).

[156] The Federal National Mortgage Association (Fannie Mae) and other entities also purchase mortgages. Whereas Fannie Mae purchases primarily from mortgage bankers, Freddie Mac primarily serves the savings and loan industry.

[157] 12 U.S.C. 1452(d).

[158] *Id.*

[159] Act §177(d)(1).

[160] *See generally* Act §177.

[161] Staff of the Joint Committee on Taxation, Legislative Recommendations of the President's Private Sector Survey on Cost Control within the Tax Writing Jurisdiction of the Committee on Finance, JCS 3-84, 98th Cong., 2d Sess. 6 (Feb. 7, 1984).

[162] Regs. §1.103-2.

[163] §501(c), 12 U.S.C. 1433.

[164] Act §177(b), Code §246(a). Sections 243-246 impose further limitations on the deductibility of intercorporate dividends; most notably the 85 percent deduction provided in §243(a)(1). Consequently, the amount "deductible" is further limited to the extent that these sections provide.

[165] Act §177(b), §246(a)(2)(A).

[166] Act §177(b), §246(a)(2)(B).

[167] Act §177(b), §246(a)(2)(B)(ii).

[168] Act §177(d)(4).

[169] §172(b)(1).

[170] §172(b)(1)(H)(i).

[171] §172(b)(1)(H)(ii).

[172] Act §177(c), §172(b)(1)(H).

[173] Act §177(d)(6).

[174] The tax treatment of purchasers of PCs from Freddie Mac, sellers of mortgages to Freddie Mac, and related matters are delineated in Rev. Rul. 71-399, 1971-2 C.B. 433; Rev. Rul. 72-376, 1972-2 C.B. 647; Rev. Rul. 74-221, 1974-1 C.B. 365; Rev. Rul. 74-300, 1974-1 C.B. 169; Rev. Rul. 80-96, 1980-1 C.B. 317; and Rev. Rul. 81-203, 1981-2, C.B. 137.

[175] Act §177(d)(3)(A).

[176] *Id.*

[177] Act §177(d)(3)(B).

[178] Act §177(d)(7).

[179] Act §177(d)(7)(B).

[180] Act §177(d)(2)(A)(ii).

[181] Act §177(d)(2)(A)(i).

[182] Act §177(d)(2)(B).

[183] H.R. Rep. No. 861, 98th Cong., 2d Sess. 1040 (1984).

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CHAPTER 34

AMENDMENTS TO TAX TREATMENT OF REGULATED INVESTMENT COMPANIES

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I. Introduction

A. Regulated Investment Companies In General

A regulated investment company (RIC), like certain real estate investment trusts (REITs), is treated for tax purposes as a conduit through which income from investments may be distributed to shareholders without being subject to tax at the corporate level. The corporation is allowed a deduction for dividends paid (or deemed paid) to its shareholders. In order to qualify as a RIC, a corporation must satisfy numerous requirements relating to its status and income during the taxable year. If any of these requirements are not met for the taxable year, a RIC will be taxed on its corporate income without regard to the special RIC deduction for dividends paid. These requirements are set forth generally in §§851 and 852 of the Code.

First, a RIC must be a domestic corporation, other than a personal holding company as defined in §542, which, at all times during the taxable year, either (1) is registered under the Investment Company Act of 1940 (either as a management company or as a unit investment trust) or (2) is a common trust fund excluded from the definition of "investment company" under the Investment Company Act of 1940 and not included in the definition of "common trust fund" in §584(a).

Second, a corporation will not be eligible for RIC treatment unless it affirmatively has elected such treatment in its return for the first taxable year to which it wishes the election to apply. The election thereafter continues and is irrevocable for all succeeding taxable years unless the corporation becomes disqualified by reason of failing to satisfy one or more of the requirements for RIC status.

Third, the corporation must satisfy certain gross income and investment requirements set forth in §851(b). Thus, at least 90 percent of a RIC's gross income must be derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. Not more than 30 percent, however, of a RIC's gross income may be derived from the sale or disposition of stock or securities held for less than three months and, at the close of each quarter of the taxable year, at least 50 percent of the value of a RIC's total assets must be represented by cash and cash items, government securities and securities of other regulated investment companies, and certain other securities. Not more than 25 percent of the value of a RIC's total assets may be invested in the securities of any one issuer or of two or more issuers which the RIC controls and which are determined to be engaged in the same or similar trades or businesses or related trades or businesses as the RIC.

Fourth, §852 requires that, in order to be taxed as a RIC, a corporation must distribute to its shareholders at least 90 percent of its investment company taxable income for the taxable year (determined without regard to the dividends paid deduction) and 90 percent of its tax-exempt interest income for the year. A corporation which is subsequently determined, through an adjustment to its income or deductions for the taxable year, to have failed to meet the distribution requirements, may avoid disqualification as a RIC by paying a "deficiency dividend" under §860.

A RIC which meets the above requirements is taxed only on the undistributed portion of its net income at the corporate rates regularly applicable to the net ordinary and capital gains income of a corporation.[1]

B. Personal Holding Companies In General

A personal holding company (PHC) pays a tax of 50 percent on its undistributed personal holding company income.[2] The term "personal holding company" means a corporation which satisfies certain gross income and stock ownership requirements set forth in §542. To satisfy the gross income test, at least 60 percent of the adjusted ordinary gross income of a PHC must consist of personal holding company income which, in general, includes interest, dividends, rents and royalties.[3] In addition, the stock ownership test requires that, during the last half of the taxable year, more than 50 percent in value of a corporation's outstanding stock must be owned actually or constructively by or for not more than five individuals.[4]

In the absence of a statutory prohibition, a PHC might qualify as a RIC, since PHC income (consisting in large part of dividends and interest) is similar to the types of income earned by RICs. As noted above, however, prior to the Act, §851(a) excluded from the definition of the term "regulated investment company" any personal holding company as defined in §542. Thus, the Internal Revenue Service has ruled that a RIC which, due to constructive ownership, becomes a PHC by reason of five or fewer individuals continuing to own 50 percent of the RIC's stock at any time during the last half of the taxable year, will lose its status as a RIC effective as of the beginning of the tax year.[5]

C. Accounting for Short-Term Government Obligations

Under §454(b) of the Code, original issue discount on short-term obligations of the United States, or of a State, a possession of the United States, or any political subdivision thereof, or of the District of Columbia is considered to accrue for tax purposes on the date on which the obligation is paid at maturity, sold, or otherwise disposed of. Short-term obligations are those having a fixed maturity date not exceeding one year from the date of issue. Accrual basis taxpayers thus are not taxable on the discount until the obligation matures. In the case of a RIC which uses the accrual method of accounting, this rule with respect to the

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taxation of discount on short-term government obligations is at variance with the book accounting methods used in accounting for and computing distributions to shareholders.

II. Overview

A. Statutory Changes

Section 1071 of the Act amends the rules with respect to taxation of regulated investment companies in three ways:

First, the Act amends §851(a) of the Code to permit a PHC to be a RIC. In connection with this amendment the Act amends §852(e)(1) to provide that, in the case of a RIC which is a PHC, undistributed investment company taxable income will be subject to tax at the highest corporate rate (currently 46 percent).

Second, the Act amends §852(a) of the Code to provide that a corporation will not be eligible for RIC treatment unless (1) the RIC provisions apply to the company for all taxable years ending after November 8, 1983 or, (2) at the close of the taxable year, the company had no accumulated earnings and profits from a non-RIC taxable year. Section 852 also was amended by adding a new subsection (e) to provide a deficiency dividend procedure which would permit those companies having accumulated earnings and profits from a taxable year which later is determined to be a non-RIC taxable year to distribute within the 90-day period beginning on the date of the determination the accumulated earnings and profits of the non-RIC year. If the dividend deficiency procedure is followed the RIC will not lose its status as a RIC for years subsequent to the determination year. The Act in addition provides for the payment of interest by the RIC at the annual rate established under §6621 on an amount equal to 50 percent of the accumulated earnings and profits from the non-RIC taxable year for the period beginning on the last day prescribed for payment of the tax imposed for the non-RIC year and ending on the date the determination is made.

Third, the Act amends §852(b)(2) by adding a new subparagraph (F) to provide that a RIC may elect to accrue ratably the discount on short-term government obligations without regard to the requirements of §454(b).

B. Effective Dates

The amendments made by §1071 of the Act with respect to RIC status for personal holding companies and with respect to RIC status of corporations having previously accumulated earnings and profits from non-RIC taxable years generally are effective for taxable years beginning after December 31, 1982.[6] An exception is provided, however, for investment companies which were RICs for years ending before November 8, 1983, where such companies subsequently are determined to have failed to qualify as RICs for any of such years. In such case, no earnings and profits accumulated in any taxable year ending before January 1, 1984, shall be taken into account.[7] A further exception is provided for investment companies which began business in 1983 (and were not successors to another corporation), so that earnings and profits accumulated during their first taxable year will not be taken into account for purposes of applying the prohibition on the accumulation of pre-RIC earnings and profits contained in amended §852(a)(3)(B).[8] In addition, corporations which between December 31, 1981, and November 8, 1983, were engaged in the active conduct of a trade or business, sold substantially all of their operating assets, registered under the Investment Company Act of 1940 either as a management company or a unit investment trust, and qualified as a RIC for the first taxable year beginning after November 8, 1983, will be taxed as a RIC for such first taxable year ending after November 8, 1983, without being required to distribute the earnings attributable to the non-RIC years.[9]

The amendments with respect to accounting for short-term government obligations are retroactive and apply to taxable years beginning after December 31, 1978.[10]

III. Detailed Analysis

A. PHCs May Qualify As RICs

The amendment made by §1071(a) of the Act permits a PHC to qualify as a RIC but imposes a tax at the highest corporate rate (currently 46 percent) on the investment company taxable income of a RIC which is also a PHC. Since undistributed personal holding company income is taxed at 50 percent under §541, the election to be taxed as a RIC presents a slight rate advantage, assuming that the RIC provisions preempt the PHC provisions. The legislation is silent, however, on the coordination of the two provisions.

Both the House and Senate committee which considered this change believed that a PHC should be able to elect RIC status since the Subchapter S Revision Act of 1982 allows a PHC to elect subchapter S status and thus have its income taxed directly to the shareholders without the imposition of a corporate tax.[11] While the shareholders of an S corporation in general are taxable on the income of the corporation in a manner similar to the taxation of partnerships, however, a regulated investment company shareholder is taxed only on the income distributed or deemed distributed to him, with the corporation bearing the tax on the undistributed investment company income at rates generally applicable to corporations under §11 of the Code. The Subchapter S Revision Act of 1982 also provided for a tax at the corporate level to be imposed on the portion of the passive income of an S corporation representing accumulated earnings from a "pre-S" year.[12] In this respect the S corporation rules are similar to the amendments to the RIC provisions discussed below which deal with previously accumulated earnings and profits of a corporation electing to be taxed as a RIC.

B. Pre-RIC Accumulated Earnings and Profits

1. Effect on RIC Qualification

The Act amends §852(a) to provide that a corporation will not be eligible for RIC treatment unless it had elected such treatment for all taxable years ending after November 8, 1983, or at the close of the taxable year, the company had no accumulated earnings and profits from a non-RIC taxable year. The committees were concerned that operating corporations would accumulate earnings and profits, sell operating assets, invest the profits in passive investment assets, and then elect one of the types of entities (such as an S corporation or a RIC) that is treated as a conduit for tax purposes, thus converting their holdings from operating

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assets into investment assets without distributing the earnings from the operating activities.[13] As noted above, the Subchapter S Revision Act of 1982 included, in §1375, a limitation on the use by an S corporation of passive income accumulated during a "pre-S" year. The amendment made by the Act to §852(a) of the Code, therefore, is designed to prevent corporations from electing RIC status and exempting themselves from the corporate tax on those earnings. The prohibition on electing RIC status where there are accumulated earnings and profits from a pre-RIC year, therefore, primarily is directed at preventing the *future* election of RIC status by a corporation without a prior distribution of those earnings and profits.

2. Deficiency Dividend Procedure

The Act includes a procedure, similar to the deficiency dividend procedure in §860, for those corporations which may be subject to a determination resulting in disqualification as a RIC for any taxable year. A corporation in such case will not be prohibited from requalifying as a RIC by reason of having accumulated earnings and profits from the year to which the determination relates if, within 90 days after the determination is made, the corporation distributes property in an amount equal to the accumulated earnings and profits attributable to the non-RIC year (less any interest charge).[14] This distribution is not includible in the dividends paid deduction for the taxable year in which it is made,[15] and must be taken into account by the shareholders as a dividend under §301 of the Code.[16]

The Act provides for the imposition of an interest charge at the annual rate established under §6621 on an amount equal to 50 percent of the accumulated earnings and profits attributable to the non-RIC year. Interest will be imposed from the last day prescribed for the payment of tax imposed for the non-RIC year to the date on which the determination is made. As under §860, the deficiency dividend procedure is not available if the determination contains a finding that the loss of RIC status was due to fraud with an intent to evade tax.[17] Also as under §860, the term "determination" means a decision by the Tax Court, or a final judgment decree or other order of any other court of competent jurisdiction; a closing agreement under §7121 of the Code; or an agreement between the RIC and the Secretary of the Treasury agreeing to the loss of RIC status for any taxable year.[18]

3. Exceptions Provided by Effective Date Provisions

While the deficiency dividend procedure would appear to provide relief in the case of any RIC established after November 8, 1983 which had accumulated earnings and profits attributable to a non-RIC year, the effective date provisions of the Act provide further relief to certain investment companies established or registered before that date. In the case of any investment company to which the RIC provisions applied prior to November 8, 1983, no earnings and profits accumulated in any taxable year ending before January 1, 1984 need be taken into account under §852(a)(3)(B). The deficiency dividend procedure thus need not be resorted to by these corporations for earnings accumulated prior to taxable year 1984. Similarly, an investment company which began business in 1983 need not take into account earnings and profits accumulated during its first taxable year.

The Act also contains an exception for operating companies which, between December 31, 1981 and November 8, 1983, sold substantially all of their assets and became registered under the Investment Company Act of 1940, if the RIC provisions applied to those companies in their first taxable year beginning after November 8, 1983. The effect of this exception is to treat those companies as if they were RICs for all taxable years ending on or after November 8, 1983 for purposes of §852(a)(3)(A), and exempt them from the requirement to distribute pre-RIC earnings and profits. This exception (which was added in the Conference and is described as a "transitional rule")[19] appears to provide an opportunity for those corporations which have completed all of the economic steps necessary to elect RIC status by November 7, 1983, and do elect such status for their first taxable year beginning after November 8, 1983, to retain their accumulated non-RIC year earnings and profits without distributing them. Since such corporations, assuming the economic qualifications had been met by November 7, 1983, and depending upon the start of their taxable year, could elect RIC status at any time up to November 8, 1984, the Act appears to provide a "window period" for those corporations with accumulated earnings which are able to take advantage of this opportunity.

C. Accounting For Short-Term Government Obligations

The amendment permitting a RIC to accrue for income tax purposes the discount on a short-term government obligation on a ratable basis is intended to permit the RICs to conform the income tax accounting rules for short-term government obligations with the book accounting methods employed by RICs. The Act provides that a RIC must elect this treatment with respect to short-term government obligations in a manner to be prescribed by regulations of the Internal Revenue Service.[20] The amendment is effective retroactively to taxable years beginning after December 31, 1978.

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[1] §852(b).
[2] §541.
[3] *See* §§542(a)(1) and 543(a).
[4] §542(a)(2).
[5] Rev. Rul. 82-107, 1982-1 C.B. 103.
[6] P.L. 98-369, §1071(a)(5), 98th Cong., 2d Sess. (July 18, 1984).
[7] P.L. 98-369, *supra*, §1071(a)(5)(B).
[8] *Id.* §1071(a)(5)(C).
[9] *Id.* §1071(a)(5)(D).
[10] *Id.* §1071(b)(2).
[11] *See* H. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1745 (1984); and S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 825 (1984).
[12] §1375.
[13] H. Rep. No. 432 (Part 2), *supra* at p. 1745-1746 and S. Rep. No. 169 (Vol. I), *supra* at 825-826.
[14] Act §1071(a)(4), adding new subsection 852(e) to the Code.
[15] New §852(e)(2)(C).
[16] New §852(e)(2)(B)(i). Regs. §1.860-2(a)(3)(I), applicable to deficiency dividends under prior law, provide that the shareholder must take the dividend into income in the year in which it is distributed and not in the year to which the deficiency relates. It is unclear whether this rule will be applied to deficiency dividends distributed under new §852(e).
[17] *See* new §852(e)(4) and §860(i).
[18] New §852(e)(5). See also §860(e).
[19] Conf. Rep. No. 98-861, 98th Cong., 2d Sess., p. 1282 (1984).
[20] *See* Act §1071(b).

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Chapter 35

CHANGES AFFECTING SUBCHAPTER S CORPORATIONS *

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I. Technical Corrections to S Corporation Provisions [Act §§721, 712(b), 722(e)]

A. Introduction — A History of Subchapter S and Its Problems

The original Subchapter S provisions were enacted in 1958 as a measure intended to help small business.[1] At the time the Internal Revenue Code of 1954 was being drafted, the Senate Finance Committee would have authorized corporations with 10 or fewer individual shareholders to elect to be taxed under the partnership rules of Subchapter K.[2] The House bill did not contain a companion provision, however, and the measure died in the Conference Committee. When the rules we now refer to as "Subchapter S" were subsequently enacted in 1958,[3] the concept had changed markedly, although it still afforded shareholders the state law benefits of incorporation without subjecting the income of the entity to tax at both corporate and shareholder levels. Further, shareholders were allowed to deduct corporate losses on their individual tax returns (to the extent of their bases) as do partners. However, unlike partners, Subchapter S shareholders did not receive additions to basis for corporate indebtedness.[4]

Subchapter S quickly became popular, but as its provisions were supplemented by rulings, regulations and court decisions, it turned out to be one of the most complex and difficult parts of the Internal Revenue Code. Conceived to "... permit businesses to select the form of business organization desired, without necessity of taking into account major differences in tax consequences,[5] the provisions of Subchapter S have been so widely misunderstood that it has repeatedly been described in court decisions as "a trap for the unwary." [6]

Many of the earlier difficulties with Subchapter S stemmed from the often repeated misconception that a Subchapter S corporation is an "incorporated partnership." While this concept had substantial validity during the drafting of the 1954 Code, the Subchapter S corporation as it emerged from the legislative process in 1958 was by no means an "incorporated partnership." Except as specifically changed by the Subchapter S rules, all of the "normal" corporate provisions of Subchapter C apply to Subchapter S corporations. Thus, a Subchapter S corporation could have accumulated earnings and profits even though all income was taxed to its shareholders currently.

Subchapter S introduced very important non-partnership concepts such as "undistributed taxable income" and "previously taxed income." Each shareholder had to report his pro rata share of the corporation's income on his own personal tax return whether or not such income was distributed to him. Since in many cases corporate earnings were retained to build up the business, problems frequently resulted. After the end of the taxable year this undistributed income became "previously taxed income," funds which the shareholder was entitled to withdraw from the corporation without incurring any additional tax liability. Frequently, however, these undistributed profits on which a tax had been levied at a rate up to 70 percent became "locked-in."

Distributions to a shareholder in a given year were not considered to include any amount of previously taxed income until the shareholder had received in cash an amount equal to his share of the corporation's current earnings and profits for that year; nothing but money (neither notes nor tangible or intangible property) was deemed to carry out previously taxed income from the corporation. Distributions of property were characterized as either a return of capital (reducing a shareholder's basis in his stock), dividends (if the corporation had accumulated earnings and profits), or capital gains, if neither of the foregoing applied. Thus, a shareholder who had paid taxes on income never distributed to him might find that a distribution in kind of corporate assets, for example, a piece of real property that was in excess of the corporation's needs, would be a further taxable event. In addition, this previously taxed income was personal to the taxpayer and did not follow the stock if he died or sold his shares. Hence, the concept of "locked-in" income.

Subchapter S stockholders frequently tried to get around these situations by thinly capitalizing their corporations and then lending their firms the necessary operating capital. Interest on the loan was deductible by the corporation and repayment of principal was not a taxable event to the shareholder. The Internal Revenue Service attempted to discourage this practice by declaring such debt to be a "second class of stock." Since a Subchapter S corporation could only have one class of stock, such a finding meant that the corporation's Subchapter S status was terminated retroactive to the issuance of the debt and a corporate tax was owed on top of the ordinary income tax which had already been paid by the shareholders.[7] The second class of stock issue was litigated for years, and although the Service lost many of the cases, the prospect of litigation certainly had a chilling effect.

Retroactive termination of a Subchapter S election with severe tax consequences could also occur if the corporation had too much of the wrong kind of income, *i.e.*

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"passive" income. Much litigation took place to determine what types of businesses Subchapter S corporations could engage in. Worse yet, a corporation in an admittedly active business could, through circumstances beyond its control, have a disproportionately small amount of active income in a given year and thus have its election terminated. Reinstatement after termination of Subchapter S status was not available as a matter of right until five years had passed (although the Commissioner might sometimes be persuaded to exercise his discretion to permit reacquisition of Subchapter S status in a shorter period of time).

Because the use of Subchapter S corporations was so widespread, momentum for reform built up over a number of years and some changes for the better were made. No major reform took place however, until 1982, when fundamental alterations were made by the Subchapter S Revision Act of 1982 (P.L. 97-354) (hereinafter the "1982 Act"). The 1982 Act changed the tax treatment of Subchapter S corporations to more nearly resemble that accorded to partnerships, with some items of income and loss passing through to the shareholders in proportion to their interests rather than being accounted for at the corporate level. Many of the traps for the unwary were removed from the statute. With certain exceptions, S corporations were allowed to have unlimited "passive" income and thus could be used as investment vehicles. The permissible number of shareholders was enlarged to 35. S corporations [8] may issue stock of one class with different voting rights, including stock which has no voting rights at all. S corporations may now derive all of their income from sources outside the United States. Corporate losses allocated to shareholders can be carried forward indefinitely. An S corporation will not be considered to generate or to have earnings and profits after December 31, 1982 except for, and to the extent of, pre-1983 accumulated earnings and profits. Distributions (other than out of pre-1983 earnings and profits) are tax free to the extent of the shareholder's basis in his stock and the indebtedness of the corporation to him. Additional technical changes were made to cause the tax treatment of S corporation shareholders to more closely resemble that of partners. Again, however, caution is advised in this respect—Subchapter S corporations are still not "incorporated partnerships."

B. Overview of 1984 Legislation

The Subchapter S Revision Act of 1982 was found to have a number of inadequacies and inconsistencies which Congress and the Service felt needed to be remedied by legislation. In addition, changes in other parts of the Code made conforming changes necessary in the Subchapter S area. This Chapter discusses these so-called technical and conforming corrections. Some of the issues addressed by the 1984 legislation arise from errors and omissions in the 1982 legislation, others from a lack of conformity between the congressional intent as expressed in the legislative history and the words of the statute itself, or ambiguities in the 1982 legislative language, or omissions, or other items leading to a lack of symmetry.

Changes made by the Tax Reform Act of 1984 (P.L. 98-369, hereinafter the "Act" or "TRA 1984") are summarized below. A more detailed explanation follows in Part C.:

(1) The basis of a shareholder's stock is to be adjusted for the taking or recapture of the investment credit. A corresponding adjustment is to be made to the accumulated adjustments account (if applicable).

(2) The corporation's accumulated earnings and profits (if any) are to be reduced by the amount of any investment credit recapture.

(3) Several changes are to be made respecting the accumulated adjustments account of a corporation that has accumulated earnings and profits: (i) Losses may serve to create a negative balance in the account, in which case the negative balance must be offset by future income before tax free distributions can be made by the corporation; (ii) Nondeductible expenses not related to the production of tax-exempt income will also cause a reduction of the accumulated adjustments account; and, (iii) If distributions during a taxable year exceed the account balance after the year's adjustments have been made, then the amount of the accumulated adjustments account will generally be deemed to have been divided *pro rata* among all distributions made that year.

(4) Election of S corporation status may be made within two months and 15 days after the start of a short taxable year even if such year is less than two and one-half months in length. If such election is not timely made, but if it would be timely for the following year, then the election is deemed to have been made for the following year. Pre-1981 Subchapter S corporations whose status was voluntarily revoked before 1982 may reelect Subchapter S status without waiting five years.

(5) The Conference Report makes it clear that an election can only be revoked by the vote of a majority of *all* shares of the corporation, *not* just a majority of the *voting* stock of the corporation.

(6) A trust beneficiary may elect to have his trust treated as a "Qualified Subchapter S Trust" by making the appropriate election within two months and 15 days (rather than 60 days) after the trust acquires stock of the Subchapter S corporation. If the trust becomes disqualified by reason of failure to meet distribution requirements, the election is terminated as of the first day of the first taxable year beginning after the year in which the trust ceased to be a Qualified Subchapter S Trust.

(7) No gain will be recognized by an S corporation upon the distribution of appreciated property in complete liquidation under §336 or on sales of such property in connection with a §337 liquidation. The corporation will recognize no gain on the distribution of stock in a reorganization in which §§354, 355 or 356 are applicable.

(8) Changes are made in the discharge of indebtedness provisions of §108(d) to require the basis reduction election be made at the corporate rather than the shareholder level. The corporation will not be required to recognize income upon the contribution to it of its debt the basis of which had been reduced (pursuant to §1367(b)) by the pass-thru of losses after 12/31/80. A technical change is made to §108(d) regarding reduction of tax attributes in bankruptcy/insolvency.

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(9) In the year the debt of a Subchapter S corporation to its shareholder becomes worthless, such shareholder's share of corporate losses will still be applied to reduce the basis of such debt; this will have the additional effect of reducing the shareholder's short term capital loss for such worthless debt.

(10) Where losses have been applied to reduce a shareholder's basis in a debt owed to him by a Subchapter S corporation, subsequent income of the corporation allocated to such shareholder will restore the basis of the debt only to the extent it was reduced in a taxable year of the corporation beginning after December 31, 1982.

(11) If a corporation (regular corporation) elects to become an S corporation, its corporate tax preference items remain applicable for the first three taxable years after a Subchapter S election.

(12) A Subchapter S election will now terminate on the first day during its taxable year on which a formerly inactive subsidiary has gross income. This eliminates the possibility of a deliberate termination retroactive to the beginning of the year.

(13) (i) A corporation acquiring an S corporation which elects to treat the acquisition as a §338 purchase of assets will be allocated the tax consequences flowing from such election; (ii) The §1362(e)(3)(B) allocation of items of income and loss on a daily basis over the two short taxable years which may result from the termination of a Subchapter S election is no longer available if there is a sale or exchange of 50 percent or more of the stock of the corporation during the S corporation's termination year — instead there must be a "closing of the books" as of the last day of Subchapter S status; (iii) If all of the persons were shareholders in the corporation at any time in the year of termination and all persons who are shareholders on the first day following termination consent to a "closing of the books" as of the last day of Subchapter S status the §1362(e)(3)(B) allocation can be precluded.

(14) During the year following termination of Subchapter S status, with the consent of all shareholders receiving cash distributions from the corporation, such distributions will be treated as taxable dividends in order to avoid the imposition of accumulated earnings and personal holding company taxes.

(15) A corporation may elect to have the passive income rules imposed by the 1982 Act apply only for taxable years beginning after 1982 (vice 1981). By making such an election, an S corporation more than 20 percent of whose taxable income for its taxable year beginning in 1982 was passive can elect to terminate its Subchapter S election as of the beginning of that year, thus avoiding the tax on excessive passive investment income imposed by §1375. Another newly enacted provision allows the Commissioner to waive the tax on passive income in some cases.

(16) TRA 1984 changes to §1378(c) make the clarification that the grandfather provisions of the subsection cover a corporation which made an election before October 19, 1982 to be effective for a taxable year beginning in 1983. It makes the further clarification that an estate which held stock in the S corporation on December 31, 1982, is deemed to be a "qualified transferor" for purposes of the "permitted year" rules of §1378(c).

(17) For purposes of the attribution rules of §318, shareholders are treated as partners and an S corporation is treated as a partnership. This rule does not apply to make a nonshareholder constructively a shareholder.

(18) Interest and other deductible expenses owed by an accrual basis Subchapter S corporation to a cash basis related taxpayer may not be deducted prior to the time they are included in the income of such related taxpayer.

(19) For purposes of determining liability for capital gains taxes at the corporate level, the §1374(c)(2) exception has been broadened to allow the Commissioner discretion to ignore the existence of a predecessor corporation.

(20) A conforming amendment has been made to §1367(a)(2)(E) to reflect changes made by the 1982 Act.

C. Detailed Analysis

1. Investment Credit Basis Adjustment [9]

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248, hereinafter "TEFRA") required reduction of the basis of depreciable property by one half of the allowable investment credit (unless the taxpayer elected to take a reduced credit). The Act clarifies the operation of the basis reduction provisions with respect to partnerships and Subchapter S corporations. Where the basis of property owned by an S corporation is adjusted either upward or downward because of the allowance or recapture of investment credit, a corresponding adjustment is to be made to the basis of the stock of the shareholders of the corporation. The Conference Report states that corresponding adjustments are to be made to the accumulated adjustments accounts of S corporations which have accumulated earnings and profits. Presumably, such adjustments could cause the balance in the account to become negative, in which case it would have to be restored before the shareholder could receive tax free distributions. *See* C,3, *infra.*

Effective Date: As if included in TEFRA.

2. Investment Credit Recapture [10]

Act §721(e) provides a clarifying amendment to §1371(c) and (d) of the Code by stating that investment credit recapture amounts reduce the earnings and profits ("E & P") of an S corporation that has accumulated E & P. The omission of recapture amounts from subsection 1371(c) was an apparent oversight by the drafters of the 1982 Act.

Effective Date: As if included in the Subchapter S Revision Act of 1982 (hereafter the "1982 Act.")

3. Accumulated Adjustments Accounts [11]

The Act makes several changes in the provisions relating to the maintenance and operation of accumulated

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adjustment accounts by S corporations still having accumulated E & P.[12]

a. Losses of the corporation reduce the accumulated adjustment account [13] and may result in a negative balance therein.[14] While it is clear that distributions in excess of the (positive) balance in the account would constitute taxable distributions from E & P to the extent thereof, the 1982 Act did not address the issue of negative balances. The House Report makes it clear that the account may be reduced below zero and that the account must be rendered positive again (through the generation of corporate taxable income) before further tax-free distributions can be made.[15]

b. Nondeductible expenses not related to the production of tax-exempt income will also cause a reduction in the accumulated adjustments account, presumably on the grounds that such expenditures either produced a benefit for the shareholders or were nondeductible because of public policy considerations. No explanation is provided in the committee reports.

c. After adjusting the account for items of income and loss and credit and deduction at the end of the year, a "look-back" to the year's distributions is required; if they exceeded the adjusted amount in the account, the account is to be allocated *pro rata* among all distributions. The Treasury is given the authority, however, to promulgate regulations varying this rule. The Conference Report states: "It is anticipated that this authority would be used to provide a different rule where substantial amounts of stock in the corporation are sold or exchanged during the taxable year."

Effective Date: As if included in 1982 Act.

4. Additional Rules for Elections [16]

a. Election of Subchapter S status for a short taxable year can be accomplished within two months and 15 days of the start of that year even if the short year is less than two and a half months in length. The change was made to remedy an anomaly in §1362(b).

b. If an election for a short taxable year is untimely for that year, it will be considered as made for the following taxable year if timely for that year. This eliminates a possible formalistic quibble which in times past might have foreclosed an election for either year.[17]

c. The Act makes it clear that revocations that occurred before the effective date of the 1982 Act, as well as involuntary terminations, will not bar a re-election within five years under §6(e) of the 1982 Act.

Effective Dates: The provisions of paragraphs a and b above are effective for elections made after October 19, 1982. Paragraph c is effective as if included in the 1982 Act.

5. Vote Required for Revocation of Election [18]

The Conference Report explains the apparent conflict between the statute and the Senate summary of the 1982 Act by stating that the summary is in error. A majority vote of *all* stock, *not just voting stock*, is necessary to revoke a Subchapter S election.

6. Qualified Subchapter S Trusts [19]

The period of time during which a beneficiary (or his legal representative) may elect to have his trust treated as a Qualified Subchapter S Trust is extended from 60 days to two months and 15 days after such trust becomes the owner of S corporation stock. The election is made with respect to the stock of each S corporation held by the trust. The purpose of the change is to bring this section into conformity with other election provisions.

If the trust becomes disqualified by reason of a failure to meet the distribution requirements of §1361(d)(3)(B) (but continues to meet the requirements of §1361(d)(3)(A)), the Subchapter S election of the corporation(s) whose stock the trust holds is *not* terminated retroactively but on the first day of the first taxable year of the corporation beginning *after* the year in which the trust ceased to be a Qualified Subchapter S Trust. It should be noted that the rule requiring termination as of the day the trust fails to meet any of the requirements of §1361(d)(3)(A) remains unchanged. Presumably, the reason for the amendment was to preclude manipulation of tax consequences after a look-back at the year's financial results.

Effective Date: As if included in 1982 Act.

7. Corporate Liquidations and Tax-Free Property Distributions [20]

The 1982 Act (§1363) required S corporations to realize gain upon a distribution of appreciated property to shareholders as if the property had been sold at its fair market value since the shareholders became entitled to claim a fair market value basis in the property received. Although the Senate Report on the 1982 Act contains the exception "... other than distributions in complete liquidation of the corporation, ..." this is not self-evident from the statute. The Act codifies this exception. The House Report also states that it is intended that the non-recognition provisions of §337 will continue to apply to sales of property after adoption of a plan of complete liquidation.

Observation: If a shareholder distributee of appreciated property owns 80 percent or more of the corporation's stock, directly or by attribution, §1239 will operate to convert the corporation's gain on a distribution of depreciable property to ordinary income. The corporation's gain will be allocated to all the shareholders in proportion to their shareholdings. Accordingly, care must be taken not to unwittingly change capital gain to ordinary income.

The Act also states by way of clarification that the corporation will recognize no gain on the distribution of stock in a reorganization where the receipt of such stock is tax free to the shareholders under §§354-56.

Effective Date: As if included in 1982 Act.

8. Treatment of Discharge of Indebtedness [21]

a. The 1982 Act required that elections under §108(b)(5) or (d)(4) (relating to the reduction of basis of depreciable property in conjunction with a discharge of indebtedness) be made at the individual shareholder level. The TRA 1984 does away with this rule and places the

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election at the corporate level, as in a C corporation. The House Report states that this was done in order to treat all corporate shareholders in the same manner. The change would appear advantageous to Subchapter S shareholders, some of whom might not have been able to take advantage of the basis reduction option.

b. A second benefit to shareholders in the discharge of indebtedness area is the rule contained in new subsection 108(d)(7)(C) that a shareholder's contribution to the capital of his corporation of a debt owed by it to the shareholder will not result in income to the corporation. Formerly §108(e)(6) caused the corporation to have cancellation of indebtedness income to the extent that the shareholder's basis in the debt had been reduced by the pass-thru of corporate losses to the shareholder. Now such basis reduction will be disregarded for purposes of §108(e)(6). Previously, cancellation by a shareholder of a low basis debt owed him by the corporation might have caused the shareholder to recognize taxable income.[22]

c. In the case of a discharge of indebtedness in a Title 11 case or insolvency, except where the indebtedness discharged is excluded from gross income by reason of being qualified business indebtedness, any loss or deduction which is disallowed for the taxable year of the discharge because the shareholder has insufficient basis in his stock or the corporation's debt to him, is to be treated as a net operating loss for such year and subject to reduction pursuant to §108(b) prior to the other tax attributes set out therein. This provision is not discussed in the committee reports but is apparently designed to soak up tax benefits which might arise out of insolvency.

Effective Dates: In the case of paragraphs a and c, the changes are effective as if included in the 1982 Act. Changes described in paragraph b are effective as to contributions to capital made after December 31, 1980.

9. Treatment of Worthless Debt [23]

In the year the debt of an S corporation to a shareholder becomes worthless, such shareholder's share of corporate losses is applied first to reduce the basis of his stock before the shareholder becomes entitled to claim any deduction for worthless stock. The change made by the Act provides that after the basis of the stock is exhausted the year's losses will next be applied to reduce the basis of any debt of the corporation to the shareholder. This will diminish or eliminate the §166(d) short term capital loss for the worthless debt.

Effective Date: As if included in 1982 Act.

10. Application of Debt Restoration Rules [24]

This amendment was enacted to make it clear that where losses have been applied to reduce a shareholder's basis in a debt owed to him by the corporation, subsequent income of the corporation allocated to such shareholder will restore the basis of the debt *only* to the extent such basis was reduced in a taxable year of the corporation beginning after December 31, 1982.

Observation: If, for example, the taxpayer holds pre-1983 zero basis open account debt of the corporation, he might investigate the feasability of contributing same to the corporation, or at least of causing the debt to be reduced to a written obligation so that its eventual repayment will not result in ordinary income.

Effective Date: As if included in 1982 Act.

11. Corporate Preference Items [25]

Prior to the enactment of TRA 1984, §291 corporate preference items were not applicable to an S corporation. Such entity's individual tax preference items pass through *pro rata* to their shareholders. During the process of drafting the TRA 1984 the Ways and Means Committee perceived that some C corporations might be electing Subchapter S status in order to reduce their tax liability arising from certain isolated transactions. Accordingly, §1363 was amended to provide that the regular corporate preference rules will apply (in addition to the S corporation rule) for the first three taxable years after a regular corporation elects Subchapter S status.

Effective Date: As if included in 1982 Act.

12. Inactive Subsidiaries [26]

Generally, an S corporation's election is terminated if it is a member of an affiliated group. An exception is provided if the corporation owns only an inactive subsidiary, *i.e.*, a corporation which during the S corporation's taxable year had not commenced doing business or had *taxable* income. It was perceived that this rule permitted a degree of manipulation since if it were violated the election would be terminated as of the beginning of the S corporation's taxable year. The TRA 1984 amends §1361 to provide that an S corporation's election will terminate on the day its subsidiary has *gross* income. Contributions to capital by a shareholder will not constitute gross income.

Effective Date: As if included in 1982 Act.

13. Accounting Treatment on Termination of Election [27]

a. A corporation purchasing the stock of an S corporation may elect to treat such acquisition as a purchase of assets under §338. The acquired corporation's Subchapter S election terminates on the date of acquisition and it is treated as if it had sold its assets to a new C corporation whose first day of existence was the following day. The Act provides that recapture income arising out of the §338 election is reported by the C corporation. This change protects the selling shareholders from the tax consequences of an event beyond their control, the §338 election.

b. Under §1362(e)(3) the shareholders may elect to have all tax items for the S short year allocated to the S short year rather than accepting an allocation of the termination year's items on a *pro rata* daily basis. The Act amends §1362(e)(3)(B) to require the unanimous consent to such closing of the books by all persons who were shareholders during the S short year and all persons who were shareholders on the first day of the C short year.

c. Where there is a sale or exchange of 50 percent or more of the corporate stock in the S termination year, the books must be closed at the end of the S short year and the *pro rata* allocation prescribed by §1362(e)(2) is not applicable. This change also protects the selling shareholders from unanticipated tax consequences.

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Effective Dates: The provisions of paragraph a will not apply if the purchasing corporation can establish that a contact for the purchase of the S corporation stock entered into on or after October 19, 1983 and before enactment was negotiated on the contemplation that §1362(e)(2) (the *pro rata* allocation over the entire S termination year) would apply. The other provisions of paragraph a, b, and c are effective as if part of the 1982 Act.

14. Cash Distributions Following Termination [28]

Under the 1982 Act a distribution of cash by a corporation within one year after its S election terminates is tax free to the extent of the amounts in the accumulated investment account. The Act permits the shareholders to whom such distributions are made during the post termination transition period to (unanamously) elect to receive taxable distributions of earnings and profits. The purpose of the amendment is to allow shareholders to avoid the imposition of personal holding company and accumulated earnings taxes in appropriate cases.

Effective Date: As if included in 1982 Act.

15. Passive Income Rules for 1982 [29]

The 1982 Act amendments to the passive income rules, preventing an S election from terminating by reason of excess passive income for a single taxable year, were made effective for years beginning after December 31, 1981. The TRA 1984 allows an S corporation to elect to have such rules apply only for taxable years beginning after 1982. This allows a corporation which had excess passive income in 1982 to cause the termination of its election as of the beginning of that year, thus avoiding the tax on excess passive income imposed by §1375. It seems unlikely that many corporations will utilize this election.

A perhaps more useful related provision allows the Commissioner to waive the tax on passive investment income if a corporation determined in good faith that it had no Subchapter C earnings and profits at the close of a taxable year and it was later determined that the corporation did, in fact, have such E & P and if, within a reasonable time after discovery of same, such earnings were distributed.

Effective Date: As if included in 1982 Act.

16. Taxable Years of Existing S Corporations [30]

Under the 1982 Act, an S corporation must use a "permitted taxable year" (12/31 or another year end allowed by the Commissioner) rather than a fiscal year of its choice if it has a more than 50 percent change in ownership after December 31, 1982 (with certain exceptions), if it seeks to change its taxable year, or if it elects Subchapter S status after October 19, 1982, the effective date of the 1982 Act provision. Act §721(m) grandfathers corporations which made an election before October 19, 1982, effective for a taxable year beginning in 1983.

One of the exceptions to the 50 percent change of ownership rule covers stock acquired by reason of death. Act §721(q) makes the clarification that stock held by the estate of a decedent on December 31, 1982 may qualify as stock acquired by reason of death, for purposes of the change of ownership rules.

Effective Date: As if included in 1982 Act.

17. Attribution Rules [31]

Under §318 of the Code, a partner is deemed to own a proportionate share of the corporate stock owned by the partnership and a partnership is deemed to own all the stock owned by the partners. Attribution of stock ownership in a corporation occurs only with respect to shareholders owning 50 percent or more in value of the corporation's stock. Act §721(j) changes this rule to provide that S corporations are to be treated as partnerships and S corporation shareholders as partners. The rule is not to be applied to make a non-shareholder constructively a shareholder.

Effective Date: As if included in 1982 Act.

18. Special Rules for Certain Expenses of S Corporations [32]

Interest and other deductible expenses owed by an accrual basis Subchapter S corporation to a related taxpayer are now allowable as deductions no earlier than the day on which such amount is includable in the gross income of the payee. This is a companion provision to §174 of the Act which amends §267 of the Code respecting partnerships and is a part of the overall tightening up of the related party rules.

Effective Date: As if included in 1982 Act.

19. Treatment of Predecessor Corporation Under Section 1374 [33]

Section 1374 is designed to stop the avoidance of capital gains taxes by a C corporation which makes a "one shot" Subchapter S election because of a non-recurring capital gain. Generally, a capital gains tax is not payable by an S corporation which has had an election in effect for the three preceeding taxable years or if it is a new corporation and it and any predecessor has been in existence less than four taxable years. The Act amends §1374(c)(2) to allow the Commissioner discretion to ignore the existence of a predecessor corporation.

Effective Date: As if included in 1982 Act.

20. Basis Adjustments in Subchapter S Stock for Percentage Depletion [34]

Act §722(e)(2) sets out a conforming amendment relating to §3(a) of the 1982 Act which added new subparagraph (c)(13) to §613A providing that in the case of S corporations, depletion deductions for oil and gas properties are to be computed separately by each shareholder.

Effective Date: For taxable years beginning after December 31, 1982.

II. Elections to Treat Subchapter S Income Under Prior Law for Purposes of Investment Interest Limit [35]

Section 1066 of TRA 1984 [36] states that for taxable years of S corporations beginning in 1983 or 1984, a shareholder may elect that any "qualified income" (income other than personal service income) which a shareholder takes into account by reason of being a shareholder "... shall be treated for purposes of section 163(d) ... as such income would have been treated but for the enactment of the [1982 Act]." However, the Conference Report cautions that "No inference is intended as to the proper interpreta-

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tion of prior law." [37] For a more detailed discussion *see* Chapter 8 (III).

Effective Date: As if included in 1982 Act.

III. Treatment under Subchapter S of Commodity and Option Dealers

Code §1374 imposes a tax on certain capital gains realized by an S corporation. To facilitate S corporation elections by options and commodities dealers, Act §102(d) exempts from this provision any gain or loss that is attributable to regulated futures contracts or a related property. In addition, for purposes of computing the passive investment income of an S corporation under §1362(d)(3) (relating to the termination of election of an S corporation having passive investment income exceeding 25 percent of gross receipts), these gains and losses shall not be taken into account. Finally, the Act provides that a commodities or options dealer may make an S corporation election within 75 days after the date of enactment of the Act, regardless of the usual requirement that the election be made on or before the 15th day of the third month of the taxable year.

For a complete discussion of these provisions, see Chapter 27.

IV. Revision of §267 Rules as Applied to S Corporations

The rule deferring the deduction of expenses and interests owed by an accrual-basis taxpayer to a related cash-basis taxpayer, applicable only to obligations of an S corporation to its shareholders under prior law, will now be extended to the obligations of a shareholder to an S corporation, obligations of partnerships to partners, and obligations of partners to partnerships. The former exception from the rule for amounts owing from an S corporation to a shareholder with less than a 2 percent interest in the S corporation has been eliminated. The rule requiring deferral of a deduction for expenses or interest of an accrual-basis taxpayer owed to a related cash-basis taxpayer until actual payment will also apply to a partnership or S corporation that owns a partnership interest in a lower-tier partnership and another partner in the lower-tier partnership, and to an S corporation or partnership and any person related (within the meaning of §267(b) or §707(b)(1)) to partners in the partnership, shareholders in the S corporation, or partners in a lower-tier partnership in which the upper-tier partnership or S corporation owns an interest. The rule will not apply to guaranteed payments to which §707(c) is applicable. Instead, the prior law requirement continues, that a partner must include such payments as ordinary income for his taxable year during which the partnership's taxable year in which the partnership deducted such payments ends. The Act also contains an exception for certain resyndications of low-income housing (within the meaning of §189(e)(5)) permitting the deduction of specified expenses and interest incurred in connection with the resyndication.

The Act amends §267(b) to broaden the relationship rules. The extension of the relationship rules will apply to both the disallowance of loss on a sale or exchange of property between related parties and to the deferral of deductions for unpaid expenses and interests owed by an accrual-basis taxpayer to a cash-basis taxpayer. Section 267 will now apply to transactions between a partnership and a corporation which are commonly controlled, and to transactions between an S corporation and a C corporation which are commonly controlled (whether by one individual, as under prior law, or by more than one person). The Act also extends §267 to transactions between groups of controlled corporations. Corporations will be treated as members of a controlled group if they satisfy the tests of §1563(a), except that a 50 percent control test will be substituted for the 80 percent control test of §1563(a). In the case of a transaction between members of a controlled group of corporations, the disallowance of a loss on the sale or exchange of property under §267(a)(1) will not apply. Instead, losses will be deferred until the property is disposed of to an unrelated third party in a transaction which results in recognition of gain or loss under consolidated return principals. Loss on a transfer to a DISC or on certain sales of inventory to a foreign member of the same controlled group, and certain foreign currency losses, will not be subject either to disallowance or deferral.

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* Parts II and III were prepared respectively by Samuel M. Maruca, Esq. and Douglas E. Jacobs, Esq., of Silverstein and Mullens, Washington, D.C.

[1] Until recently, Subchapter S corporations were referred to in the statute as "Electing Small Business Corporations."

[2] Amendment 259 to H.R. 8300, 83rd Cong., 2d Sess., proposing IRC §1351 (Subchapter R, Part I). See Senate Rept. 1622, pp. 118-19 and House Rept. 2543 (the Conference Report) p. 72.

[3] As section 64 of the Technical Amendments Act of 1958 (P.L. 85-866) which added §§1371-1377 to the Code.

[4] Except for debts of the corporation to a shareholder, as to that shareholder, pursuant to §1366(d).

[5] Senate Rept. 1983, 85th Cong., 2d Sess., p. 87.

[6] Ironically, the small businessmen Subchapter S was designed to aid have often found that expensive (and perhaps hard to obtain) expert tax advice may be required to avoid encountering serious tax problems.

[7] This additional tax was sometimes enough to render the hapless corporation insolvent.

[8] The Act introduced the "S Corporation" and "C Corporation" terminology; "Subchapter S" and "regular corporation" remain in general use, however.

[9] Act §712(b); Code §48(q)(6); H.R. Rep. No. 432 (Part 2) 98th Cong., 2d Sess., (1984) p. 1613 (hereafter House Report). H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 1226 (hereafter Conf. Report).

[10] Act §721(e); Code §1371(c)(1) and (d)(3); House Report: p. 1641; Conf. Report: p. 1226.

[11] Act §721(r); Code §1368(c) and (e)(1); House Report: p. 1645; Conf. Report p. 1225.

[12] Although an S corporation will not have E & P in any taxable year beginning after 12/31/82 for which a Subchapter S election was in effect (unless it maks a corporate acquisition and succeeds to the E & P of the target corporation pursuant to §381(a) and (c)(2)), it can have E & P attributable to years beginning before 1983 or years after 1982 for which no election was in effect.

[13] *See* §1368(e)(1)(A).

[14] Since §1368(e)(1)(A) states that the accumulated adjustment account is adjusted "in a manner similar to the [basis] adjustments under §1367," it could be implied that the account balance could not be reduced below zero. This would seem illogical, however.

[15] These provisions are *not* self evident from the statutory language and are not mentioned in the Conference Report. The amendment to §1368(e)(1)(A) states only that ". . .the phrase '(but not below zero)' shall be disregarded in §1367(b)(2)(A)."

[16] Act §721(k) and (l); Code §1362(b)(3) and (4) and 1982 Act §6(e); House Report p. 1643; Conf. Report p. 1226.

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[17] The result could have been a retroactive disqualification with exacerbated tax consequences.
[18] Code §1362(d)(1); Conf. Report p. 1226.
[19] Act §721(f); Code §1361(d)(2)(D), (d)(3) and (d)(4); House Report p. 1642; Conf. Report p. 1225.
[20] Act §721(a); Code §1263(e)(new); House Report p. 1640.
[21] Act §721(b); Code §§1363(c) and 108(d); House Report p. 1640.
[22] Ordinary income in the case of open account indebtedness.
[23] Act §721(d); Code §1367(b)(3); House Report p. 1641.
[24] Act §721(w) Code §1367(b)(2); Conf. Report p. 1226.
[25] Act §721(p); Code §1363(b)(4); House Report p. 1644.
[26] Act §721(c); Code §1361(c)(6); House Report p. 1641.
[27] Act §721(g)(h) and (t); Code §1362(e)(2), (3) & (6); House Report p. 1642.
[28] Act §721(o); Code §1371(e); House Report p. 1644.
[29] Act §721(i) and (v); Code §1375(d); 1982 Act §6(b)(3); House Report p. 1643; Conf. Report p. 1226.
[30] Act §721(m) and (q); Code §1378(c); House Report p. 1644.
[31] Act §721(j); Code §318(a)(5)(E); House Report p. 1643.
[32] Act §721(s); Code §267(f)(1)(B).
[33] Act §721(u); Code §1374(c)(2).
[34] Act §722(e)(2); Code §1367(a)(2)(E).
[35] Act §1066; House Report p. 1755; Conf. Report p. 1270.
[36] There is no change made in the Code.
[37] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 1270.

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CHAPTER 36

NEW AND AMENDED RULES RELATING TO TRANSACTIONS BETWEEN PARTNERSHIPS AND PARTNERS

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I. Overview

Subchapter K of the Code contains a comprehensive body of rules for the taxation of partnerships. The hallmark of these rules is their flexibility, allowing partners a broad range within which to shape business arrangements to meet their needs with minimum constraints imposed by the Code. These rules permit partners to allocate among themselves, relatively freely, the tax benefits and detriments of their business arrangement. To the extent that the partners' agreement is respected by the Service, partners may achieve a high degree of certainty and predictability as to tax results.

The flexibility of Subchapter K, however, has also permitted sponsors of tax shelters to accomplish the sale of tax benefits in a manner disassociated, wholly or partially, from the economic substance of the underlying business arrangement. In response to this perceived abuse, the Service at first attempted to constrict the definition of a "partnership" in order to make this form of business organization less available to sponsors of tax shelters. That effort met with only limited success. More recently, Subchapter K has been amended to impose rules designed to eliminate specific abuses or to ameliorate particular concerns. These amendments have precluded retroactive allocations and allocations without substantial economic effect, limited certain deductions claimed by partnerships, and overhauled the rules for reporting, examining and litigating items in partnership and partners' tax returns.

The Tax Reform Act of 1984 continues this trend of specific amendments to particular provisions of Subchapter K. But in the process of attempting to end abuses of the partnership form in tax-sheltered arrangements, the flexibility generally characterizing Subchapter K — particularly the ability of partners to agree among themselves concerning the tax consequences of their actions — has been markedly reduced. Instead, partners and partnerships will be constrained to adhere more closely to intrinsically less flexible patterns to be established in Treasury regulations, with a consequential increase in the uncertainty and unpredictability of ultimate tax results. It remains to be seen whether the Treasury will be able to prescribe rules which will be broad enough to cover the diverse business arrangements encompassed within the term "partnership," but are effective enough to eliminate the perceived abuses of tax shelters.

II. Mandatory Allocations with Respect to Contributed Property

A. Background

Typically, when a partnership is formed, the economic relationship between or among its partners is based on their agreement concerning the economic value of each partner's contribution to the business. If two partners form an equal partnership in which one contributes $1,000 in cash and the other contributes $1,000 in property, they would expect to share the economic profits and losses of the venture equally. Thus, if the property were sold for $1,500, each partner should realize an economic gain of $250.

However, because no gain or loss is recognized when property is contributed to a partnership,[1] the tax consequences of the transaction described above do not necessarily follow its economic consequences. Since the contribution of property to a partnership is a nontaxable transaction, the basis of the contributed property to the partnership is the same as its basis to the contributing partner.[2] As a result, there may be a difference between the value of property contributed to a partnership and its basis, and that difference may distort the tax consequences of a partnership transaction. Thus, in the above illustration, if the basis of the contributed property is $800, the partnership will realize taxable income of $700 upon a sale of the property for $1,500. If that taxable income is also allocated equally between the partners in accordance with their agreement, the partner who contributed $1,000 in cash and realized a $250 economic gain will be taxed on $350 of taxable income, while the partner who contributed $1,000 in property and realized (at least for the moment) a $450 economic gain ($200 in precontribution appreciation and $250 in post-contribution appreciation) will also be taxed on $350 of taxable income. This distortion is, in theory, a temporary one, because if the partnership were liquidated and its net assets distributed in accordance with the partners' agreement, the amount of the distributions in relation to the basis of each partner in his partnership interest would compensate for and correct the initial distortion caused by the difference between the value of the contributed property and its basis. For example, after the sale, the partner who contributed cash would have a basis of $1,350 in his partnership interest (his $1,000 capital contribution plus his $350 share of taxable income), but would receive a distribution of $1,250 (one-half of the partnership's assets),

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resulting in a $100 loss. That loss, in theory, offsets the excess $100 of taxable income, bringing the partner's economic and tax situation into balance. Similarly, the partner who contributed property would have a basis of $1,150 (his $800 of cost plus basis property plus his $350 share of taxable income), and would receive a distribution of $1,250, resulting in $100 of additional taxable income. Again, economic and tax consequences are brought to balance because the partner should ultimately realize $450 of taxable income in respect of a $450 economic gain.[3]

While the distortions caused by any difference between the value of contributed property and its basis are, in theory, self-correcting, the mechanism for that correction is, at best, imperfect. Correction may not occur until the partnership is liquidated, potentially an extended period of time. Moreover, the character of the taxable income or loss (as capital or ordinary) realized during the operating phase of a partnership's life may be different from the character of such income or loss realized at liquidation. Finally, correction will not occur if the death of a partner intervenes, resulting in an adjustment to the basis of his partnership interest to reflect its value at the date of death.

Given these difficulties, the Code (prior to its amendment by the 1984 Act) provided partners with an optional method for eliminating any distortion caused by the difference between the value of contributed property and its basis. Under §704(c)(2), partners could allocate depreciation, depletion or gain or loss among themselves "in a manner which takes into account all or any portion of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution." This option permitted partners to allocate any part or all of the precontribution difference between the basis and value of contributed property to the property-contributing partner, thereby currently eliminating some or all of the difference between tax and economic results at the outset rather than at liquidation of the partnership. Section 704(c)(2) was expressed as an option on the theory that any distortion between tax and economic results principally affected the partners themselves and was mutually offsetting between or among them, with little, if any, adverse tax revenue effect. Therefore, partners were given great latitude to adjust tax and economic results among themselves in any manner they deemed suitable.

B. Reasons for Change

In enacting §71 of the Tax Reform Act of 1984, Congress determined that the latitude allowed to partners to allocate precontribution gains or losses was subject to abuse and should be terminated. Both the Ways and Means Committee and the Finance Committee found that, because partners often have significantly different tax positions, "special rules are needed to prevent an artificial shifting of tax consequences between the partners." For example, precontribution gains or income could be shifted to a partner who is tax exempt, who is in a lower tax bracket, or who has expiring net operating loss carryovers. Conversely, built-in losses in contributed property could shift to high rate partners in need of tax shelter. A similar potential for abuse arises when a cash-method partner contributes earned but uncollected income or incurred but not paid expenses to a cash-method partnership. The post-contribution income or expense could be shifted to another partner, resulting in tax avoidance.

C. Explanation

To preclude this abuse, §71 of the 1984 Act amends §704(c) of the Code to require that the allocation of tax consequences between or among partners reflect the difference between the fair market value of contributed property and its basis to the partnership. Similar rules are to be prescribed for cash-method partnerships to ensure that items of income or expense that economically accrued prior to contribution are allocated to the contributing partner and not shifted improperly to other partners. These rules are to be provided in Treasury regulations. The legislative history contemplates that these regulations will require, rather than permit (as under prior law), that precontribution gains or losses, when realized, be allocated to the contributing partners. Similarly, depreciation or depletion would be allocated to each money-contributing partner based on the value of the partnership property (determined by reference to his cash contribution) rather than the partnership's basis in the property.

> *Example 1*: *A* and *B* form an equal partnership to which A contributes $1,000 in cash and *B* contributes $1,000 in inventory having a basis to *B* of $800. If the inventory is sold for $1,500, §704(c)(2), as amended, requires that the taxable income allocable to *B* would be $450, consisting of the $200 precontribution appreciation plus his one-half share of the partnership's post-contribution income; the rest of the taxable income of $250 would be allocable to *A*. *B* cannot shift income to *A* by means of their partnership agreement.
>
> *Example 2*: *C* and *D* form an equal partnership to which *C* contributes $1,000 in cash and *D* contributes $1,000 in equipment having a basis of $1,600. Assuming a 20 percent annual depreciation rate, the partnership would be entitled to a deduction of $320 per year. Since *C*'s investment in the partnership gives him a one-half interest in depreciable property worth $1,000, at the time of contribution, *C* would be entitled to aggregate depreciation of $500, or $100 per year, under amended §704(c)(2); the remaining $220 depreciation deduction must be allocated solely to *D*. *D* cannot, therefore, shift that depreciation to *C* by virtue of their partnership agreement.

It should be noted that the fair market value of contributed property is the key factor in the now-mandatory allocation of taxable income or loss, depreciation and depletion. Adjustments to the partners' agreement concerning the fair market value of contributed property could be used to shift the tax consequences among partners. In Example 2, for instance, if the partners valued the equipment at $1,600 and partner C issued his note for $600 to the partnership as an additional capital contribution, it is possible that C would be entitled to a depreciation deduction of $160 rather than $100.

In light of the foregoing possibility, the Report of the Senate Finance Committee ("Senate Report") states that "[g]enerally, the fair market value of contributed property will be determined by reference to the arm's-length dealings of the various partners as reflected in their capital accounts

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if the parties have sufficiently adverse interests and normally will not be upset by the Treasury except in cases of manipulations or abuse. The committee anticipates that the regulations may require a partnership to file a statement of the agreed fair market value of contributed property with the partnership return for the year in which the contribution is made." [4] Given the increased importance that the fair market value of contributed property will have in the calculus of allocating tax benefits and burdens among partners, there could be closer IRS scrutiny of transactions incident to the organization of a partnership, and the tax consequences of those transactions will not be determinable by agreement of the partners themselves and, consequently, will be substantially less predictable.

In its consideration of the legislation, it became apparent to the Finance Committee that mandatory allocations among partners of the difference between the adjusted basis and value of property must be eliminated through special allocations of depreciation or depletion. Any new rules will have to address the various problems posed when more than one property is contributed by a partner (*i.e.*, whether the basis of several properties can be aggregated); when more than one partner contributes property; when property has built-in depreciation or investment credit recapture; when contributed property is disposed of in exchange for property having a substituted basis; when there are disproportionate profit and loss-sharing arrangements provided in the partnership agreement; and when property is retained by the partnership after the contributing partner disposes of his partnership interest. Given this list of concerns, it is evident that any Treasury regulations under §704(c)(2) will, of necessity, be at least as complex as those now proposed under §704(b).[5]

In short, the now mandatory allocation of gains, losses, depreciation and depletion to reflect the difference between the value and the basis of property contributed to a partnership does reduce (but not wholly eliminate) the potential for tax avoidance by shifting the incidence of tax among partners in a partnership agreement. As a result of this change, the rules governing the taxation of partnership have become less flexible and the results somewhat less predictable; it is likely that tax practitioners will be faced with another intricate set of partnership regulations implementing this mandatory allocation and then abating its consequences in certain circumstances.

D. Effective Date

The mandatory allocation provision applies to property contributed after March 31, 1984, in taxable years ending after that date.

III. Character of Gain or Loss on Contributed Property

A. Background

The character of gain or loss on the disposition of property distributed by a partnership to a partner is generally determined with reference to the distributee-partner. This general rule does not apply, however, if the distributed property consists of unrealized receivables or inventory items. Section 735 provides that in the case of unrealized receivables,[6] gain or loss on disposition by the distributee-partner is treated as ordinary income or ordinary loss, regardless of the duration of the distributee-partner's holding period.[7] Gain or loss on the sale or exchange of inventory items [8] is treated in the same manner, but only if it is sold or exchanged by the distributee-partner within five years from the date of distribution.[9] The purpose of these provisions is to prevent partners from converting potential ordinary income gain on partnership assets into capital gain. Even if the distributed receivables or inventory would be considered investment property in the hands of the distributee, any gain on a subsequent sale, even gain attributable to post-distribution appreciation, will be ordinary in nature (subject to the five-year limit for inventory).

B. Reasons for Change

Prior to the Tax Reform Act of 1984, the Code did not provide specific rules for characterizing gain or loss on disposition by a partnership of property contributed by a partner. Under case law and IRS rulings, this determination generally is made at the partnership level.[10] With respect to property contributed to a partnership, the absence of restrictions similar to those applicable to contributed property (§735) has permitted taxpayers to alter the character of potential gain or loss by contributing property to a partnership and causing the partnership to dispose of the property. For example, a real estate dealer may convert potential ordinary income gain into capital gain by contributing the real estate to a non-dealer partnership for subsequent sale by the partnership. The gain realized on the sale flows through the partnership to the partner under §702. Conversely, a taxpayer who owns capital assets that have declined in value may convert the potential capital loss into ordinary loss by contributing the assets to a partnership that is engaged in trading similar assets.

The Report of the Committee on Ways and Means ("House Report") evidences a particular concern on the part of Congress that prior law enabled an investor in securities to receive the benefit of capital gain on appreciated stock by selling it himself, while converting capital losses on stock to ordinary losses through the simple mechanism of a partnership contribution. The new provisions are designed to obviate this abuse by fixing the character of gain and loss on certain types of property (generally, the same properties subject to §735) at the time of contribution to the partnership.

C. Overview of Amendments

Act §74 essentially imports the rules of §735 into Subpart A, part II of subchapter K (relating to contributions to a partnership) as new §724. The character of potential gain on unrealized receivables will be permanently fixed as of the date of contribution. In the case of inventory items and property having built-in capital loss potential, the ordinary income asset characterization will expire five years after the date of contribution.

If property subject to the restrictions of §735 and new §724 is transferred in a nonrecognition transaction (other than a §351 exchange), the tax treatment mandated by §735 or §724 (as the case may be) will attach to the property received in the exchange ("substituted basis property").

By special provision, the characterization rules under §§735 and 724 will not apply to property used in a trade or

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business (*i.e.*, §1231 property), regardless of whether the property is held for the period required under §1231(b).

D. Effective Dates

The new rules will apply to property contributed to a partnership or distributed by a partnership after March 31, 1984, in taxable years ending after that date.

E. Explanation

1. Contributed Property

New §724(a) provides that property constituting an unrealized receivable in the hands of a partner will retain that character indefinitely in the hands of the partnership. Disposition of the property by the partnership will generate ordinary income or loss. An "unrealized receivable" is any right to payment for inventory or services (to the extent not previously included in income by the contributing partner).[11]

Property that was an inventory item in the hands of the contributing partner will retain that characterization for a five-year period commencing on the date of contribution. For purposes of this section, the term "inventory item" includes (1) §1221(1) property (stock in trade and property held by the contributing partner primarily for sale to customers); (2) any other noncapital assets, other than §1231 property; and (3) foreign investment company stock.[12] Section 1231 property that was not held prior to the contribution for the holding period required under §1231(b) will not be treated as inventory property for purposes of §724.[13] Thus, §1231 property that would have qualified for capital gain treatment had the contributing partner continued to hold it will not receive less favorable treatment after the contribution.

The rules applicable to inventory items also apply in the case of property having capital loss potential in the hands of the contributing partner.[14] The partnership must retain such property for a minimum of five years if it is to avoid capital loss treatment on disposition. A premature disposition will result in capital loss to the extent that the adjusted basis to the contributing partner exceeded the fair market value of the property at the time of the contribution (*i.e.*, to the extent of losses that were not realized by the partner prior to the contribution.[15]

2. Substituted Basis Property

In the case of any property that is subject to the rules of §§724 and 735, a disposition by the partnership or the distributer-partner, respectively, in a nonrecognition transaction will not purge the property of its ordinary income or capital loss characterization.[16] This rule applies to a series of nonrecognition transactions as well.[17] The House Report states, however, that these "basis tainting rules" are intended to apply only for the period during which the property would have been treated as ordinary income or capital loss property had it not been disposed of. Thus, for example, property received by a partnership in a tax-free disposition of capital loss property occurring three years after contribution of the capital loss property will retain its capital loss character for two rather than five years.

The substituted basis rule does not apply to stock of a C corporation received in a §351 exchange. Because corporate gains and losses, unlike those of a partnership or S corporation, do not pass through to the owner of the business, the corporate form does not permit the conversion of gain or loss through contributions and distributions of property. The potential for abuse, therefore, is not present in the case of a §351 transaction.

IV. Treatment of Payments for Property or Services

A. Background

Under the taxing scheme of Subchapter K, a partnership is not, as such, a taxable entity.[18] Instead, items of income, gain, loss, deduction or credit attributable to partnership activities flow through and are taxed directly to the partners. Partners are free to allocate these items by agreement among themselves, provided that the allocation reflects the economic substance of the underlying business arrangement.

Although a partnership is not a tax-paying entity, the income and expenses incurred in the course of the partnership's business are determined at the partnership level in the same manner as in the case of any taxpayer.[19] A partnership is therefore subject to the usual rules governing computation of taxable income. Amounts paid by a partnership for new buildings or improvements to property must be capitalized, rather than currently deducted.[20] The Code specifically provides that no deduction is permitted for expenses incurred in organizing a partnership or in promoting or selling partnership interests,[21] although partnership organizational expenses may be amortized over five years at the election of the partnership.[22]

When a partnership pays a third party (*i.e.*, a non-partner) for property or services, the proper tax treatment of the expenditure under the foregoing principles is relatively clear. The situation is otherwise in the case of payments by a partnership to a partner. The tax effects of such payments depend upon the capacity in which the partner engaged in the transaction. If, in providing property or services to his partnership, the partner acted in his capacity as a non-partner, the transaction is viewed as having occurred between the partnership and a third party, and is taxed in accordance with the general provisions of the Code.[23] On the other hand, if the partner acted as a partner in the transaction, amounts paid to him by the partnership are generally treated as a distributive share of partnership income.[24] Whether a partner is acting as a partner or in his capacity as a third party depends upon all of the facts and circumstances surrounding the transaction. Under the Treasury Regulations, the substance of the transaction, rather than its form, is controlling.[25]

B. Reasons for Change

The legislative history of the 1984 Act evidences a concern on the part of Congress that the partnership form has been used to avoid Code rules governing the characterization of items of income and expense. For example, if a partner provides services to his partnership in the form of managing and supervising the construction of a shopping center, the partnership must capitalize amounts paid to the partner as part of the cost of the shopping center. If instead of paying the partner directly, and without regard to the income generated by the shopping center, the partnership specially allocates a share of its income (and makes a

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corresponding distribution of cash) to the partner, the partnership has effectively skirted the capitalization requirement. The allocation of income in payment for services reduces the taxable income otherwise allocable to the remaining partners, just as if the partnership had taken a current deduction in the amount of the payment.

In this example, the tax consequences to the service partner are identical whether he receives payment directly or in the form of an allocation of income and concomitant distribution. But, as noted by the Senate Finance Committee, the latitude in gain allocation afforded partnerships may permit a service partner to convert ordinary income into capital gain.[26] This will occur if the partnership specially allocates capital gain income and makes a distribution to the partner in payment for services.

A similar tactic has been used to convert part of the purchase price for real estate into a current deduction. In *Ellison v. Comr.*,[27] the Tax Court held that reserved rents paid by two partnerships to the sellers of two apartment buildings constituted part of the purchase prices for the buildings, and therefore must be included in the taxable income of the partnership. The petitioners argued unsuccessfully that the sellers received the reserved rents as distributive shares of partnership income.

Of greatest concern to Congress is the treatment of organization and syndication expenses. As noted above, neither organizational nor syndication expenses of a partnership are deductible currently. Organizational expenses may be amortized over five years (or capitalized and recovered over the life of the partnership), but syndication expenses are never deductible.[28] An allocation of partnership income and a related distribution to a partner that in substance constitute payment for the partner's services in organizing or syndicating the partnership in effect permits a current deduction for these expenses.

C. *Overview and Effective Date*

TRA §73 amends §707(a) to provide that if (1) a partner performs services for or transfers property to a partnership, (2) the partnership makes a related allocation and distribution to the partner, and (3) the provision of services or property and the allocation and distribution, viewed together, are "properly characterized" as a transaction between the partnership and a non-partner, then the transaction will be so characterized.[29] The partnership will be required to treat the payments as if made to a non-partner for purposes of tax accounting and the computation of the partnership's taxable income.

The Act authorizes the Secretary of the Treasury to promulgate regulations for implementing the new provision, which will apply to services performed or property transferred after February 29, 1984.[30]

D. *Explanation*

Drafting regulations that clearly delineate the circumstances in which the new provision will apply will not be an easy task. Arrangements for disguising capital expenditures of a partnership as income allocations coupled with cash distributions may be difficult to distinguish from bona fide allocations and distributions to partners. Under long-standing partnership taxation rules, the contribution of property to a partnership in exchange for an interest in the partnership is a nonrecognition transaction.[31] Moreover, a partner *qua* partner is entitled to share in the income generated by his efforts on behalf of the partnership, or by property he has contributed to the partnership's business.

The Report of the Senate Finance Committee describes, in considerable detail, the factors that should be taken into account under the regulations in determining whether an allocation and distribution is made to a partner in his capacity as such. The first factor, considered to be the most important, is whether the payment is subject to the risk of the partnership's business. The theory here is that to the extent an allocation and distribution to a partner is reasonably certain to occur, the partner is acting in an individual capacity in providing services or property and should be treated as, in effect, an independent contractor. Conversely, the presence of substantial entrepreneurial risk as to the amount and fact of payment is characteristic of a genuine allocation and distribution. As examples of risk-limiting arrangements, the Report refers to "capped" allocations and allocations fixed as to duration, when it is "reasonably certain" that the partnership will have sufficient income to pay the stipulated amount.

One obvious difficulty with this concept is that it requires a prediction as to the amount of income that will be generated by the partnership's business. In some instances, for example where the partnership owns fullyleased commercial real estate, profits may be predicted with some confidence. In other types of enterprises, however, there may be no basis for projecting an income stream with any accuracy. Unless the Treasury is able to devise workable standards for gauging the likelihood of an allocation, much uncertainty will accompany tax planning in this area.

Comment: It will be interesting to observe not only how, but *when* the possibility of payment will be measured. Theoretically, the likelihood of payment should be determined at the time of the transaction, not years later when the partnership has in fact made (or not made) the payment.

The second and third factors discussed in the Senate Report are more susceptible to quantification in regulations. These factors are the duration of the payee's partnership status and the timing of the payment in relation to the provision of services or property. If partner status is transitory, an allocation and distribution resembles a fee rather than a return on investment, and the "partner" will be viewed as having joined the partnership for tax-motivated purposes. If an allocation and distribution is proximate in time to the performance of services or transfer of property by the recipient partner, the transactions are likely to be regarded as related. Conversely, allocations remote in time from the provision of services or property are more likely to be respected (in part because the risk of nonpayment increases with time). With respect to these factors, the regulations could provide numerical tests or presumptions which, even if arbitrary, would to some degree reduce the uncertainty inherent in a facts and circumstances standard.

The fourth factor focuses on the recipient partner's motivation in becoming a partner, *i.e.*, whether based on the facts and circumstances it appears that tax consider-

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ations caused the association. This factor does not appear to contribute significantly to the analysis. Apart from the difficulties usually incurred in applying a standard based on the taxpayer's subjective intentions, it would seem that the test will involve nothing more than a reconsideration of the other specific factors set out in the Report.

The fifth factor is whether the allocation in question is disproportionately large in relation to the recipient partner's continuing interest in partnership profits. A short-term allocation that is larger than the recipient's general profits interest suggests that the allocation is a disguised fee. This factor is functionally related to the question of the duration of a partner's status as a partner. Each factor measures the substantiality of the partner's relationship to the partnership to determine whether the partner providing services or property is doing so in his capacity as a partner.

The sixth and final factor is whether the requirement that capital accounts be respected under §704(b) and the proposed allocation regulations [32] makes disguised payments for property economically unfeasible, and therefore unlikely to occur. The Report states that this will generally be the case unless, for example, the property contributed by the partner is undervalued, resulting in an understatement of the partner's capital account. The precise thrust of this factor is unclear. The underlying theory apparently is that when a partner's capital account reflects the full value of contributed property, a further special allocation of income and distribution to the partner (which would not reduce his capital account balance) would be unacceptable to the remaining partners. If capital accounts are respected, the recipient partner will be entitled to receive the full value of the property on liquidation (assuming no further allocations and distributions) despite the prior distribution to him of cash commensurate with the property's value.

The Senate Report specifically contemplates the bifurcation of an allocation and distribution in certain circumstances. If an allocation is determined to be only partly related to services or property provided by the recipient, the provision will apply so as to recharacterize the appropriate portion of the allocation.

The Senate Report provides two examples [33] illustrating the application of the foregoing factors. In the first example, a partnership constructs an office building that is projected to generate $100,000 of annual gross income. The architect of the building (whose normal fee would be $40,000) contributes cash to the partnership in return for (1) a 25 percent partnership interest, (2) a 25 percent share of net income, and (3) an allocation of $20,000 per year of gross income for the first two years after leaseup. The partnership agreement requires that $20,000 in cash be distributed to the architect in each of the first two years. For the following reasons, the allocation and distribution would be treated as a fee under §707(a):

> (1) The allocation is fixed in amount and there is a substantial probability that the partnership will have sufficient gross income and cash to make the allocation and distribution;
>
> (2) The architect's general profits interest is small in relation to the allocation at issue;
>
> (3) The distribution is close in time to the provision of the services; and
>
> (4) Based on all of the circumstances surrounding the transaction, it appears that the architect became a partner primarily for tax reasons.

The example goes on to state that if the partnership agreement allocates 20 percent of gross income (rather than $20,000) for two years, the tax treatment of the allocation will depend on the likelihood that the architect will receive substantially more or less than the imputed $40,000 fee. If the building was constructed on speculation (*i.e.*, the partnership may have difficulty leasing the building), the allocation might, even though a gross income allocation, be treated as a genuine distributive share, since the architect would assume a risk of nonpayment. His fortunes (unlike those of a third-party contractor) would be at the risk of the business.

The second example demonstrates that even allocations that are contingent in amount may be treated as fees:

> "[A] partnership is formed to invest in stock. The partnership admits a stock broker as a partner. The broker agrees to effect trades for the partnership without the normal brokerage commission. In exchange for his partnership interest, the broker contributes 51 percent of partnership capital and receives a 51 percent interest in residual partnership profits and losses. In addition, he receives an allocation of gross income that is computed in a manner which approximates his foregone commissions. It is expected that the partnership will have sufficient gross income to make this allocation. The agreement provides that the broker will receive a priority distribution of cash from operations up to the amount of the gross income allocation. In this case, even though the broker/partner's special allocation appears contingent and not substantially fixed as to amount, it is computed by means of a formula like a normal brokerage fee and effectively varies with the value and amount of services rendered rather than with the income of the partnership. Thus, this contingent gross income allocation along with the equivalent priority distribution should be treated as a fee under Sec. 707(a), rather than as a distributive share and partnership distribution."

Again, however, it is assumed for purpose of this example that the partnership will have sufficient income to make the intended allocation. Once this assumption is made, fee characterization inevitably results, based on the risk analysis as set forth in the Report. By specifying in reasonable detail the means by which probability of payment is to be measured, the regulations would greatly reduce the uncertainties attending economic risk analysis.

V. New Restrictions on Disguised Sales

A. Background

Under Code §721, the contribution of property to a partnership in exchange for a partnership interest is generally a non-recognition event. The contributing partner re-

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ceives a basis for his partnership interest equal to his adjusted basis in the transferred property. Under §731, a distribution of partnership assets is not taxable to the recipient partner except to the extent that the amount of cash distributed exceeds the partner's basis in his partnership interest. A partner is, therefore, entitled to a return of his capital investment in the partnership before recognizing any gain.

The tax treatment of a sale of property by a partner to his partnership is very different from the treatment of a capital contribution under §721. A sale is taxed under §707, and is treated as occurring between a partnership and a partner acting other than in his capacity as a partner. The selling partner recognizes gain on the sale computed by applying general rules for determining gain or loss on the disposition of property.[34] The partnership generally must capitalize the purchase price of the property and recover the cost over the applicable recovery period (if any).

It is sometimes difficult to distinguish a contribution of property to the capital of a partnership from a sale. The regulations provide only limited guidance in this area. Under Regs. §1.721-1(a), the tax treatment of a purported contribution of property depends upon the underlying substance of the transaction, and not its form. If a transfer of property results in the receipt by the transferor-partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction is a sale and not a contribution. In addition, the regulations disallow tax-free treatment of a distribution under §731 if, within a short period before or after a contribution of property, other property is distributed to the contributing partner, or the contributed property is distributed by the partnership to another partner.[35] The transfer of property and accompanying distribution are treated as an exchange between the contributing partner and the partnership, or between the partners.[36]

Taxpayers and the Service have frequently tangled in litigation over the proper characterization of a transfer of property by a partner to a partnership. The courts have generally ruled in favor of the taxpayer. In *Otey v. Comr.*,[37] a leading case, the Commissioner attempted unsuccessfully to recharacterize a transaction structured by the taxpayer as a contribution of property under §721. The taxpayer and a developer had formed a partnership that was to develop an apartment complex. As his capital contribution to the partnership, the taxpayer contributed to the partnership real property having an adjusted basis of $18,500 and a fair market value of $65,000. Under the partnership agreement, the taxpayer was to receive the first $65,000 of the proceeds of a construction loan anticipated to be made to the partnership. The agreement provided further that profits, losses and distributions would be shared equally, except for the priority distribution of loan proceeds to the taxpayer. Shortly after the taxpayer transferred the property to the partnership, the partnership closed a construction loan, in the amount of $870,300, for which the partners were jointly and severally liable. On the day the loan was closed, the partnership distributed $32,500 to the taxpayer. Within five months, the partnership had made additional distributions to the taxpayer until he had received a total of $64,750, or approximately the fair market value of the contributed property.

On these facts, the Tax Court held that the transaction was a genuine contribution of property. The court based its decision on the following factors:

(1) The transaction was structured by the parties as a contribution to capital and there was no artificiality in the form selected;

(2) The property constituted the sole asset and business of the partnership, and therefore must have been transferred by the taxpayer to the partnership in his capacity as a taxpayer;

(3) The property was the only non-borrowed capital in the partnership and was a prerequisite to any borrowing by the partnership;

(4) The taxpayer was personally liable on the construction loan. Thus, the taxpayer bore the risk that the business would be unsuccessful and he would be called upon to return the cash that had been distributed to him;

(5) The transaction was a customary partnership capitalization in which the partner who puts up a proportionately greater share of partnership capital receives preferential distributions designed to equalize capital accounts; and

(6) The taxpayer could have accomplished the same results without the use of a partnership by simply mortgaging the property himself. Thus, the partnership form was not used to mask an otherwise taxable transfer.

In other cases, the IRS has taken the position that transfers of cash or property to a partnership by new partners, coupled with a distribution to existing partners in reduction of their partnership interests, should be recast as a sale of partnership interests taxable under §741. In *The Jupiter Corporation v. U.S.*,[38] the plaintiff was a general partner in a real estate joint venture. At the inception of the partnership, the plaintiff loaned approximately $4,000,000 to the partnership as partial financing for construction of an apartment building. Following completion of the project, the partnership entered into negotiations with a group of prospective investors, with the intention of using newly-invested funds to repay the plaintiff. These negotiations resulted in the sale of a limited partnership interest to a group of real estate investors. The partnership agreement provided for priority distributions to the new investors. The plaintiff would retain control as general partner over the partnership's business. The partnership thereafter distributed to the plaintiff a portion of the cash contributed by the investors.

The court held that the substance of the transaction matched its form. The parties could not have accomplished by sale what had been accomplished by reorganizing the partnership. Even though the plaintiff's general partnership interest was decreased following admission of the investors, the plaintiff retained total control over management of the partnership. Moreover, the investors, who desired limited liability and an assured return on capital, had no interest in assuming the obligations of a general partner.[39]

The legislative history of the 1984 Act reflects a dissatisfaction on the part of Congress with the results in *Otey*

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and similar cases. According to the Senate Report, the transactions at issue in these cases are "economically indistinguishable" from sales of real estate or partnership interests.[40] The TRA amendments are intended to insure that purported contributions of property are treated in a manner consistent with the underlying economic arrangement of the parties.

B. Section 707(a) Amendment and Effective Date

New §707(a)(2)(B) provides as follows:

> "TREATMENT OF CERTAIN PROPERTY TRANSFERS. – If –
>
> (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers is described in clauses (i) and (ii), when viewed together, are properly characterized as a sale of property,
>
> then such transfers shall be treated either as [occurring between the partnership and one who is not a partner] or as a transaction between two or more partners acting other than in their capacity as members of the partnership."

The Act authorizes the Secretary of the Treasury to prescribe regulations for implementing this provision.[41]

The new rule will apply generally in the case of transfers of property occurring after March 31, 1984. The Act sets forth certain exceptions to the March 31, 1984 effective date. Specifically, the new rule will not apply to a transfer that is made pursuant to a binding contract that was in effect on March 31, 1984, and at all times thereafter prior to the transfer.[42] The new rule is also inapplicable to a transfer made before December 31, 1984, if (1) the transfer was proposed in a written private offering memorandum circulated before February 28, 1984; (2) the out-of-pocket costs with respect to the offering exceeded $250,000 as of that date; (3) any encumbrances placed on the property in anticipation of the transfer secure obligations for which neither the partnership nor any partner is liable; and (4) the transferor is the sole general partner of the partnership.[43]

C. Explanation

In promulgating regulations to implement the new disguised sale provision, the Treasury is urged to keep in mind that the provision is directed at abusive practices, rather than genuine business arrangements reflecting the relative value of the partners' economic contributions to the partnership.[44] The provision is not intended to prohibit a partnership from providing by agreement for preferential distributions to partners, such as distributions intended to correct disparities in capital accounts arising from contributions of property.[45] Similarly, the provision will not affect distributions if they are reflected in capital accounts maintained in accordance with the proposed §704(b) allocation regulations.[46] The legislative history states that the rule will not be applied to a distribution that is accompanied by a corresponding allocation of income or gain, but that the new provision governing payments for property or services could apply in that situation.[47]

The Senate Report encourages the Treasury to adopt a bright-line test for determining whether a contribution and a distribution are related. The Report states that the regulations may provide for a period, such as three years, during which contributions and distributions will be presumed to be related.[48]

Comment: The obvious advantage to this formulation is that it provides a reasonable degree of certainty as to the treatment of a transaction. Nevertheless, the taxpayer should have the opportunity to show, based on all of the circumstances surrounding the transaction, that a disguised sale did not take place. If the regulations were to apply a three-year period in all events, many legitimate distributions would be subject to recharacterization as purchase payments.

With respect to transactions of the type involved in the *Otey* case, the legislative history takes conflicting positions. On the one hand, the Senate Report in effect states that the *Otey* case was wrongly decided, *i.e.*, that the transaction was the economic equivalent of a sale and should have been treated as such for tax purposes. On the other hand, the Senate and Conference Reports emphasize that the new provision will apply to a distribution of loan proceeds only to the extent that responsibility for repayment is shifted to the other partners or to the partnership's assets:

> "[W]hen a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (*i.e.*, to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner." [49]

As previously noted, one of the factors leading the court in *Otey* to hold for the taxpayer was that the partner contributing the property assumed the risk that the partnership's business would falter and that he would be required to return the loan proceeds distributed to him.[50] In light of the ambiguity in the legislative history, whether a transaction structured in this manner would survive scrutiny under the new rule is uncertain. It seems clear, however, that an assumption of liability in respect of contributed property will support to some extent a claim for taxation under §721. The other side of the coin is that the proceeds of a nonrecourse financing will likely be treated as proceeds from the sale of the property, unless other factors suggest that the taxpayer has somehow assumed a meaningful economic burden with respect to repayment of the loan.

The Senate Report specifically contemplates that under some circumstances, a transaction may be split into a sale component and a contribution component. This treatment may be appropriate where, for example, the taxpayer has personal liability for only a portion of loan proceeds distributed to him during the relevant period, or where the

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distributions are not approximately equal to the fair market value of the contributed property.

Legislative explanations of the new disguised sale provisions leave many unanswered questions, at least some of which may be resolved in the forthcoming regulations. Given the difficulties inherent in distinguishing sales from contributions in the partnership context, however, the Treasury faces what may prove to be an exasperating task.

VI. Allocation of Partnership Liabilities

A. Background

Under Code §704(d), a partner is permitted to deduct partnership losses only to the extent of the adjusted basis in his partnership interest as of the end of the year in which the losses were incurred. A partner's original basis for his interest generally includes the amount of money and the adjusted basis of property contributed to the partnership by the partner.[51] This original basis is increased by the partner's distributive share of partnership income and decreased by distributions under §733 and the partner's distributive share of partnership losses.[52]

Cash, property and partnership income are not the only sources of basis for a partnership interest. Section 752(a) provides that an increase in a partner's share of partnership liabilities (or an increase in the partner's individual liabilities due to the assumption by the partner of partnership liabilities) will be treated as a contribution of money by the partner, increasing the basis for his partnership interest commensurately. For this purpose, mortgage indebtedness is considered a liability of the owner of the mortgaged property (to the extent of fair market value).[53]

The rules for allocating liabilities among partners are set forth in Regs. §1.752-1(e), which provides as follows:

> "A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits." [Example omitted.]

Under the regulations, partners, including limited partners, are entitled to share in the nonrecourse liabilities of the partnership in the ratio in which they share profits. The reason for this allocation is that such liabilities will be amortized (if they are paid at all) only out of partnership profits.

The ability of limited partners to share in the partnership's nonrecourse liabilities, coupled with the exclusion of real estate investment from the ambit of §465 at risk rules, has fostered the use of nonrecourse financing by syndicated partnerships engaged in real estate projects. The basis increase attributable to nonrecourse mortgage liability enables the partners to deduct losses financed by debt for which they have no personal liability. Perhaps more than any other factor, this right to share nonrecourse liability for basis purposes is responsible for the exponential growth of the tax-sheltered real estate investment in the recent past. The potential benefits are substantial, even for a moderately affluent taxpayer.

> *Example*: Each of 10 investors contributes $10,000 in cash to a partnership in exchange for a limited partnership interest and a 9.9 percent share of the partnership profits. The partnership makes a $100,000 downpayment on a $1,000,000 office building, financing the balance of the purchase price with a nonrecourse mortgage. Each investor may report up to $11,800 in depreciation deductions alone for the first year that the building is in service, worth approximately $5,000 to a 42 percent bracket taxpayer filing a joint return. If not for the right to include nonrecourse liabilities in basis, the investor would be limited to $10,000 of losses in year one, and no further losses could be claimed (assuming no further increase in basis).[54]

The availability of nonrecourse mortgage financing is therefore critical to the success of a tax-sheltered real estate syndication. Prospective lenders are generally hesitant to provide such financing, however, since the lender bears the risk of economic depreciation in the mortgaged property. For this reason, the lender will often demand security, in addition to the mortgage, from either the borrower or third parties. On the other hand, the partnership as borrower will attempt to structure the loan so as to preserve the right of the partners to include the debt in the basis of their partnership interests.

One device that has been utilized to accommodate the competing interest of borrower and lender in this context is the general partner guaranty. In the recent decision in *Raphan v. U.S.*,[55] the United States Claims Court held that general partner personal guaranties of a partnership's otherwise nonrecourse mortgage financing did not alter the nonrecourse nature of the debt. The partners in Raphan were permitted to include the debt in basis, thereby increasing the amount of deductible losses from partnership operations. This ruling was based on the court's finding that in providing guaranties to the mortgagee, the guarantors acted other than in their capacity as partners. According to the court, upon payment of the debt by the general partner guarantors, the general partners would be subrogated to the foreclosure rights of the lender, placing them in a non-partner position. Thus, the guarantor-partners, as such, were not "personally liable" within the meaning of Regs. §1.752-1(e).[56]

Shortly after the Claims Court's decision in *Raphan*, the Service issued Rev. Rul. 83-151.[57] In that ruling, the Service held that a general partner's personal guaranty of his partnership's nominally nonrecourse mortgage loan makes the general partner personally liable to the extent that the value of the property securing the loan is insufficient to cover the amount due. On the facts of the ruling, the limited partner was not liable for any amount in excess

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of his original capital investment, and was not required to contribute any additional funds to the partnership. The limited partner was not permitted any additional basis on account of the loan or otherwise.[58]

B. Reasons for Change

The legislative history completely rejects the *Raphan* holding, but suggests that Congress viewed the decision in that case as symptomatic of inadequacies in the §752 regulations themselves. These regulations are considered outdated and inadequate for dealing with new commercial lending arrangements involving assumptions, indemnity agreements and various types of guaranties.

C. Explanation of Provision

Act §79(a) provides that §752 shall be applied without regard to the result in *Raphan*. Act §79(b) provides the Treasury with virtually carte blanche authority to revise and update the §752 regulations, "to take account of current commercial practices and arrangements . . ." [59] The Treasury is advised that the new regulations should focus on the manner in which the partners (and any related persons) share the economic risk of loss.

Comment: This directive provides little, if any, guidance as to how the current regulations should be revised. Although they may not be perfect, the current regulations already implement this basic risk analysis.

It is not intended that the revised regulations will alter to any significant extent the present rule permitting a basis step-up with respect to genuine nonrecourse indebtedness. Rather, the regulations will remove present uncertainties as to the kinds of financing arrangements that will qualify as nonrecourse for §752 purposes. Presumably, the revisions will prescribe the proper treatment of, for example, a general partner's agreement to guarantee a certain level of cash flow from operations of a real estate partnership. Under present law, it is not clear whether this type of guarantee affects the status of otherwise nonrecourse mortgage indebtedness of the partnership. Another area of uncertainty is the effect of fluctuations in the partners' sharing ratios on the allocation of liabilities, both recourse and nonrecourse. Current rules provide for allocation of nonrecourse liabilities in accordance with profit-sharing percentages, since the liabilities will be amortized out of future profits. A change in these percentages should also result in a reallocation of nonrecourse liabilities. The revised regulations could provide a mechanism for accomplishing this result in specific cases.

Although the delegation of nearly untrammeled regulatory authority is no doubt disquieting to the real estate development industry, it seems unlikely that the Treasury will treat every type of security given by a partner as transforming the otherwise nonrecourse nature of partnership debt. In recently-issued Rev. Rul. 84-118, the Service held that the amount of a partial recourse mortgage loan could be split into recourse and nonrecourse portions for purposes of §752. This ruling suggests that the Service may take a flexible position in the new regulations.

D. Effective Date

Under the Conference Report, the legislative rejection of *Raphan* is to be made effective, by regulation, as of March 1, 1984. The regulations otherwise are to apply prospectively from the date of their adoption.

VII. Changes Affecting Partnership Basis

The TRA makes four changes in the basis rules for partnership interests. With the exception of the prohibition on so-called "California basis strips," the changes are in the nature of technical corrections.

A. California Basis Strips

Section 754 provides for an election allowing partnerships to adjust the basis of partnership assets upon distribution of partnership assets (§734 adjustment) and upon sale or exchange of a partnership interest (§743 adjustment). Once the election is made, however, it must apply regardless of whether basis in partnership assets is increased or decreased. Congress became concerned that use of tiered partnerships could lead to manipulation of the basis adjustment rules, as evidenced by the following example from the Ways and Means Committee Report:

> "For example, assume that partnership AB holds two assets, asset 1 with a basis of 0 and a fair market value of $100 and asset 2 with a basis of $100 and a fair market value of $100. A distribution of asset 2 to partner A, who has a zero basis for his interest, would result in A holding the asset at a zero basis, and the basis of asset 1 will be increased to $100, assuming that the partnership has a section 754 election in effect. Thus, if asset 1 is sold, no gain or loss will be realized, but if asset 2 is sold, A will realize $100 gain. However, if asset 2 is instead contributed to a second partnership in which partnership AB has a major interest (*e.g.*, 99 percent), its basis will remain at $100. A distribution of AB's interest in the second partnership to partner A will result in the basis of the interest being reduced to zero but (if the second partnership does not have a section 754 election in effect) the basis of asset 2 will remain $100. Thus, the effect is an increase in total basis of assets so that, in this example, both asset 1 and asset 2 can subsequently be sold without recognition of gain. While the basis of A's interest in the second partnership would be reduced by $100, this would not have any effect so long as A retains his interest in the partnership. A could cause asset 1 to be sold and reinvest the proceeds through the second partnership without recognizing any gain."

This potential manipulation is eliminated by TRA §78 which amends §734(b) to provide that no basis adjustment is available with respect to the distribution of partnership interests unless the partnership whose interest is distributed also has a §754 election in effect.

The amendment is effective for distributions after March 1, 1984.

B. Section 48(q) Adjustment

Section 48(q) requires that a taxpayer reduce the recovery basis of any property for which investment tax credit is claimed by an amount equal to 50 percent of the credit. TRA §712(b) amends §48(q) to make clear that where such a reduction is made to the recovery basis of

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partnership assets, appropriate reductions are made to the partners' bases in their partnership interests.

C. *Basis Adjustment for Depletion*

TRA §722(e) amends §705(a)(3) to read:

> "The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests) —
>
> * * *
>
> decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under section 613A(c)(7)(D)."

Prior to the change, the section read as follows:

> "The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests) —
>
> * * *
>
> decreased (but not below zero), by the amount of the partner's deduction for depletion under section 611 with respect to oil and gas wells."

The change is retroactive to January 1, 1975.

D. *Sections 722 and 723 Basis Adjustments*

Sections 722 and 723 are amended to clarify that only gain recognized under §72(b) gives rise to a basis adjustment under those sections.

VIII. Extension of Section 267 Rules to Partnerships

The rule deferring the deduction of expenses and interests owed by an accrual-basis taxpayer to a related cash-basis taxpayer, applicable only to obligations of an S corporation to its shareholders under prior law, will now be extended to the obligations of a shareholder to an S corporation, obligations of partnerships to partners, and obligations of partners to partnerships. The former exception from the rule for amounts owing from an S corporation to a shareholder with less than a 2 percent interest in the S corporation has been eliminated. The rule requiring deferral of a deduction for expenses or interest of an accrual-basis taxpayer owed to a related cash-basis taxpayer until actual payment also applies to certain partnerships and S corporations. The rule applies to transactions between: (i) partnerships and any person owning, directly or indirectly, a capital or profits interest therein; (ii) S corporations and any shareholder thereof; and (iii) any partner in an upper-tiered partnership which owns, directly or indirectly, a capital or profit interest in a lower-tiered partnership. The deduction denial rule also applies to any person related to a person described in (i) through (iii), above, within the meaning of §267(b) or §707(b)(1). Rule (iii) above applies only if the transaction relates either to the operations of, or an interest in, the lower-tiered partnership. The rule will not apply to guaranteed payments to which §707(c) is applicable. Instead, the prior law requirement continues, that a partner must include such payments as ordinary income for his taxable year during which the partnership's taxable year in which the partnership deducted such payments ends. The Act also contains an exception for certain resyndications of low-income housing (within the meaning of §189(e)(5)) permitting the deduction of specified expenses and interest incurred in connection with the resyndication.

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[1] §721.
[2] §723.
[3] Alternatively, if the partnership's distributions were made in accordance with the partners' capital accounts computed by reference to the tax basis, as required by Prop. Regs. §1.704-1, the first partner's capital account will be $1,350 for tax purposes and he should then receive distributions of $1,350, while the second partner's capital account is $1,150 for tax purposes and he should receive distributions of that amount. Again, economic and tax results would be the same, but the parties will not have achieved the desired equal sharing of post-contribution profits.
[4] S. Rep. No. 169, 98th Cong., 2d Sess. 214 (1984).
[5] Prop. Regs. §1.704-1(b).
[6] The term "unrealized receivables" is defined in §751(c) as any rights to payments for (1) inventory goods delivered or to be delivered, or (2) services rendered or to be rendered.
[7] §735(a)(1).
[8] "Inventory items" under §751(d)(2) include property described in §1221(1) (*i.e.*, stock in trade or property held primarily for sale to customers in the ordinary course of business), any other noncapital asset other than §1231 property, foreign investment company stock, and any other property of the partnership which, if held by the distributee-partner, would be property in one of the foregoing categories.
[9] §735(a)(2).
[10] *See, e.g., Estate of Freeland v. Comr.*, 393 F.2d 573 (9th Cir.), cert. denied, 393 U.S. 845 (1968); *Podell v. Comr.*, 55 T.C. 429 (1970); Rev. Rul. 67-188, 1967-1 C.B. 216.
[11] §724(d)(1).
[12] §724(d)(2).
[13] *Id.* Act §74(b) amends §735 to include this waiver of the §1231(b) holding period requirement in the case of distributed property.
[14] §724(c).
[15] *Id.*
[16] §§724(d)(3) and 735(c)(2).
[17] *Id.*
[18] §701.
[19] §703(b).
[20] §265(a)(1).
[21] §709(a).
[22] §709(b)(1).
[23] §707(a).
[24] Payments to a partner for services or for the use of capital, if they are computed without regard to partnership income, constitute ordinary income to the partner and are deductible or capitalizable as appropriate by the partnership. §707(c).
[25] Regs. §1.707-1(a).
[26] S. Rep. No. 169, 98th Cong., 2d Sess. 224 (1984).
[27] 80 T.C. 378 (1983).
[28] §709.
[29] §707(a)(2)(A).
[30] Act §73(b)(1)(A).
[31] §721(a).
[32] Prop. Regs. §1.704-1(b).
[33] S. Rep. No. 169, 98th Cong., 2d Sess. 228-30.
[34] §§1001 *et seq.*
[35] Regs. §1.731-1(c)(2).
[36] *Id.*

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[37] 70 T.C. 312 (1978) aff'd *per curiam*, 634 F.2d 1046 (6th Cir. 1980).
[38] 83-1 USTC ¶9168 (U.S. Court of Claims, 1983).
[39] *See also Communications Satellite Corp. v. U.S.*, 625 F.2d 997, 1001 (Ct. Cl. 1980).
[40] S. Rep. No. 169, 98th Cong., 2d Sess. 225.
[41] §707(a)(2).
[42] Act §73(b)(2).
[43] The specificity of this effective date exception suggests that it was drafted with a particular project or projects in mind.
[44] S. Rep. at 230.
[45] *Id.* at 231.
[46] *Id.*
[47] *See* discussion, Chapter 36, III.
[48] S. Rep. at 231.
[49] S. Rep. at 231; Conf. Rep. at 862.
[50] *Otey v. Comr.*, 70 T.C. at 820.
[51] §722.
[52] §705.
[53] §752(c).
[54] These figures are based on pre-1984 Act depreciation rules. The 1984 Act extended the cost recovery period for real property from 15 to 18 years. *See* Act §111(a).
[55] 83-2 USTC ¶9613 (Cl. Ct. 1983).
[56] The conclusion of the *Raphan* court is subject to dispute. When the mortgaged property is the partnership's sole asset and is worth less than the outstanding liability, the guarantor-general partner's "right over" against the partnership (and the property) will leave him in no better position economically than if the debt were a full recourse liability of the partnership. In either case, the general partner bears the risk that the value of the property at foreclosure will be insufficient to pay the mortgage debt. In the case of a true nonrecourse loan, it is the lender who shoulders this risk.
[57] 1983-2 C.B. 105.
[58] It is worth noting that the Service, in a number of cases, has taken the position that limited partner guarantees of partnership debt do not result in a basis step-up. *See, e.g., Block v. Comr.*, 41 T.C.M. 546 (1980); *Brown v. Comr.*, 40 T.C.M. 725 (1980).
[59] H.R. Rep. No. 861, 98th Cong., 2d Sess. p. 869 (1984).

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Chapter 37

NEW AND REVISED PROVISIONS DEALING WITH SHIFTS IN, OR TRANSFERS OF, PARTNERSHIP INTERESTS

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I. Allocation of Partnership Items Upon Change in Partnership Interests

A. Introduction

1. Background

Section 706(c)(2)(B) provides that the distributive share of a partner who sells or exchanges less than his entire interest in a partnership or has his interest reduced (whether by entry of a new partner, partial liquidation, gift or otherwise) is determined by taking into account his varying interests in the partnership during the taxable year. The intent of this provision was to prevent retroactive allocations of partnership deductions upon entry of new partners into the partnership.[1] However, the provision failed to properly account for the impact of other Code provisions, and taxpayers have been able to structure transactions within the rules of the Code which have the effect of allowing entering partners deductions for partnership items incurred prior to their entry into the partnership.

Under the cash basis method of accounting, items are deductible upon payment rather than as the liability for payment is incurred.[2] By delaying payment of partnership items until after the new partners are admitted, the partnership may reasonably take the position that newly-admitted partners are entitled to deductions which are attributable to the pre-admission part of the year. Thus, a partner admitted late in the twelfth month of the partnership year can obtain a full year's deductions if the payment of the liabilities occurs after his admission.

A similar effect may be obtained through the use of "tiered" partnerships. Section 706(a) provides that a partner takes partnership items into account "for any taxable year of the partnership ending within or with the taxable year of the partner." Some taxpayers have used this provision to argue that where one partnership (upper tier partnership) owns an interest in another partnership (lower tier partnership), the last day of the lower tier partnership's taxable year is the day upon which the upper tier partnership recognizes all items of income and loss from the lower tier partnership. Thus, by admitting new upper tier partners shortly before the end of the lower tier taxable year, the newly-admitted upper tier partners can get the benefit of deductions which are attributable to periods prior to their entry into the upper tier partnership. The House Ways and Means Committee Report contains the following example:

> Assume that Parent partnership owns a 90 percent interest in Subsidiary partnership and that both Parent and Subsidiary use calendar year taxable year. Assume further that Subsidiary has a $10,000 loss for the calendar year 1983, and that Parent's distributive share is $9,000. If Partner A buys an 80 percent interest in Parent at the close of business on December 31, 1983, Parent may make an interim closing of its books on December 20, 1983, in order to determine A's distributive share of partnership items. Parent may take the position that, for tax purposes, it incurs its entire $9,000 portion of Subsidiary's loss on December 31, 1983, *i.e.*, at the close of Subsidiary's taxable year, regardless of when the loss was actually incurred by Subsidiary. Partner A will, therefore, claim a $7,200 loss on his 1983 return (Parent's $9,000 loss multiplied by his 80 percent interest in the partnership on December 31, 1983) rather than the $19.73 that he would be entitled to under a proportioned share computation (*i.e.*, $9,000 x 80% x 1/365 days).

The Internal Revenue Service has taken the position that §706(a) does not mean that an upper tier partnership's share of the lower tier partnership's loss is sustained on the last day of the lower tier partnership's taxable year. In Rev. Rul. 77-311, 1977-2 C.B. 218, the Service said that an upper tier partnership's share of any items of gain, loss, deduction, or credit of a lower tier partnership would be considered to be realized or sustained by the upper tier partnership at the same time and in the same manner as the items are sustained by the lower tier partnership.

2. Outline of New Provisions

TRA §72 amends §706 by adding a new subsection (d). Section 706(d) provides that certain deductions of a cash basis partnership ("allocable cash basis item") are assigned to partners on an accrual basis, day-by-day, during any year in which there is a change in any partner's interest in the partnership. Where the item is properly assignable to a prior partnership taxable year, it is assigned to the first day of such taxable year.

With respect to multi-tiered partnership structures, §706(d)(3) essentially adopts the position of Rev. Rul. 77-311 by providing that each upper tier partner's distributive share of lower tier items is determined by assigning the appropriate portion of each item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion as-

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signed to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.

In addition to the specific changes made to eliminate the cash basis and tiered partnership problems, the Treasury Department is given broad authority to promulgate regulations which prescribe methods for taking into account the varying interests of the partners in a partnership during the taxable year.

3. Effective Date

The new provisions apply to amounts attributable to periods after March 31, 1984 and, in the case of multi-tiered partnerships, to amounts paid or incurred by the lower-tier partnership after March 31, 1984.

B. Detailed Analysis

1. General Provisions

Section 706(d)(1) provides that except for the specific rules provided for cash basis and multi-tiered partnerships, each partner's distributive share of partnership items for any taxable year in which there is a change in any partner's interest in the partnership shall be determined by the use of methods prescribed by regulations which take into account the varying interests of the partners in the partnership during such taxable year. While the regulations are unlikely to be issued for sometime, it can be expected that they will reflect the sort of economic accrual concept similar to that touted in other sections of the TRA. Moreover, the regulations will probably attempt to set forth principles which will forestall problems similar to those presented by cash basis and multi-tiered partnerships. It is expected that regulations will include a monthly convention whereby partners entering by the 15th of the month are deemed partners on the 1st, and partners entering thereafter are deemed partners on the 1st of the following month.[3]

2. Cash Basis Partnerships

Section 706(d)(2)(A) provides that allocable cash basis items of cash basis partnerships are to be allocated among the partners by assigning the appropriate portion of each item to each day in the period to which it is attributable and by allocating the portion assigned to any such day among the partners in proportion to their interests at the close of such day. "Allocable cash basis items" include interest, taxes, payments for services, rents or lease payments and any other item specified by regulations to be prescribed.[4]

Example: Partnership AB begins the year owned 50 percent by A and 50 percent by B and is a cash basis, calendar year partnership. The partnership makes quarterly interest payments of $150,000 each on March 31, June 30, September 30 and December 31, an annual real estate tax payment of $300,000 on July 1, and an annual equipment rental payment (in arrears) on December 15 of $100,000. The partnership admits C as a partner on September 1 with a 10 percent interest (A and B equally diluted) and admits D as a partner on December 1 with a 20 percent interest (A and B, but not C, equally diluted). The first and second quarter interest payments are allocated 50-50 between A and B. The third quarter interest payment is assigned 62/92 to the period prior to C's entry to the partnership and 30/92 to the period during which C is a partner. The fourth quarter interest payment is allocated 61/92 to the period before D became a partner and 31/92 to the period after D became a partner. Thus, each partner's share of the $600,000 interest deduction is as follows:

A and B (each)		
Q1	50% x $150,000	$ 75,000
Q2	50% x $150,000	75,000
Q3	50% x 62/92 x $150,000	50,543
	45% x 30/92 x $150,000	22,011
Q4	45% x 61/92 x $150,000	44,755
	35% x 31/92 x $150,000	17,690
		$284,999
C		
Q3	10% x 30/92 x $150,000	4,891
Q4	10% x $150,000	15,000
		$ 19,891
D		
Q4	20% x 31/92 x $150,000	$ 10,109

Assuming that the real estate tax assessment is for the calendar year, the $300,000 tax payment would be allocated as follows:

$300,000/365 = $821.918

A and B (each)	
50% x 243 x $821.918 =	$ 99,863
45% x 91 x $821.918 =	33,658
35% x 31 x $821.918 =	8,918
	$142,439
C	
10% x 122 x $821.918 =	$ 10,027
D	
20% x 31 x $821.918 =	$ 5,095

Assuming that the lease payment is also for the calendar year, the lease payment would be allocated as follows:

$100,000/365 = $273.973

A and B (each)	
50% x 243 x $273.973 =	$ 33,288
45% x 91 x $273.973 =	11,219
35% x 31 x $273.973 =	2,973
	$ 47,480
C	
10% x 122 x $273.973 =	$ 3,342
D	
20% x 31 x $273.973 =	$ 1,698

Observation: As can be seen with regard to the lease payment above, the new rules operate to prevent D from

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taking a deduction for payments with respect to the use of the property prior to the time he becomes a partner. The new rules work to D's benefit, however, with respect to annual cash payments made prior to the time he becomes a partner. Under the cash method, D would not normally be entitled to any deduction with respect to the real estate tax payment since the payment was made prior to his admission as a partner. Under §706(d)(2), however, the accrual-type assignment acts to give him a share of the deduction.

2. Cash Basis Items Attributable to Periods Before or After the Taxable Year

Where an allocable cash basis item is attributable in part to the preceding or succeeding taxable year, that portion is assigned to the first day of the taxable year of payment or the last day of the taxable year of payment, respectively.[5] To prevent abuses, the amount so assigned to the first day of a taxable year may only be allocated among partners who were partners in the partnership during the period to which such amount is attributable in accordance with their varying interests during the preceding period.[6] If part of the amount is properly allocable to a former partner who is not a partner in the year of payment, the partnership must capitalize the amount and treat it under §755.[7]

Example: ABC partnership is a calendar year, cash basis partnership. A, B and C each own equal 1/3 shares. On December 15, C sells his entire interest to D. On January 1, E is admitted as a partner, with each partner thereafter having a 25 percent interest. On January 31, the partnership pays a $75,000 rent obligation which is attributable to November, December, and January. Under §706(d)(2)(A), $25,000 is assigned to January and is deductible by A, B, D and E in four equal shares of $6,250 each. The $50,000 attributable to November and December is assigned to January 1 under §706(d)(2)(C)(i). Because E was not a partner in the period to which the $50,000 relates (November and December), he is not allocated part of the deduction. The $50,000 is allocated among A, B, C and D in accordance with their varying interests during November and December. Accordingly, the November payment is allocable $8,333 each to A, B and C, and the December payment is allocable $8,333 each to A and B and $4,167 each to C and D. Thus, in the year of payment, A and B will each deduct $22,916 ($8,333 + $8,333 + $6,250), D will deduct $10,417 ($4,167 + $6,250) and E will deduct $6,250. Because C is not a partner on January 1, his share of $12,500 ($8,333 + $4,167) is capitalized by the partnership and treated under §755.

3. Multi-Tiered Partnership Structures

To prevent the use of multi-tiered partnerships as a means of making retroactive allocations to partners, §706(d)(3) provides that the distributable shares of upper-tier partners which are attributable to lower-tier items are determined by assigning the appropriate portion of each lower-tier item to the appropriate days during which the upper-tier partnership is a lower-tier partner and then allocating the portion assigned to any such day among the upper-tier partners in proportion to their upper-tier partnership interests at the close of such day.[8] Thus, lower-tier items flow up to upper-tier partners as if the upper-tier partnership were itself generating its proportionate share of the lower-tier items.

II. Recognition of Corporate Gain Upon Distribution of Partnership Interests

New §386 provides that distributions of partnership interests by a corporation under §§311 or 336 and sales of partnership interests in §337 liquidations shall not be entitled to nonrecognition treatment under those sections to the extent that the partnership holds property which would not qualify for nonrecognition treatment if held directly by the corporation. Section 386 is described in detail in Chapter 31 (VII).

III. Application of Section 751 to Tiered Partnerships

Section 751(a) provides that the amount of consideration received by the transferor of a partnership interest which is attributable to the partnership's unrealized receivables or substantially appreciated inventory is considered an amount realized upon the sale or exchange of a noncapital asset. Unrealized receivables are rights to payment for (noncapital) goods delivered or services rendered to the extent such amounts have not been taken into income under the partnership method of accounting.[9] The term also includes certain defined amounts, such as the depreciation recapture inherent in partnership property, which would be realized if the property had been sold at its fair market value. Substantially appreciated inventory is inventory whose fair market value exceeds both 120 percent of its adjusted basis and 10 percent of the fair market value of all partnership property other than money.[10]

The Conference Report states that some taxpayers have argued that §751 can be avoided by the use of multi-tiered partnerships.[11] Thus, if unrealized receivables or substantially appreciated inventory are held by a lower-tier partnership, the taxpayers argue that disposition of an upper-tier interest does not cause the transferor to recognize ordinary income under §751.

TRA §76 amends §751 to provide that an upper-tier partnership will be deemed to hold its proportionate share of lower-tier unrealized receivables and inventory items.[12] Thus, transfer of upper-tier partnership interests will be subject to §751.

The amendment is effective for distributions made after March 31, 1984,[13] in taxable years ending after such date.

IV. Exchange of Partnership Interests Disqualified from Section 1031 Treatment

Section 1031(a) provides that no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be similarly held. TRA §77 amends section 1031(a) to provide that partnership interests are specifically excluded from property qualified for nonrecognition treatment under section 1031.[14]

This change is discussed in detail in Chapter 29 (I).

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[1] H.R. Rep. No. 658, 94th Cong., 1st Sess. 124 (November 12, 1975); S.Rep. No. 938, 94th Cong., 2d Sess. 97 (June 10, 1976).
[2] Regs. §1.446-1(c)(1)(i).
[3] Conference Report at 858.
[4] §706(d)(2)(B).
[5] §706(d)(2)(C).
[6] *Id.*
[7] §706(d)(2)(D).
[8] §706(d)(3).
[9] §751(c).
[10] §751(d).
[11] Conference Report at 865.
[12] §751(f).
[13] TRA §76(b).
[14] §1031(a)(2)(D).

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CHAPTER 38

1984 TRA PROVISIONS RELATING TO TAX SHELTERS

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I. Introduction

For purposes of this discussion, a "tax shelter" is an investment, usually in the form of a limited partnership interest, which generates a deduction or deductions which can be used by the investor to offset income unrelated to the investment. The deduction will almost invariably serve only to defer the payment of tax, and will be reflected in an item or items of taxable income in some later year or years. "Tax shelters" will also refer to tax motivated transactions by means of which ordinary income is converted to capital gain.

Anti-tax shelter provisions have been enacted in successive revenue acts since 1969. Congress intended that the general reduction in marginal tax rates effected by ERTA (P.L. 97-34) in 1981 would dampen, if not put an end to, the tax shelter industry, especially when combined with a number of anti-sheltering provisions (notably the tax straddle rules). But this proved to be overly optimistic since, for various reasons, tax shelters continued to proliferate. TEFRA (P.L. 97-248) contained numerous provisions aimed at tax shelters; one of the most important was the addition of partnership audit procedures, concentrating heavily on the additional information reporting requirements and severe penalties for the promotion, aiding and abetting of abusive tax shelters. The 1984 TRA continues the TEFRA reforms in three major areas which are discussed below.

II. Compliance

This area of anti-shelter legislation relates to the capacity of the IRS to detect tax-shelter transactions so that timely action may be taken to inform potential investors of possible penalties, and to discourage or enjoin the creation of abusive shelters. It also relates to the addition of new information reporting provisions (together with appropriate penalties for failure to comply), and the increasing of penalties already provided.

Act §141 enacts §6111 requiring for the first time the registration of tax shelters with the Service. A tax shelter for purposes of registration is defined as any investment with respect to which one could reasonably infer from promoter or seller representations that the ratio of gross deductions (counting 200 percent of any credit as a deduction) to the amount invested will exceed 2 to 1 as of the close of any of the first five years. In addition, the investment must be one that is required to be registered under federal or state securities laws or exempt from such registration pursuant to an exemption that requires the filing of a notice; alternatively, the investment must be a substantial investment (total of $250,000 offered for sale and at least five investors). §6111(c). A further tax shelter measure imposed by §6112, enacted by Act §142, is to require organizers and sellers of potentially abusive tax shelters "to maintain investor lists." The new registration and investor list requirements, including the temporary regulations implementing them, are discussed at length in Chapter 43, II, A and B.

Two additional tax shelter oriented provisions were enacted in Act §§143 and 144. The first raises the penalty on promoters and sellers of abusive tax shelters to the greater of $1,000 or 20 percent of the gross income to be derived from the activity. The second establishes a higher interest rate, equal to 120 percent of the regular rate, for underpayments attributable to "tax motivated transaction." A tax motivated transaction includes (i) any valuation overstatement of 150 percent or more, (ii) any loss or investment credit disallowed under the at-risk rules, (iii) any straddle, (iv) any accounting method listed in regulations that substantially distorts income, and (v) any other transaction designated as tax motivated by regulations.

III. Time Value of Money

Act §§41-44 (subtitle C — Treatment of Bonds and Other Debt Instruments) contain a number of provisions which will affect tax shelters of various kinds, especially real estate shelters.

A. Real Estate Shelters

Real estate tax shelters provide investors with pass through losses based principally on depreciation (cost recovery), interest deductions, and investment credits where the assets acquired include §38 property. Shelter operators have often arranged purchase terms so as to overstate the purchase price, while understanding the true interest charge. So long as interest at a rate of 9 percent simple interest was charged, no adjustment could be made under §483 to characterize any of the payments of the sales price as unstated interest. The overstated sales price gave rise to depreciation (cost recovery) deductions and, where allowable, investment credits. Section 1274, as enacted by the TRA, together with §§1271–1288, replaces the repealed provisions of §§1232, 1232A, and 1232B. Under §1274, a debt instrument issued in exchange for property (other than a farm sold by an individual or small business for less than

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$1,000,000), where total payments to be made under such instrument exceeds $250,000, will be charged with imputed interest at 120 percent of the applicable federal rate (AFR), unless the instrument bears interest of at least 110 percent of the AFR. The AFR is the average yield of U.S. Government securities. It is updated every 6 months by the Treasury Department. This rate is applied on the basis of semiannual compounding. The "imputed principal amount" of the instrument is treated as the sale price of the property for all tax purposes, and the imputed interest is includible in the income of the note holder and deductible by the issuer over the life of the note as original issue discount (OID). Where the property is financed by tax exempt bonds issued by a municipality, county, etc., for purposes of §163 (allowing interest deductions), the AFR is adjusted to reflect the lower rates paid on tax exempt bonds. The developer's obligation in the latter case need not carry the full federal rate to escape interest imputation.

Section 483 was also amended by Act §41(b) to adopt the same AFR test and imputation rules. In addition, as to any sales after March 1, 1984, no interest will be accruable which is not properly allocable to the taxable year using a constant interest rate computation. This means that the maximum interest deduction for any one year is the actual yield to maturity of the obligation (which is determined on the basis of the principal amount of the obligation and all payments to be made thereunder) multiplied by the unpaid principal amount at the time of each payment and adjusted to reflect the time period since the last payment. Semiannual compounding is required.

B. Leveraged Market Discount Bond Shelters

Shelters involving the leveraged acquisition of bonds at market discount will no longer be feasible because of §§1276-1278. Under these rules, any gain from the sale or exchange of a bond purchased at market discount (*i.e.*, where the purchaser's basis is less than the stated redemption price at maturity) is treated as ordinary income to the extent of the market discount accrued while the bond was held by the person realizing such gain. Market discount is accrued on a straight line or constant interest basis at the election of the taxpayer. Interest on indebtedness incurred or continued to purchase or carry a market discount bond is disallowed to the extent it does not exceed the market discount accrued with respect to such bond during the taxable year. The disallowed interest is allowed in the year the bond is disposed of. All TRA changes relating to imputed interest and market discount are fully analyzed in Chapter 21.

IV. Tax Straddles

The deferral of income tax through regulated futures contracts straddles was largely ended by the reforms enacted by ERTA (§§263(g), 1092, and 1256 were the principal reform provisions). These did not usually involve tax shelters as such, meaning limited partnerships and similar arrangements for the passing through of deductions and losses. However, further tightening of the straddle rules was seen as necessary by Congress.

A frequently encountered shelter scheme after the ERTA reforms was the limited partnership engaged as an options market maker. Under §1234(b)(3), gains and losses of such an entity are ordinary (rather than short-term capital) losses. Market makers could purchase or grant stock options while holding offsetting direct ownership positions in the stock. Losses on the options could be passed through to the partners. Under the amendments made to Code §1092 by Act §101, direct ownership of stock, when offset by an option position in the same stock is a position in personal property and both positions are, therefore, subject to the loss deferral rule of §1092(a)(1). Gains and losses from the granting of options by a market maker are, under the post-TRA 1984 §1256 rules, subject to 60/40 treatment (*i.e.*, 60 percent long-term, 40 percent short-term capital gain or loss) unless an election under §1256(d) (relating to certain "mixed straddles") is made. In the case of any gain or loss from "dealer equity options" which are allocable to limited partners or limited entrepreneurs (*see* §1256(e)(3)), §1234(b)(3) does not apply, and all such gains or losses are treated as short-term gains or losses.

Another shelter device was to form a limited partnership dealing in commodities or other property with respect to which offsetting positions qualifying as hedges (as defined by §1256(e)) would be established. The loss deferral rules of §1092 and the mark to market and 60/40 rules of §1256 did not apply to such hedging transactions. Gains and losses from these transactions were accorded ordinary income treatment. While §1256(e)(3), containing special rules for "syndicates" (*i.e.*, partnership or other entity [other than a corporation which is not an S corporation] if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs), made the hedging transaction exception inapplicable to such syndicates, Congress further provided in post-TRA 1984 §1256(e)(5) additional limitations on hedging losses which may be passed through to such limited participants, allowing any losses only to the extent of the taxable income of the limited participant attributable to the trade or business in which the hedging transactions were entered into (taxable income to be determined not taking into account the hedging transactions).

The offshore commodity fund was utilized as a species of shelter in that a foreign corporation could acquire positions in personal property offsetting positions entered into by its shareholders without running afoul of the tax straddle rules. Section 1092(d)(3), as added by the Act characterizes stock in such a corporation as a position in personal property effectively disallowing losses on the stock or on the shareholder position where there is unrecognized gain from the offsetting position as of the end of the year.

V. Accounting Changes

Act §91 amended Code §461, adding subsections (h) and (i). Under subsection (h), in determining whether an amount has been incurred with respect to an item during any taxable year, the all events test is not to be treated as met any earlier than when "economic performance" with respect to the item occurs. Thus, an accrual basis taxpayer may not deduct expenses relating to the purchase of goods, performance of services, or its obligation for interest until such goods have been provided, the services have been performed or the interest obligation has accrued through the passage of time. Shelters based on tax deferral through the prepayment of such expenses will no longer be feasible.

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Where the shelter is a cash basis entity, deductions for payment for such items is not allowable any earlier than the time when such item would be treated as incurred under subsection (h). An exception is made, to the extent of a partner's basis in the partnership, determined without regard to partnership liabilities or any amount borrowed by the partner with respect to the partnership which was arranged by the partnership or the promoter, or, in other words, to the extent of the cash or the fair market value of property contributed by the partner to the partnership. A deduction is allowed in a taxable year where economic performance occurs within 90 days after the close of the partnership's taxable year. For these purposes, a partnership is defined as any enterprise (other than a C corporation) in which the interests offered were required to be registered by federal or state law, or a "syndicate" as defined by §1256(e) (*see* discussion above), or any tax shelter within the meaning of §6661(b)(2)(C)(ii).

VI. Summation

The foregoing review of TRA 1984 tax shelter measures is by no means exhaustive, but is intended to point out the major compliance oriented and substantive provisions. The Act also makes changes in the partnership rules, analyzed in Chapters 36 and 37, to render the partnership a less malleable form for allocating tax shelter benefits among partners. The Act amends the corporate tax rules to curb the use of various techniques developed by corporations to shelter corporate income. The relevant corporate amendments are described in Chapter 31. Lastly, the TRA expands the related party rules for partnerships and S corporations in §267 to preclude the mismatching of income and deductions between related parties for such typical tax shelter items as interest and management fees. The related party amendments are analyzed in Chapter 9.

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Chapter 39

THE TREATMENT OF BELOW MARKET INTEREST LOANS

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In *Dickman v. Comr.*,[1] the Supreme Court held that an interest-free or below-market interest rate loan to a family member without consideration results in a gift from the lender to the borrower for gift tax purposes. There are no cases that have considered whether such loans have any income tax consequences. However, where interest-free or below-market interest loans have been made to employees or shareholders, the courts have held that such loans do not give rise to taxable income.[2]

In the belief that interest-free and below-market interest loans have been utilized to circumvent various tax rules, such as the assignment of income rules and grantor trust rules in the case of family loans, and the corporate income rules in the case of corporate-shareholder loans,[3] Congress has adopted statutory rules for the treatment of such loans.

Effective as to loans made after July 18, 1984, §7872 added by Act §172(a) provides the following rules.[4]

In the case of a loan all of which is repayable upon the demand of the lender (a demand loan) made during any calendar year, there will be computed as of December 31 of such year the amount of interest which would have been payable by the borrower had interest been charged at the "applicable federal rate" (AFR) [5] for any period during the year in which the demand loan was outstanding. If the interest charged on such loan (if any) was less than the amount thus computed, it is known as "foregone interest." Where there is foregone interest the amount thereof is treated as if it had been transferred by the lender to the borrower and retransferred by the borrower to the lender on December 31 as interest. Where the demand loan is a gift loan (*i.e.* the foregoing of interest is treated as a gift under gift tax principles) the deemed transfer to the borrower is includible as a gift for gift tax purposes (subject to the special exemptions explained below). Otherwise, the deemed transfer will have tax consequences depending on the relationship of the parties.

Where the loan is other than a demand loan, it is a "term loan." In this case, where the loan is a gift loan, for income tax purposes (but not for gift tax purposes) the loan is treated in the same manner as a demand loan. That is, interest is computed at the AFR on the principal amount of the loan as if it had been charged (where interest less than the AFR was charged as determined by discounting all payments to be made under the loan terms at the AFR) and such foregone interest is deemed paid by the lender to the borrower on December 31, and retransferred by the borrower to the lender on the same date as interest.

Where the loan is a term loan, and is not a gift loan, the payments to be made are discounted at the AFR. The sum of their present values is the principal amount of the loan. Where the amount actually loaned exceeds this amount (*e.g.* where the lender has loaned, say, $38,000 to be repaid in installments over a two year period without interest or with interest below the AFR, and the sum of the present value of all payments discounted at the AFR is $32,000) there is deemed transferred by the lender to the borrower on the date of the loan of an amount equal to the difference between the amount loaned and the principal amount of the loan as computed by discounting the payments at the AFR ($6,000 in the example set forth above). In such a case, the borrower is treated as having issued a debt instrument having original issue discount (OID) in an amount equal to the deemed transfer. The OID rules of §1272 and §1273 will apply to this deemed debt instrument Where such below-market interest term loan was a gift loan, the amount of the deemed transfer ($4,000 in the example) is treated as a gift. The income tax consequences are as described in the preceding paragraph.

Exceptions to these rules are provided where the outstanding balance of the below-market interest loan (including all loans between the lender and borrower) does not exceed $10,000. Also, for any day on which the outstanding balance of a gift loan made directly between individuals does not exceed $100,000, the amount treated as retransferred from the borrower to the lender as of the last day of the year is not to exceed the borrower's net investment income (a *de minimis* amount of $1,000 is ignored) for the year. "Net investment income" is defined, generally, in §163(d).

These rules apply to: (1) all gift loans, (2) loans from (by) an employer to (from) an employee, (3) loans from (by) a corporation to (from) a shareholder, (4) any loan a principal purpose of which is tax avoidance through interest arrangements, and (5) other types of loan as will be provided by regulations where the interest arrangements have a significant effect on the tax liability of either the lender or borrower.

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[1] 52 U.S.L.W. 4222 (U.S. February 22, 1984).
[2] *Dean v. Comr.*, 35 T.C. 1083 (1961); *Greenspun v. Comr.*, 670 F.2d 123 (9th Cir. 1982).
[3] H. Rep. No. 432, Part II, 98th Cong., 2d Sess. 1373-1374 (1984).
[4] §1274(d).
[5] The "AFR" is determined by the Treasury based on the average yields of U.S. Government obligations falling within three categories of maturity — short-term, mid-term, and long-term — and is compounded semiannually.

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CHAPTER 40

LIMITATIONS ON INVESTMENT TAX CREDIT AND ACRS FOR LUXURY AUTOMOBILES

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I. Introduction

A. Background

Taxpayers are entitled to claim an investment tax credit and to take depreciation deductions for automobiles used in their trade or business. Prior to ERTA, the amount of the credit and the length of the depreciation period were dependent on the useful life of the automobile, which was usually in the three to five year range.[1] Thus, prior to ERTA, an automobile used in a trade or business produced a 3 percent investment tax and was depreciated over three to five years. ERTA classified automobiles as three year recovery property and provided a 6 percent investment tax credit for such property. However, as a result of the basis reduction instituted by TEFRA where an investment credit is claimed (the reduction is equal to 50 percent of the credit allowed) only 97 percent of the cost of the automobile can be recovered over three years. If an election is made to take a 4 percent investment tax credit, no basis reduction is required for purposes of ACRS.[2]

When automobiles are used for both business and personal purposes, only the percentage of the cost corresponding to the percentage of business use is creditable and only the percentage of the basis corresponding to the percentage of business use was entitled to ACRS. Where the percentage of business use decline after the credit year, part of the credit subject to recapture.[3] Proof of the relative percentages of business and personal use could be rather lax, however, and the rule of *Cohan v. Comr.*[4] is often invoked by taxpayers. This led to frequent litigation.

Impetus for the change in treatment of credits and deduction with respect to automobiles used in business arose from two concerns. First, there was concern that the tax system was underwriting automobiles whose cost and luxury far exceeded that needed for their business utility. One committee report expresses the view that beyond a certain level, "the extra expense of a luxury automobile operates as a tax-free personal emolument which the committee feels should not qualify for tax credits and deductions."[5] Second, the Internal Revenue Service has long been concerned that the proof requirements for the relative percentages of business and personal use of automobiles has led to widespread abuse. The TRA automobile provisions are designed to address these concerns.

B. Outline of New Provisions

TRA of 1984 places limits on both the use of investment tax credits and ACRS deductions with respect to passenger automobiles.[6] Investment tax credit is limited to $1,000.[7] ACRS deductions are limited to $4,000 in the first year and $6,000 in each year thereafter until the cost of the automobile is recovered.[8] These limits apply before any reduction for the percentage of personal use.[9]

Where business use of automobiles and certain other defined property does not exceed 50 percent of the use of the property, no investment tax credit is allowed and cost recovery of the property is prolonged.[10] If business use initially exceeds 50 percent and the percentage in later years falls below 50 percent, the excess of the ACRS deduction allowed in prior years over the amount which would have been allowed if the prolonged recovery rate had been used is recaptured and the slower rate must be used for the property in all future years.[11] Similar limitations will be prescribed by the Secretary to lessees (but not lessors) of property to eliminate any advantage in leasing.

TRA §179 amends §274(d) to require contemporaneous substantiation (*i.e.*, logs or receipts) for travel expenditures, entertainment expenses, business gifts and business use of automobiles and other property subject to the 50 percent rule described above.[12] TRA §179 adds a penalty for return preparers who fail to notify their clients of the substantiation rules [13] and creates a rebuttable presumption that taxpayers who claim §274(d) expenditures without adequate substantiation have been negligent in filing their returns.[14]

C. Effective Dates

The limitations on investment tax credit and ACRS deductions apply to property placed in service after June 18, 1984 in taxable years ending after such date and property leased after June 18, 1984 in taxable years ending after such date.[15] The new limitations do not apply to property which is acquired or leased pursuant to a binding contract in effect on, and at all times after, June 18, 1984, and which is placed in service or first used by the taxpayer before January 1, 1985.[16] For real property (such as entertainment facilities), the binding contract rule is satisfied if the property subject to the contract is placed in service by January 1, 1987.

The stricter substantiation rules (and the penalties which attach thereto) are effective for taxable years beginning after December 31, 1984, regardless of when the subject property was placed in service.[17]

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II. Detailed Analysis

A. *Limits on Investment Tax Credit and ACRS*

1. *Definitions*

a. *Passenger Automobiles*

The $1,000 investment tax credit and $4,000 and $6,000 ACRS limitations apply only to "passenger automobiles." [18] A "passenger automobile" is any four-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways with a gross vehicle weight rating of 6,000 pounds or less.[19] The definition specifically excludes vehicles used directly in the business of transporting persons or property for compensation or hire such as taxicabs, limousines operated by a limousine service, ambulances, hearses, and delivery or moving vehicles.[20] In addition, §280F(d)(5)(B)(iii) permits the Treasury Department to issue regulations excluding specific types of trucks or vans.

b. *Listed Property*

The 50 percent business use threshold (including ACRS recapture) applies to "listed property." [21] In addition, the §274(d)(4) substantiation rules are expanded to cover "listed property." [22] Listed property is:

(1) any passenger automobile;

(2) any other property used as a means of transportation;

(3) any property of a type generally used for purposes of entertainment, recreation, or amusement;

(4) any computer or peripheral equipment, with the exception of equipment used exclusively at a regular business establishment (including a home office qualifying under §280A(c)(1);

(5) any other property specified in regulations.[23]

The description of other property in (2) above subjects not only two-wheeled vehicles (predominantly motorcycles but also, potentially, bicycles) and aircraft to the 50 percent threshold and substantiation requirement, but will also include those four-wheeled vehicles such as taxicabs and delivery vehicles which are specifically excluded from the $1,000 investment tax credit and $4,000-$6,000 ACRS limitations in the definition of passenger automobile. It is also important to note that while a computer located at a regular business establishment will not be subject to the new 50 percent threshold and substantiation requirements, the old investment tax credit and ACRS business-personal percentage rules and proof requirements will continue to apply.[24]

c. *Qualified Business Use*

Qualified business use is any use in a trade or business [25] with the exception of (1) leasing to a person (or to anyone related to such person) who owns more than five percent of the stock or more than five percent of the combined voting power in a lessor corporation or more than five percent of the capital or profits interest in a lessor which is not a corporation ("five percent owner"); (2) use of the property as compensation for services of a five percent owner (or person related to a five percent owner); or (3) use of the property as compensation for services of a person who is not a five percent owner if an amount is not included in gross income (with appropriate withholding) with respect to the use.[26] Business aircraft are not subject to the three exceptions if at least 25 percent of the total use of the aircraft during the taxable year consists of business use other than that described in the three exceptions.[27]

Example: Corporation A has a corporate jet which is used by its officers and directors in the course of their business travel. The chairman of the board of A and president of A each own more than five percent of the A stock. On occasion, the jet is used by the chairman or president for personal travel, or the spouse of the chairman or president may accompany the chairman or president on a business trip where the spouse's travel would not qualify as a business expense. In such circumstances, A properly reports the value of the use of the jet as compensation to the chairman or president. Provided that the business use of A's jet exceeds 25 percent of the total use of the jet, A is entitled to treat the personal and spouse use of the jet as business use in computing the percentage of business use for purposes of investment tax credit and ACRS deductions.

It has long been clear that use of an automobile for commuting is not a business use.[28] The Conference Report for TRA of 1984 goes further to state that even where business is conducted or work performed during the commute, the trip is not considered a business use of the automobile.[29] Thus, use of a mobile telephone during commuting or other personal trips to make business calls does not transform the use of the car into a business trip. Similarly, commuting with colleagues for the purpose of holding business meetings does not qualify the use of the car as a business use.

Observation: Section 280F(e) gives the Secretary authority to issue regulations, including regulations with respect to items properly included in, or excluded from, the adjusted basis of listed property. The Conference Report indicates that one of the purposes of these regulations is to "ensure that taxpayers do not attempt to evade the restrictions on the investment credit and depreciation log, for example, separating an automobile into its component parts." [30] The intent of the provision is clear with respect to such "components" as engine, chassis, etc. The growth of cellular telephone and mobile telephones installed in automobiles presents an interesting problem. Is the installed telephone a component which is added to automobile basis and, therefore, subject to the investment tax credit and ACRS limitations? Or are investment tax credit and ACRS computed separately for the telephone? The better answer would seem to be the latter, since the mobile telephone would not seem to be the sort of "component" which leads to the evasion contemplated by the Conference Report. Moreover, it would seem that in the commuting example discussed above, the use of the mobile phone for a business call should be treated as a business use while the use of the car for commuting is considered personal.

Section 280F(d)(3) elevates the standard for employee deductions for use of listed property to "convenience of the employer" and "condition of employment" tests. Thus, the new standards evoke the principles contained in Regs. §1.119-1 with respect to employee meals and lodging fur-

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...ined by the employer. The Conference Report at 1027 specifically invokes the principles of *Dole v. Comr.*[31]

d. Business Use Percentage

The business use percentage is the percentage of use of any listed property during the taxable year which is qualified business use.[32] TRA leaves to regulations the determination of appropriate bases for determining the percentage of use. The Conference Report states that with respect to automobiles, a mileage basis could be authorized or "[f]or example, regulations could provide that if an automobile is used 5 days a week for business purposes and is available 2 days a week for personal purposes, in no event may the taxpayer consider more than five-sevenths of the use to be allocable to business purposes." [33]

Observation: The Conference Report would appear to endorse the days-per-week method of allocating business and personal use of automobiles only as an upper limit on the business use percentage. If days-per-week is allowed as a primary method of allocation, it would seem that the effect would be to include the taxpayer's commuting in the business use. As discussed above, this is not intended. Moreover, given the increased substantiation requirements discussed below, it would seem that a mileage-based percentage will be required.

The Conference Report is even less clear with respect to allocation methods for property other than automobiles.

e. Property Predominantly Used in Qualified Business Use

Property is "predominantly used in qualified business use if the business use percentage for the taxable year exceeds 50 percent." [34] This is the 50 percent threshold for investment tax credit and ACRS qualification and for ACRS recapture.

f. Straight-line Method over Earnings and Profits Life

Straight-line depreciation is used where the listed property fails the 50 percent threshold (is not predominantly used in qualified business use) and is used for calculating ACRS recapture where property initially meets the 50 percent threshold but fails in later years.[35] In the case of automobiles and other three-year recovery property, the earnings and profits life is five years; for five-year property the earnings and profits life is 12 years; and for 18-year real property, the earnings and profit life is 35 years.[36] Under this method, depreciation is taken ratably over the earnings and profits life of the asset.

g. Excess Depreciation

Excess depreciation is the excess of the recovery deductions taken by the taxpayer with respect to listed property in any year prior to the year in which the property is not predominantely used in qualified business use over "the amount which would have been so allocable if the property had not been predominantly used in a qualified business use for the taxable year in which it was first placed in service." [37]

Comment: Although the definition of excess depreciation is ineptly drafted, apparently the intent is that the taxpayer recapture the excess of recovery deductions over depreciation calculated using the straight-line method over earnings and profits life and that business use percentage for the first year of service not be reduced to 50 percent.[38] The Comment may be illustrated as follows:

Example: A purchases a car on January 1, 1985 for use in his business at a cost of $16,000. In 1985 and 1986, the car is used 100 percent in business. ACRS deductions in 1985 and 1986 are $4,000 and $6,000, respectively. In 1987, however, the business use percentage drops to 40 percent. A's excess depreciation is $3,600, calculated as follows:

1985		
ACRS		$4,000
Straight-line over E&P (using ½ year convention) ($16,000 x .1)	1,600	
Business use percentage	100%	
Recalculated Depreciation		$1,600
Excess		$2,400

1986		
ACRS		$6,000
Straight-line over E&P	3,200	
Business use percentage	100%	
Recalculated Depreciation		$3,200
Excess		$2,800
Total Excess Depreciation ($2,400 + $2,800)		$5,200

The excess depreciation calculation does not require the 100 percent business use percentage to be reduced to 50 percent.

2. Investment Tax Credit Limit for Passenger Automobiles

Section 280F(a)(1) limits investment tax credit for passenger automobiles to a maximum of $1,000. The net effect is to disallow an investment tax credit to the extent the purchase price of an automobile exceeds $16,666.67.[39] This limitation is permanent and not merely an annual limitation with the excess being carried over.

The limitation applies prior to any percentage reduction for personal use.[40] If the taxpayer uses the automobile for personal purposes 25 percent of the time in the first year the automobile is placed in service, the maximum credit allowable on the automobile is $750. Similarly, the $1,000 limitation is applied before any reduction in the credit pursuant to an election under §48(q)(4) to take a reduced credit in lieu of reduction of the basis of property for purpose of ACRS.[41] If the taxpayer makes a §48(q)(4) election, the ITC limit is reduced to $667.

Note: The investment tax credit limitation is only a maximum (and not minimum) amount. If the taxpayer places a $10,000 car in service, the investment tax credit (assuming 100 percent business use) is $600, not $1,000.

Observation: Section 48(q)(1) states that where a credit is determined under §46(a)(2) with respect to §38 property, the basis of the property is reduced by 50 percent of the amount of the credit "so determined." The §280F limitation is separate from the §46(a)(2) determination.

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Thus, the question is raised as to whether the basis reduction under §48(a)(1) is of the §46(a)(2) amount before or after limitation by §280F. While not covered explicitly in the TRA of 1984, examples in the Conference Report indicate that Congress intended the only sensible solution: where the $1,000 limitation applies, the maximum basis reduction is $500.[42]

Example: The taxpayer purchases a passenger automobile for $30,000. Assuming no personal use, the investment tax credit is $1,000 rather than $1,800. Similarly, the taxpayer's ACRS recovery basis is $29,500 after adjustment under §48(q)(1) rather than $29,100.

The $1,000 ITC limitation will be adjusted annually for the increase in the consumer price increase ("CPI") of the automobile component for the calendar year over the CPI automobile component for October 1983. The adjustment is made for the calendar year in which the automobile is first placed in service.[43]

3. ACRS Limitation for Passenger Automobiles

Section 280F(a)(2) limits the amount of recovery deduction for the first taxable year of the recovery period to $4,000 and for each succeeding year to $6,000, until the cost of the passenger automobile is recovered. Thus, during the three-year recovery period, a taxpayer will recover a maximum of $16,000. Unlike the investment tax credit limitation, however, ACRS recovery for cost of automobiles in excess of $16,000 is not disallowed, but deferred.[44] Automobiles costing up to $22,000 are recovered over four years, up to $28,000 over five years, up to $34,000 over six years, and so on.

The annual limitation applies prior to any percentage reduction for personal use.[45] If the taxpayer uses the automobile for personal purposes 25 percent of the time in the first year the automobile is placed in service, the maximum ACRS deduction would be $3,000 ($4,500 for 25 percent personal use in succeeding years). However, for the purpose of determining the unrecovered cost available for deduction in later years, the percentage of personal use is ignored.[46]

Example: The taxpayer purchases a passenger automobile for $28,000 and makes a §48(q)(4) election to reduce the investment tax credit to $667 rather than reduce the recovery basis by $500. The percentage of personal use of the automobile is 20 percent in each of the first five years the automobile is in service. The ACRS deductions are $3,200 for the first year and $4,800 for the second through fifth years. At the end of five years, the cost is "fully" recovered because the unrecovered cost is reduced $4,000 for the first year and $6,000 for the second through fifth years as if the automobile was only used for business purposes.

Like the ITC limitation, the $4,000 and $6,000 amounts are maximums. For automobiles costing less than $16,000, the recovery percentages of §168(b)(1) control.

Example: The taxpayer purchases a $10,000 automobile and makes a §48(q)(4) election. The automobile is not used for personal purposes. The taxpayer's recovery deductions are $2,500, $3,800 and $3,700 for the first, second and third years, respectively.

Like the $1,000 ITC limitation, the $4,000 and $6,000 limits will be adjusted annually for the increase in the CPI automobile component for the calendar year over the CPI automobile component for October of 1983. The adjustment is made for the calendar year in which the automobile is first placed in service.[47]

4. Limitations on and Recapture of ITC and ACRS When Listed Property Not Predominantly Used in Trade or Business

Investment tax credit and ACRS deductions are further limited for passenger automobiles and other listed property where the property is not predominantly used in a qualified business use (*i.e.*, where the business use percentage does not exceed 50 percent) in any year.[48] It is important to note that the 50 percent requirement is only satisfied by qualified business use, not merely by use in the production of income. Thus, while use in the production of income is added to business use for comparison to personal use and annual reduction of ACRS and ITC, use of listed property in the production of income does not count in the 50 percent test.

Example: The taxpayer purchases a personal computer for use in his business, to follow his investments, and for use by his children as entertainment. In year one, business use accounts for 60 percent, investment use 25 percent, and personal use 15 percent. The year one ACRS deduction is 85 percent of the five-year recovery amount. In year two, the business use percentage is 50 percent, investment use 35 percent, and personal use 15 percent. Because the business use percentage does not exceed 50 percent, the personal computer is not predominantly used in a qualified business. Thus, the limitations of §280F(b) will apply, notwithstanding the fact that personal use did not increase.

If the business use percentage of listed property falls to 50 percent or below, the listed property ceases to be §38 property. Where the failure occurs in the first year of service no credit is allowed, and where the failure occurs in later years the property is subject to recapture.[49] Under Regs. §1.47-1(c)(1), if property ceases to be §38 property for a reason that cannot be specifically identified with a date, it is deemed to lose its §38 status as of the beginning of the taxable year. Due to this sale and the operation of the recapture rules in §47(a)(5) for recovery property, if a passenger automobile is used for the production of income and for personal purposes 50 percent or more of its use in the first year after the year the auto is placed in service, the entire ITC will be recaptured. If this 50 percent threshold is reached in the second full year, 66 percent of the ITC previously allowed is subject to recapture, and if such threshold is reached in the third year, the recapture percentage is 33 percent. The ITC is not subject to recapture thereafter. Similarly, if five-year listed property is used in qualified business use 50 percent or less of the time in any of its first five years of service, all or part of the ITC will be recaptured.

If the business use percentage of listed property falls to 50 percent or less, the taxpayer also loses the right to use ACRS for such taxable year and all subsequent years, and must instead use the straight-line method over the earnings and profits life.[50] In addition, the excess depreciation, if any, is recaptured and included in income in the year the business use percentage first falls to or below 50 percent.[51]

Example: The taxpayer purchases a passenger automobile for $20,000 for use in business. In the first year of

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its use, the taxpayer uses the car 75 percent in the business, 15 percent for the production of income, and 10 percent for personal use. The taxpayer claims a $900 investment tax credit ($1,000 [since that is less than 6% × $20,000] × .90) and reduces the recovery basis to $19,500. The first year's ACRS deduction is $3,600 ($4,000 × .9). In the second year, the taxpayer uses the car 60 percent for business, 15 percent for production of income, and 25 percent for personal use. Under Regs. §1.47-2(e), the increased personal use triggers partial recapture of the credit. The amount of recapture is $150 ([.9 − .75] × 1,000). The ACRS deduction for the second year is $4,500 ($6,000 × .75). In the third year, the taxpayer uses the car 50 percent for business, 25 percent for production of income, and 25 percent for personal use. Under Regs. §1.47-2(e), there would be no recapture since the percentage of personal use did not increase between year 2 and year 3. Under §280F(b)(1), however, the car ceases to be §38 property because the automobile is not predominantly used in qualified business. Accordingly, the taxpayer must calculate investment credit recapture in accordance with the rules of §47(a)(5). This requires applying to the remaining ITC of $750, the recapture percentage of 66 percent specified for 3-year recovery property in service for more than one full year after the date placed in service. As a result, the taxpayer recaptures the remaining $750 of ITC in year 3. Also, because the business use percentage is 50 percent, the taxpayer must recapture excess depreciation and convert to the straight-line method over the earnings and profits life. The maximum annual deduction on the straight-line method over the earnings and profits life is $4,000 (20,000 × .2).[52] The excess depreciation is $1,500 ([$3,600 + $4,500] - [$4,000 × .9 + $4,000 × .75]). The taxpayer's ACRS deduction for the third year is $3,000 ($4,000 × .75). The maximum ACRS deduction in the fourth and fifth years is $4,000, even if the business use percentage is 100 percent.

Observation: Once the cost of an automobile exceeds $30,000, there can be no recapture and the change from ACRS to straight-line over the earnings and profits life makes no difference. This is because the $4,000 and $6,000 ACRS limits continue to apply even when the straight-line method over earnings and profits life is used. Thus, when the cost of the automobile is $30,000, the five-year straight-line amount is $6,000 and this exceeds the first-year limit and equals the maximum deduction which could be claimed whether or not the business use percentage exceeds 50 percent. This phenomenon does not occur with other listed property because only passenger automobiles are subject to the ACRS cap. It should also be noted that the impact of the use of the straight-line method over earnings and profits life will be more pronounced on five-year listed property (computers and transportation equipment other than passenger automobiles) as well as listed real property (entertainment facilities). This is because the earnings and profits life for five-year property is 12 years, and the earnings and profits life for 18-year real property is 35 years.

Comment: Example 4 of the Conference Report incorrectly computes ITC recapture in a situation where qualified business use of an automobile violates the 50 percent limit in a year subsequent to the years the car was placed in service. Based on 80 percent business use in 1984, the year placed in service, Example 4 accurately computes an allowable ITC of $536. Business use remains at 80 percent during 1985 but falls to 45 percent in 1986. The example calculates an ITC recapture as follows: $536 × .35 (which is .80 − .45) × .66 (§47(a)(5) percentage) = $123.82. However, because the 50 percent business use limit is breached, the car ceases to be §38 property in its entirety in 1986. Thus, the insertion of a personal use factor (.35) in the ITC recapture computation is incorrect. The entire amount of the previously allowed ITC of $536 should be applied to the .66 recapture percentage of §47(a)(5), resulting in a recapture of $353.76. Staff members of the Joint Committee on Taxation have confirmed that the latter amount is accurate.

5. Lease Limitations

The ACRS and the ITC limitations do not apply to lessors of listed property who are engaged in the business of leasing.[53] Thus, car leasing companies will be entitled to full ITC and ACRS deductions on leased passenger automobiles. Additionally, the lessee's percentage of personal and business use percentage of a listed item does not affect the availability of ITC and ACRS deductions to the lessor. The exemption would not apply, however, to employers who lease company cars to employees unless the employer is in the leasing business.

Lessees, however, will be subject to both the passenger automobile and listed property limitations on ITC and ACRS deductions. Section 280F(c)(2) provides that deductions for rentals or other payments under a lease which exceeds 30 days are only allowable to the extent of the "applicable percentage" of the payments to be determined by tables published by the Treasury Department. The tables are not yet available; however, the intent is that reduction of the deduction should substantially equal the limitations contained in §§280F(a) and (b).

B. Substantiation Requirements

TRA §179(b) adds listed property to the items subject to the §274(d) substantiation requirements and upgrades the quality of substantiation requirements to require contemporaneous records. This means that business usage of passenger automobiles, other transportation vehicles, personal computers and entertainment property may no longer be approximated, but must be proved as to the amount of expense or use, the time and place of use, the business purpose for the use, and the business relationship to the taxpayer of persons using the property. In addition, all deductions subject to §274(d) (including travel expenses and business gifts) will have to be substantiated by *contemporaneous* records. This will require logs where the use of property is in issue and receipts where payments have been made to others.[54] Failure to maintain the log or receipts will result in automatic disallowance of the deduction except when records have been destroyed by circumstances beyond the taxpayer's control, such as fire or flood.[55]

C. Requirement of Preparers' Disclosure

TRA §179(b)(2) requires tax return preparers to notify customers of the substantiation requirements of §274(d) and obtain a written statement from the taxpayer confirming that adequate contemporaneous records have been kept with respect to any deduction under §274(d). Failure of the preparer to make the notification or obtain the statement will result in a $25 per violation penalty unless the preparer proves that the failure is due to reasonable cause and not

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willful neglect. It is anticipated that either the acceptable language will be published by the Internal Revenue Service or the IRS will create a form to be used in obtaining the certification from the taxpayer.[56]

D. *Penalties for Failure to Substantiate*

Section 6653(h) provides that where the taxpayer fails to maintain the adequate contemporaneous records required under §274(d), it will be presumed that the resulting deficiency arises from the taxpayer's negligence. This presumption is only rebuttable by clear and convincing evidence to the contrary.

It can be expected that in claiming such deductions on the return the taxpayer will be required to certify that the records have been kept.[57] Thus, failure to maintain automobile logs and receipts for the other specified deductions will attract a virtually automatic five percent penalty if the deduction is claimed on the return. The Conference Report also contains the threat that claiming of a deduction in the absence of the required records "is also potentially fraud." [58]

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[1] See, Rev. Proc. 77-10, 1977-1 C.B. 548; Rev. Proc. 72-10, 1972-1 C.B. 721; Rev. Proc. 62-21, 1962-2 C.B. 418.
[2] Sections 168(c)(2)(A), 46(c)(7), 48(q)(4). Except as hereinafter noted, section references are to the Internal Revenue Code of 1954, as amended.
[3] Regs. §1.47-2(e).
[4] 39 F.2d 540 (2nd Cir. 1930). The *Cohan* rule allows taxpayers to estimate certain deductible expenses despite the absence of adequate records to document such expenses.
[5] H.R. Rep. 98-432 Part 2, 98th Cong. 2d Sess. 1387 (March 5, 1984).
[6] TRA §179.
[7] §280F(a)(1).
[8] §280F(a)(2).
[9] §280F(a)(3).
[10] §280F(b).
[11] §280F(b).
[12] TRA §179(b)(1).
[13] §6695(b).
[14] §6653(h).
[15] TRA §179(d)(1)(A).
[16] TRA §179(d)(1)(B).
[17] TRA §179(d)(2).
[18] §280F(a).
[19] §280F(d)(5)(A).
[20] §280F(d)(5)(B).
[21] §280F(b).
[22] TRA §179(b)(1)(B).
[23] §280F(d)(4)(A).
[24] §280F(d)(4)(B); H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1026 (June 23, 1984) ("Conference Report").
[25] §280F(d)(6)(B).
[26] §280F(d)(6)(C)(i).
[27] §280F(d)(6)(C)(ii).
[28] See, generally, 400 T.M., *Travel and Transportation Expenses.*
[29] Conference Report at 1028.
[30] Id.
[31] 43 T.C. 697 (1965), aff'd, 351 F.2d 308 (1st Cir. 1965).
[32] §280F(d)(6)(A).
[33] Conference Report at 1028.
[34] §280F(b)(4).
[35] §280F(b).
[36] §312(k)(3).
[37] §280F(b)(3)(B).
[38] See, Conference Report at 1030, Example 4.
[39] $10,000 divided by .6 = $16,666.67.
[40] §280F(a)(3).
[41] §280F(a)(4).
[42] Conference Report at 1029, Example 1.
[43] §280F(d)(7).
[44] §280F(a)(2)(B).
[45] §280F(a)(3).
[46] §280F(d)(2).
[47] §280F(d)(7).
[48] §280F(b).
[49] If the percentage of personal use increases during years when the business use percentage exceeds 50 percent, there may be partial recapture of the credit under Regs. §1.47-2(e).
[50] §280F(b)(2).
[51] §280F(b)(3).
[52] Under §48(q)(2), the recovery basis is increased by the $500 upon recapture of the ITC.
[53] §280F(c)(1).
[54] Conference Report at 1031.
[55] Id.
[56] Id.
[57] Id.
[58] Id.

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Chapter 41

MINIMUM TAXES

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I. Corporate Minimum Tax Rules Amended

A. *Introduction*

1. *Background*

Under §56 of the Code, corporations are required to pay a minimum tax on certain tax preferences. The minimum tax applies in addition to the corporation's regular income tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of: (a) the regular income tax paid by the corporation (referred to as the "regular tax deduction" in §56(c)), or (b) $10,000. *See* §56(a).

The tax preference items included in the base for the minimum tax computation are specified in §57. With respect to corporations, these items are: (1) accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period; (2) amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable); (3) in the case of certain financial institutions, the excess of the bad debt reserve deductions over the amount of those deductions computed on the basis of actual experience; (4) percentage depletion in excess of the adjusted basis of the property; and (5) 18/46 of the corporation's net capital gain.

In addition to being subject to the minimum tax, certain corporate tax preferences are subject to the cutback provisions of §291 of the Code. Added to the Code by TEFRA (P.L. 97-248), §291 requires a direct reduction in certain corporate preference items. Prior to the 1984 TRA, the required reduction was 15 percent of each item. That is, in computing the corporation's regular income tax, the amount of each preference item factored into this computation was required to be reduced by 15 percent if the item was subject to §291.

Section 57(b) prescribes an adjustment to the corporate minimum tax to prevent the combination of that tax and the cutbacks under §291 from reducing the marginal tax benefit from a preference to an amount less than that available prior to the enactment of §291. The preference items subject to cutbacks under §291 and the pre-1984 TRA treatment of these items are described below.

a. Depletion for Coal and Iron Ore

In the case of iron ore and coal (including lignite) the otherwise allowable percentage depletion deduction under §613 was reduced by 15 percent of the excess of percentage depletion deductions otherwise allowable under §613 for the taxable year over the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Only 71.6 percent of the preference as thus cut back was treated as a corporate tax preference under the minimum tax. *See* §291(a)(2).

b. Bad Debt Reserves

In the case of a financial institution to which §585 or §593 applies, the bad debt reserve deduction was reduced by 15 percent of the amount by which the otherwise allowable deduction for the taxable year for a "reasonable addition to a reserve for bad debts" exceeded the amount which would have been allowable on the basis of actual experience. Only 71.6 percent of the preference as thus cut back was treated as an item of tax preference under the minimum tax. *See* §291(a)(3) (*Certain Financial Institution Preference Items); see also* §291(e)(1)(A).

c. Tax Exempt Interest

In the case of a financial institution to which §585 or §593 applies, 15 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase or carry tax-exempt obligations acquired after 1982 was disallowed. *See* §291(a)(3); *see also* §291(e)(1)(B).

d. DISC

The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder was increased by 15 percent, to 57-1/2 percent of certain taxable income. This change had the effect of reducing the related tax benefit from DISCs by 15 percent. *See* §291(a)(4).

e. Section 1250 Property

The amount treated as ordinary income on the sale or other disposition of §1250 property (real estate) by a corporation during the taxable year was increased by 15 percent of the excess of the amount which would have been treated as ordinary income if the §1250 property were subject to recapture under §1245 (the rule applicable to personal property) over the amount otherwise treated as ordinary income under §1250. The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under §1245 was reduced by 28.4 percent and, thus, was equal to 71.6 percent of

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18/46 of the gain, or approximately 28 percent of the gain. *See* §291(a)(1).

f. Pollution Control Facilities

Fifteen percent of the basis of pollution control facilities to which an election under §169 applied was treated as if the election did not apply. The minimum tax preference for the remaining property for which five-year amortization was elected was reduced by 28.4 percent. *See* §291(a)(5).

g. Intangible Drilling Costs

In the case of an integrated oil company, 15 percent of the amount otherwise allowable as a deduction for intangible drilling costs (under §263(c)) was capitalized to the oil, gas or geothermal property and deducted ratably over a 36-month period beginning with the month the costs were paid or incurred. *See* §291(b)(1)(A).

h. Mineral Exploration and Development Costs

Fifteen percent of the amounts otherwise allowable as deductions under §§616 and 617 to a corporation were capitalized and treated as if they were used to acquire recovery property assigned to the five-year class. ACRS deductions were allowed beginning with the year the expenses were paid or incurred, and the investment tax credit was available in the year the expenses were paid or incurred. *See* §291(b)(1)(B).

2. Reasons for Change

Congress believed that "some of the tax preferences enacted over the years should be scaled back further in light of the large budget deficits." Because of the deficit, Congress decided to increase the 15-percent cutback to 20 percent.

B. Overview

TRA §68 increases the preference cutback (other than for coal and iron ore percentage depletion) from 15 to 20 percent. A similar adjustment to the new Foreign Sales Corporation (FSC) provision is made. Specifically, in the case of a corporate FSC shareholder, the benefits of the provision are reduced by 5/85.

To prevent a double tax impact of the increase in the preference cutback, Act §68 makes a corresponding adjustment to the corporate minimum tax. The 71.6 percent preference inclusion for the minimum tax is decreased to 59-5/6 percent.

As previously indicated, the cutback in the depletion allowance for coal and iron ore remains unchanged, *i.e.*, it continues to be 15 percent.

These amendments generally apply to taxable years beginning after, and transactions after, 1984.

C. Detailed Analysis

With one exception, Act §68 amends §291 by substituting "20 percent" for "15 percent" each place it appears in the section. The exception is §291(a)(2). The cutback percentage in that paragraph remains 15 percent. Thus, as amended, §291 requires a 20 percent reduction in the tax preference items subject to the section with the exception of the depletion deduction for iron ore and coal (including lignite). That deduction continues to be cut back only 15 percent.

To avoid a double tax impact of the increased cutback, Act §68 amends §57. Section 57, as stated earlier, enumerates and defines the tax preference items subject to the corporate minimum tax. As amended, §57 provides that, for purposes of the minimum tax, the preference amounts computed with respect to the amortization of pollution control facilities, the reserving of bad debts and §1250 capital gains, shall be deemed to be 59-5/6 percent of the amount they would otherwise be. Thus, the amount of these preference items included in the base for the corporate minimum tax is not the full amount, but only 59-5/6 percent thereof. Prior to the 1984 TRA, the amount included was 71.6 percent of the full amount.

The post-TRA 59-5/6 percent figure prevents the combination of the minimum tax and the 20-percent preference cutback from reducing the tax benefit from a taxpayer's marginal dollars of preference by more than it would be cut back under an unadjusted minimum tax (*i.e.*, by a minimum tax with a base that included the full amount of the tax preference items, not merely 59-5/6 percent of this amount).

Example: Assume a corporate taxpayer which has a 46 percent marginal regular tax rate, has paid more than $10,000 of regular tax, has tax preferences in excess of regular tax liability, and has $100 of excess amortization from pollution control facilities. Prior to the enactment of §291, the taxpayer received a regular tax benefit of $46 from this preference. The preference, however, led to a direct minimum tax of $15 (the 15 percent minimum tax rate times the $100 preference), as well as an indirect minimum tax of $6.90 through the reduction in the deduction for regular taxes under the minimum tax ($46 times 15 percent). Thus, the net tax benefit from the preference, at the margin, was $24.10.

When this calculation is modified to reflect the enactment of §291 and its amendment by the TRA, a 20 percent cutback must be factored into the calculation. Under this cutback, the excess amortization preference is reduced to $80. This, in turn, reduces the regular tax benefit of the preference to $36.80 (46 percent times $80). Including only 59-5/6 percent of the preference amount ($47.87, or $80 times 59-5/6 percent) in the minimum tax base reduces the direct minimum tax to $7.18 (15 percent times $47.87). Together with the indirect minimum tax, through the reduction in the deduction for regular taxes (15 percent times $36.80, or $5.52), this reduces the total tax benefit of the preference to $24.10 ($36.80 minus $7.18 minus $5.52). Thus, if only 59-5/6 percent of the preference item is taken into account for minimum tax purposes, the tax benefit from the taxpayer's marginal dollar of preference is the same as it would be if only an unadjusted minimum tax (without §291 preference cutback) were applied to the preference.

Since the cutback percentage for the depletion deduction for coal and iron ore remains 15 percent, the amount by which this preference item is reduced for purposes of

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computing the corporate minimum tax remains the same. That is, 71.6 percent of what would otherwise be the amount of this item is included in the base for computing the minimum tax.

Act §68 cuts back, in the case of a corporate shareholder, the benefits available under the new Foreign Sales Corporation provision. These benefits are codified in §923 of the Code. Act §68 amends §923(a) by substituting "32 percent" for "34 percent" in paragraph (2) and "16/23" for "17/23" in paragraph (3).

The amendments made by Act §68 generally apply to taxable years beginning after 1984. The amendments respecting the §1250 capital gain preference cutback apply to sales or other dispositions after 1984. The amendments respecting the preference cutback for pollution control facilities apply to property placed in service after 1984. The amendments respecting the preference cutback for drilling and mining costs apply to expenditures after 1984.

II. Alternative Minimum Tax Rules Amended

A. Introduction

For taxable years beginning after 1982, §55, as amended by TEFRA (P.L. 97-248) imposes on individuals, estates, and trusts, an alternative minimum tax equal to the excess of gross alternative minimum tax over the regular tax for the taxable year.[1] "Regular tax" in this context is a term of art because before comparing it with the gross alternative minimum tax, certain adjustments are required to be made: the "regular tax"[2] as computed under the normal Code rules is recomputed by disregarding the taxes imposed by §§72(m)(5)(B), 72(g), 402(e), 408(f), 409(c), and 667(b), and is reduced by nonrefundable credits allowed under Subpart A of part IV of subchapter A.

The gross AMT is determined by applying a flat 20 percent rate to the taxpayer's "alternative minimum taxable income" less the exemption amount specified in §55(f)(1).[3] Conceptually, the determination of "alternative minimum taxable income" is a two-step process:

(i) AMT adjusted gross income is computed by using the regular tax adjusted gross income as the starting point; and

(ii) AMT adjusted gross income is reduced by certain specified below-the-line itemized deductions to arrive at alternative minimum taxable income.

The following adjustments are required to the regular tax adjusted gross income to arrive at AMT adjusted gross income.[4]

(a) Any amount included in gross income under §667 is excluded,[5]

(b) The regular tax net operating loss deduction is replaced by the alternative tax net operating loss deduction as defined in §55(d); and

(c) The sum of items of tax preference is added back to gross income.

Note: In lieu of a current deduction, §58(i) provides the taxpayer with an option to write-off certain tax preference items *i.e.*, (§173) circulation, (§174(a)) research and experimental, (§263(a)) mining exploration and development, and (§616(a) and §617) intangible drilling and development expenditures) over a longer period of time and eliminate the preference amount for such items.

Once AMT adjusted gross income has been computed, alternative minimum taxable income is obtained by deducting the sum of alternative tax itemized deductions from AMT adjusted gross income. Alternative tax itemized deductions are defined to include the following below the line deductions:

(i) casualty and wagering losses under §§165(c)(3) and 165(d) respectively;

(ii) medical expenses under §213 (as modified by §55(e)(7));

(iii) charitable contributions under §170;

(iv) qualified interest as defined in §55(e)(3); and

(v) estate taxes under §691(c).

No nonrefundable credit, except the foreign tax credit, is allowed against gross alternative minimum tax.

From the mechanism of computing AMT liability as outlined above, it is apparent that, not only the items of tax preference, but also all below-the-line deductions (other than alternative tax itemized deductions) and all nonrefundable credits (other than the foreign tax credit) contribute to the taxpayer's AMT liability. Thus, for example, to the extent a below-the-line deduction for interest expense is permitted for the regular tax purposes but not for AMT purposes, it will contribute to the taxpayer's AMT liability.

The Tax Reform Act of 1984 (P.L. 98-369) makes a number of substantive, technical, and conforming amendments to the AMT rules contained in §§55-58.

B. Detailed Analysis

Sections 111(e), 555(a)(2), 711(a), and 722(a)(1) of the 1984 TRA amend §§55-58. These changes are discussed below.

1. Net Investment Income Limitation Includes a Net Loss from a Limited Business Interest

TRA §711(a)(4) amends Code §55(e)(8) to provide that the net investment income limitation on below-the-line non-housing qualified interest deductions includes a loss from a limited business interest.

a. Background

Section 55(e)(1) allows AMT adjusted gross income to be reduced by "qualified interest expense" to arrive at alternative minimum taxable income.

Qualified interest expense, which does not include investment interest carried forward under §163(d)(2) for regular tax purposes,[6] has two components: (i) qualified housing interest; and (ii) non-housing qualified interest.

(1) Qualified Housing Interest

Qualified housing interest includes interest paid or accrued by the taxpayer during the taxable year on indebtedness incurred in acquiring, constructing, or substantially rehabilitating the following two types of properties:[7]

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(i) Property which is the principal residence of the taxpayer (within the meaning of §1034) at the time the interest is paid or accrued; and

(ii) Property which is a qualified dwelling used during the taxable year either by the taxpayer, his spouse, a brother, sister, or an ancestor or lineal descendant. "Qualified dwelling" includes a house, apartment, condominium. or mobile home not used on a transient basis.[8]

Qualified housing interest is deductible in computing alternative minimum taxable income without any restriction.

(2) Non-Housing Qualified Interest

Non-housing qualified interest includes personal interest, investment interest allowable for the taxable year under §163(d), interest paid or accrued on indebtedness incurred to purchase or carry a limited business interest,[9] and all other non-housing interest which is not allowed as an adjustment to gross income.

While qualified housing interest is allowable without restriction for AMT purpose, the deduction for non-housing qualified interest is severely limited. Under §55(e)(3)(B), a deduction for such interest is allowable in computing alternative minimum taxable income only to the extent of the taxpayer's qualified net investment income for the taxable year.

Qualified net investment income is defined as the excess of qualified investment income over qualified investment expenses.[10]

"*Qualified Investment Income*" means the sum of the following items of income:

(i) Gross income from interest, dividends, rents, and royalties to the extent such income is not derived from a trade or business;[11]

(ii) Any amounts recaptured as ordinary income under §§1245, 1250, and 1254 where the gain does not derive from carrying on a trade or business (*i.e.*, ordinary income recapture on disposition of property held for investment);[12]

(iii) Capital gain net income attributable to the disposition of property held for investment;[13]

(iv) Tax-exempt interest and dividends, within the meaning of §§116 and 128, included in the minimum tax base as items of tax preference by §57(a)(1);[14] and

(v) Income derived by a taxpayer from a "limited business interest." [15] A limited business interest is defined to include a partnership as a limited partner or as a shareholder in an S corporation where the shareholder does not actively participate in the management of the corporation.[16]

Observation: "Qualified investment income" for §55 purposes is broader than "investment income" for §163(d) purposes. For example, "investment income" as defined in §163(d)(3)(B) does not include: (i) interest and dividends excluded under §§116 and 128; (ii) long-term capital gains; and (iii) net income from a limited business interest.

"*Qualified Investment Expenses*" are those deductions which are directly connected with the production of qualified investment income subject to the following limitations:[17]

(i) Only those expenses (including interest) which are an adjustment to gross income qualify as "qualified investment expenses." An expense, even though directly connected with the production of qualified investment income, does not qualify as a "qualified investment expense" if it is a below-the-line deduction. Thus, while the interest expense which is allowable in computing adjusted gross income will reduce the taxpayer's qualified investment income, the interest expense which is an itemized deduction will not reduce qualified investment income.

(ii) Deductions that are not allowed in computing the minimum tax base are not taken into account in computing qualified net investment income. Thus, those deductions which are items of tax preference are not considered qualified investment expenses.

Comment: This avoids the "double whammy" effect which would result if the expenses were first included in the minimum tax base as items of tax preference and were again allowed to reduce the taxpayer's qualified investment income limit on the non-housing itemized interest.

(iii) Interest paid or accrued on indebtedness incurred for the purpose of purchasing or carrying a limited business interest is a below-the-line deduction for purposes of the §55 tax and, therefore, is not considered a qualified investment expense.[18]

Comment: This treatment of interest is a mixed bag of blessings and evils. It is a blessing because it does not reduce the qualified net investment income limitation on the non-housing itemized interest. It is evil because such interest becomes subject to the qualified net investment income limitation and may give rise to AMT liability.

(a) Qualified Net Investment Income Limitation on Non-housing Interest

As is apparent from the foregoing discussion, the qualified net investment income limitation serves an important function: it determines directly the amount of non-business interest (other than housing interest) that may be deducted in computing alternative minimum taxable income, and indirectly, the amount of such interest which is subject to the AMT.

But for §55(e)(8) (providing a special treatment for limited business interests), the computation of the qualified net investment income limitation would be a relatively simple and straightforward task. Disregarding §55(e)(8) for a moment, the most commonly-encountered types of investment income are likely to be dividends, interest, and capital gain net income. Since the expenses directly allocable to earning these types of income are likely to be minimal, the computation of qualified net investment income involves the simple procedure of adding the different types of investment income and subtracting the expenses directly connected with such income. A slight conceptual difficulty may arise where a taxpayer has more than one type of investment income and the expenses directly connected with one category of investment income exceed the income in that category. For example, a taxpayer may have $10,000 of dividend income, $15,000 of rental income from

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a property subject to net lease within the meaning of §163(d), and $18,000 of expenses (*i.e.*, depreciation, interest, insurance, maintenance, etc.) directly connected with the rental income for the taxable year. In this situation, the question may be asked whether the $3,000 of excess expenses connected with rental income reduce the $10,000 dividend income for purposes of computing the qualified net investment income limitation. Phrased differently, the question is whether, for purposes of determining qualified net investment income limitation, various items of investment income and items of allocable expenses are aggregated separately before netting. If the answer is in the negative and income and allocable expenses for each category of investment income are required to be netted separately, a second question arises. This question is whether the excess of expenses allocable to one category of investment income will reduce investment income from another category. This second question is moot, however, because the statute clearly answers the first question in the affirmative. Section 55(e)(5)(A) provides that qualified net investment income equals the excess of: (i) qualified investment income; over (ii) qualified investment expenses. Since §55(e)(5)(B) defines "qualified investment income" as *the sum of* various items of income specified in subclauses (ii)-(iii) of that subsection, it is apparent that all items of investment income must be aggregated before subtracting the directly connected expenses. Thus, if a taxpayer has $10,000 of capital gain net income and $2,000 of expenses allocable to such income, and $15,000 of rental income derived from property subject to a net lease within the meaning of §163(d) and $18,000 of allocable expenses, his net investment income will be determined as follows:

Net Investment Income =

[Investment Income] − [Investment Expenses]
= [$10,000 + $15,000] − [$2,000 + $18,000]
= $5,000

Section 55(e)(8), as originally enacted by TEFRA, however, introduced an uncertainty in the net investment income computation. Section 55(e)(8)(A), which mandates that interest expense pertaining to a limited business interest is a below-the-line deduction, was added to the Code during the Conference Committee deliberations on TEFRA.

Comment: The Conference Committee perhaps realized that this provision, standing alone, would create a double whammy for AMT purposes. Such interest might not be deductible for lack of qualified net investment income while the income generated by the limited business interest would be subject to AMT. Perhaps, to alleviate this hardship, §55(e)(8)(B) (which provides that income derived from a limited business interest is qualified investment income) was added to ensure that, to the extent a limited business interest produced income, interest expense pertaining to such limited business interest would be deductible for AMT purposes.

There were no conceptual or practical difficulties in applying §55(e)(8) so long as a limited business interest did not generate a loss. Where a taxpayer suffered a net loss from his limited business interests, however, the question arose: would such a loss enter into the net investment income computation? The answer depended upon the legislative intent behind §55(e)(8)(B). If the intent was to remove the "double whammy" effect of banishing interest expense pertaining to a limited business interest below-the-line, the obvious conclusion was that a net loss from limited business interests could not enter into the qualified net investment income computation. This conclusion was further bolstered by a failure of the statutory language to: (i) make the distributive share of deductions from a limited business interest "qualified investment expense," and (ii) mention the word "loss" in conjunction with the word "income" in §55(e)(B)(8). Instead, that provision simply states that:

> "Any income derived from a limited business interest shall be treated as qualified investment income."

Further, nothing in the legislative history indicated that "any income," as used in §55(e)(8)(B), included a loss.

As is apparent from the following excerpt, however, the Joint Committee Staff explanation of TEFRA interpreted §55(e)(8)(B) to include a loss:[19]

> "... However, interest on indebtedness incurred to acquire or carry a limited partnership interest or an interest in a subchapter S corporation (in the case of a person who does not actively participate in the management of the corporation) is "below-the-line" interest for purposes of the minimum tax and therefore is subject to the net investment income limitation on the interest deduction. Further, net income or *loss* taken into account, directly or indirectly, from such an interest will be considered net investment income for the purposes of the net investment income limitation on the interest deduction." [Emphasis supplied.]
>
> "Thus, for example, assume a taxpayer had $100,000 of dividend income and also held a limited partnership interest in a partnership all of whose income is derived from a trade or business. The taxpayer's distributive share of partnership income included $200,000 of gross income and $300,000 of deductions which are not preferences (including partnership deductions for business interest). Because the partnership items are treated as items of investment income and investment expense to the limited partners for purposes of computing net investment income, the taxpayer would have no net investment income for the taxable year ($300,000 gross investment income less $300,000 investment expenses) and, therefore, could deduct no "below-the-line" interest (other than eligible housing interest), including interest on debt used to purchase or carry the limited partnership interest."

Doubts, however, continued to persist about the Joint Committee's explanation. One commentator believed that the Joint Committee's interpretation was an afterthought and that the issue would have to be decided by the courts:

> "This interpretation appears to be an afterthought. The statute specifically treats "income" from limited business interests as 'qualified investment income.' The statute neither mentions including losses in arriving at qualified net investment income nor treating deductions

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from such activities as qualified investment expenses. If the drafters intended this result, treatment for such items should have been specifically mentioned."

"... Without further legislative support for this position, however, final determination as to whether limited business losses reduce qualified net investment income for purposes of the AMT will have to be made by the courts. The best solution is for Congress to clarify its intent with respect to the treatment of such losses." [20]

(b) 1984 TRA Resolves the Controversy

TRA §711(a)(4) resolves the controversy. It amends §55(e)(8)(B) to include the word "loss" in that subparagraph. As amended, §55(e)(8)(B) reads:

"Any income or loss derived from a limited business interest shall be taken into account in computing qualified net investment income."

Since the amendment is supposedly a technical correction, and since TRA §711(a) does not contain an effective date provision, the amendment presumably is effective as of the original date of enactment of §55(e)(8).

To illustrate the application of amended §55(e)(8), the Conference Report [21] includes the same example as given by the Joint Committee Explanation of TEFRA.[22]

The net affect of the amendment is that, in certain situations, an investor in a limited business interest may be worse off from an AMT standpoint than he would be if he made no investment.

Example: Assume a taxpayer, for the relevant taxable year, had $100,000 of dividend income; $50,000 of personal interest expense and $30,000 of interest expense on indebtedness incurred to purchase a limited business interest. The taxpayer's distributive share from the limited partnership in the relevant taxable year included $200,000 of gross income and $300,000 of deductions which are not tax preference items. Under amended §55(e)(8), the $100,000 net loss from the limited partnership wipes out the $100,000 dividend income and, consequently, the taxpayer, in computing alternative minimum taxable income, cannot deduct any of the $80,000 non-housing itemized interest expense.

Note that, in the above example, the taxpayer would be better off not making an investment in the limited partnership because, in that case, he would be able to deduct $50,000 personal interest expense in computing alternative minimum taxable income.

2. Amendments to Section 58(i) Election Rules

a. Background

Section 58(i), added to the Code by TEFRA, provides the taxpayer with an opportunity to avoid preference income with respect to certain specified expenditures, i.e., circulation, research and development, mineral exploration and development, and intangible drilling and development expenditures. Under §58(i), a taxpayer's deductions for these expenditures are not treated as tax preference items if the taxpayer elects to amortize these expenditures over a longer period of time. The period for amortization of all expenditures specified in §58(i) is generally 10 years. Section 58(i)(4), however, provides the taxpayer with a special election to amortize intangible drilling and development costs over a period of five years.

TRA §711(a)(2) makes a clarifying amendment to the special election rules of §58(i)(4). TRA §711(a)(3) reduces the amortization period for circulation expenditures from 10 to three years.

b. Section 58(i)(4) Election Rules Clarified

TRA §711(a)(2) amends §58(i)(4)(A) to add the parenthetical phrase "(with respect to wells located in the United States)" after the words "intangible drilling costs." Thus, a taxpayer will be able to make the special five-year election provided in §58(i)(4) only with respect to intangible drilling costs allocable to oil and gas wells located in the United States.

The amendment is of a clarifying nature. Since the special §58(i)(4) election entitles the taxpayer to an investment tax credit for the IDCs and since the investment tax credit is generally not available with respect to property used outside the United States, it is logical that the §58(i)(4) election should be restricted to IDCs incurred with respect to wells located in the United States.

c. Ten-Year Amortization Period for Circulation Expenditures Reduced to Three Years

Prior to the TRA, the taxpayer, in lieu of taking a current deduction under §173, was required to elect a 10-year period of amortization for the circulation expenditures to avoid the preference item for such expenditures.

This 10-year period was unrealistic because, according to industry experience, the subscriptions generated by circulation expenditures have an average life of three years. Also, since a current deduction for circulation expenditures under §173 is not a preference item for corporate taxpayers, the 10-year amortization requirement of §58(i) placed non-corporate taxpayers at a distinct disadvantage as compared to corporate taxpayers.

Congress, therefore, reduced the required period of amortization under §58(i) from 10 to three years for circulation expenditures. Thus, noncorporate taxpayers may avoid the preference amount with respect to circulation expenditures by electing to amortize such expenditures over a three-year period.

3. Other Technical Amendments

The TRA makes three other technical amendments discussed below.

(1) Section 711(a)(1) amends §55(f)(2) (defining "regular tax") to clarify that, for purposes of computing a taxpayer's AMT liability, regular tax will not be reduced by any investment credit recapture. This amendment ensures that a taxpayer is not able to avoid recapture of the investment credit upon the disposition of investment credit property by reason of being subject to AMT.

(2) Under Code §87, the taxpayer is required to include in gross income an amount equal to the amount of alcohol fuel credit allowable to the taxpayer for the taxable year. Since alcohol fuel credit is not allowed against the AMT, to

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balance the scale, TRA §711(a)(5) amends §55(b)(1) (defining alternative minimum taxable income) to provide that any amounts included in gross income under §87 will be disregarded in computing alternative minimum taxable income.

(3) The Technical Corrections Act of 1982 added a provision to clarify that amortization of low income housing under §167(k) remained a tax preference item but erroneously added that provision to §57(a)(12)(A). TRA §722(a)(1) rectifies this error. It strikes §167(k) from §57(a)(12)(A) and inserts it in §57(a)(12)(B), where it logically belongs.

4. Conforming Amendments

Finally, a couple of conforming amendments to the minimum tax rules are also worthy of note:

(1) With certain exceptions, most real property placed in service by the taxpayer after 1980 could be depreciated under ACRS over as short a period as 15 years. TRA §111, however, increases this minimum recovery period to 18 years. TRA §§111(e)(5), (6), and (7) make conforming amendments to §57(a)(12) (setting forth the computation of the preference amount for property depreciated under the ACRS) to reflect the increase in the recovery period of real property from 15 to 18 years. Thus, under amended §57(a)(12)(B), the preference amount for 18-year real property is equal to the amount by which the deduction allowed under §168(a) exceeds the deduction which would have been allowed had the property been written off using the straight-line method over 18 years. The preference amount for low income housing is equal to the amount by which the deduction allowed under §168(a) exceeds the deduction which would have been allowed had the property been depreciated using the straight-line method over 15 years.

(2) TRA §555 makes certain technical amendments to the incentive stock option rules (ISO) of Code §422A. Under §422A, there are generally no tax consequences when an ISO is granted or exercised. The recipient is generally taxed at capital gains rate when the stock received pursuant to the exercise of an ISO is sold. The exercise of an ISO, however, gives rise to a tax preference amount which is subject to the alternative minimum tax. One of the requirements for an option to qualify under §422A is that the option price must equal or exceed the fair market value of the stock at the time the option is granted. To insure that the fair market value requirement is not avoided, TRA §555 makes two amendments to the ISO rules of §422A: (i) the determination of fair market value is required to be made without regard to any restriction other than a restriction which, by its terms, will never lapse; and (ii) a change in the terms of an option to make it nontransferable in order to qualify as an ISO will be treated as a grant of a new option.

TRA §555(a)(2) makes a conforming change to §57(a)(10) (defining the preference amount for an incentive stock option) by adding a new sentence at the end thereof. The sentence makes it clear that, for purposes of determining the fair market value of a share of stock, any restriction, other than a restriction which by its terms will never lapse, shall be disregarded.

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[1] Although the alternative minimum tax (AMT) is, in effect, a true alternative tax in that it is imposed only when it exceeds the regular tax as defined in §55(f)(2) for the taxable year, technically, the regular tax continues to be imposed and the amount of the alternative minimum tax imposed under §55 is the excess of the gross AMT over the regular tax.

[2] *See* §55(f)(2). The discussion in this paragraph does not take into account the amendment made to the definition of the term "regular tax" by the Tax Reform Act of 1984. All section references herein are to the 1954 Internal Revenue Code as amended and the regulations promulgated thereunder unless otherwise specified.

[3] The exemption amount is $40,000 for joint returns, $30,000 for single returns, and $20,000 for married individuals filing separately and estates and trusts.

[4] §55(b).

[5] The discussion in this paragraph does not take into account the amendment made by the Tax Reform Act of 1984.

[6] §55(e)(2).

[7] §55(e)(4)(A).

[8] §55(e)(4)(B).

[9] §55(e)(8)(A).

[10] §55(e)(5)(B)(i).

[11] §55(e)(B)(i).

[12] *Id.*

[13] §55(e)(5)(B)(ii).

[14] §55(e)(5)(B)(iii).

[15] §55(e)(8)(B).

[16] §55(e)(8)(C).

[17] §55(e)(5)(C).

[18] §55(e)(8)(A).

[19] *See* General Explanation of the Revenue Provisions of the TEFRA, 1982, prepared by the Staff of the Joint Committee on Taxation, at 20.

[20] Ginsberg and Gottlieb, "Tax Planning Under the New Alternative Minimum Tax Rules," Thirty-Fifth Tax Institute U.S.C. Law Center 1-11 and 1-12 (Jan. 1983).

[21] H.R. Rep. No. 98-861, 98th Cong., 2d Sess., 1219 (1984).

[22] *See* the example at footnote 19, above.

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CHAPTER 42

AN OVERVIEW OF THE TRA CHANGES AFFECTING REAL ESTATE

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I. Introduction

The TRA has enacted numerous provisions that will affect the acquisition, development, ownership, use, and disposition of real property. Consistent with the TRA's principal purpose of raising revenue, the thrust of the TRA changes relating to real estate is to diminish the tax benefits accorded real estate. Among the more notable examples of this are the lengthening of the ACRS depreciation period for most real property from 15 to 18 years, and the new installment sale recapture rules requiring full recognition of recapture income in the year of disposition.

Although the TRA amendments are generally unfavorable, certain changes should prove advantageous. For example, the long-term capital gains holding period is reduced to six months, and the 60-month write-off provided for the costs of rehabilitating low-income housing is extended through 1986.

The ensuing portions of this Chapter will identify the major TRA changes, both favorable and unfavorable, affecting real property. Cross-references indicating the chapter in which a change is analyzed in detail will also be supplied.

II. Acquisition and Development

Some of the more significant TRA changes relating to the acquisition and development of real property are in the tax-exempt bond area. Tax-exempt industrial development bonds may no longer be used to finance the acquisition of existing facilities unless the facilities are substantially rehabilitated within two years after acquisition; limitations are also placed on the use of industrial development bonds to finance the purchase of land. An analysis of all TRA changes relating to industrial development bonds may be found in Chapter 20, II.

On a more positive note, the TRA extends state and local authority to issue tax-exempt mortgage subsidy bonds through 1987. Proceeds of mortgage subsidy bonds may be loaned to first-time home buyers (or other home buyers who have not owned a principal residence within three years) at a lower interest rate than the rate charged by commercial mortgage lenders. Moreover, beginning in 1985, the TRA provides state and local governments with the authority to issue mortgage credit certificates to first-time home buyers in lieu of issuing mortgage subsidy bonds. A recipient of a mortgage credit certificate is entitled to claim a credit against federal income tax equal to a percentage (set by the state or local government and ranging from 10 to 50 percent) of the mortgage interest paid or incurred by the recipient during the year. For a full analysis of the extension of the mortgage subsidy bond provisions and the new mortgage credit certificate, *see* Chapter 20, I.

Another important TRA change relating to the financing of real property acquisitions is the extension of the original issue discount rules after 1984 to purchase money notes given by a purchaser to a seller of real property where the note does not carry an adequate interest rate. If the original issue discount rules apply, two major consequences ensue: (i) a portion of the deferred purchase price is recharacterized as interest deductible by the purchaser but includible in the seller's income on an economic accrual basis when paid, in the case of a cash basis taxpayer, or when due, in the case of an accrual method taxpayer; and (ii) due to the imputation of interest, the basis of the property acquired is reduced both for purposes of computing depreciation and for purposes of determining gain or loss on a subsequent disposition. The original issue discount rules are fully described in Chapter 21.

The TRA amends §189 to require corporations to capitalize construction period interest and taxes on residential real property (other than low-income housing). The Act also revises §195 to mandate the capitalization of start-up expenditures prior to the commencement of an active trade or business, including expenditures of the type held deductible under §212 in *Hoopengarner v. Comr.*, 80 T.C. 538 (1983) (ground rents). The §§189 and 195 capitalization requirements are discussed in Chapter 11, I and II, respectively.

Demolition losses are no longer deductible after 1983, whether incurred to prepare land for construction, lease, or any other purpose. Such losses must be capitalized as part of the basis of land. This TRA amendment is described in Chapter 12, IX.

Finally, the TRA renders less attractive a tax-savings technique often used in condominium conversions. It involved the use of a corporation to sell approximately 40-50 percent of the condo units, paying a corporate level tax, followed by the distribution of the remaining units in complete liquidation of the corporation, thereby obtaining a basis step-up in these units to fair market value. Since the corporation had realized a "substantial part" of the income from the conversion, the corporation was not collapsible, and the gain recognized by the shareholders on liquidation was therefore taxable at capital gains rates. The shareholders would then complete the conversion at no further gain.

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The TRA amends the collapsible corporation rules to raise the substantial part requirement to two-thirds of the taxable income to be derived from the corporate property, which means that only one-third of a condominium conversion can be achieved at capital gains rates. The new collapsible corporation rules are fully analyzed in Chapter 31, VI.

III. Ownership and Use of Real Property

One of the principal tax benefits provided to owners of depreciable real property held for use in a business or for investment purposes is cost recovery under the ACRS. Prior to enactment of the ACRS, the depreciation period assigned real property generally depended on its projected economic life, usually at least 30 years. The ACRS fixed the recovery period for real property at 15 years, thereby effectively increasing the rate at which property was depreciated by 100 percent. The TRA, in response to Congress's concern that the 15-year period provided overly generous depreciation deductions resulting in the churning of real estate, lengthened the recovery period for real property to 18 years, except low-income housing. The new 18-year life, the exception for low-income housing, plus the half-month convention adopted by the TRA for computing cost recovery for 18 year-property placed in service or disposed of, are discussed in Chapter 6, I.

The TRA further lengthens the recovery period to a minimum of 40 years for any real property leased to a tax-exempt organization, governmental unit, or foreign person in a disqualified lease. A lease may be treated as disqualified if (i) tax-exempt financing obtained through the exempt entity financed the leased property at least in part, (ii) a fixed option to purchase the property exists, (iii) the lease term exceeds 20 years, or (iv) the property was the subject of a sale and leaseback. Real property will be excepted from the tax-exempt use restrictions if no more than 35 percent of the property is leased to an exempt entity of if the term of the lease is less than three years. The tax-exempt entity leasing rules are analyzed in full in Chapter 18.

On the other hand, the TRA extends the 60-month amortization rules for the costs of rehabilitating low-income housing through 1986, and restores the 60-month amortization rules for the costs of removing architectural and transportation barriers for the handicapped and elderly through 1985. A discussion of these provisions may be found in Chapter 6, VI and VII.

The TRA makes two changes of note to the rehabilitation credit. The Act denies the credit for rehabilitation expenditures allocable to property that will be tax-exempt use property. However, it liberalizes the 75 percent external wall requirement, permitting the retention of only 50 percent of a building's walls as external walls if certain conditions are met. The rehabilitation credit amendments are further described in Chapter 15, II.

In the lease area, new §467 must be considered whenever there is a rental agreement under which (i) rents increase during the term of the agreement, or (ii) at least one rental payment allocable to the use of the leased property during the calendar year will not be paid until the second calendar year after the year in which the use occurs. Section 467 will apply only if aggregate payments under the agreement exceed $250,000. If applicable, an interest element may be imputed under §467, and the lessor and lessee must report rental and interest income and deductions on an accrual basis, irrespective of their methods of accounting. Special rules apply to long-term leases and sale-leaseback transactions where the rent increases can be ascribed to tax avoidance motives. It should also be noted that regulations may be prescribed under §467 providing for comparable rules where rents decrease during the term of the lease. For a complete analysis of §467, *see* Chapter 22.

IV. Dispositions

One beneficial change made by the TRA is to reduce the holding period for long-term capital gain treatment to six months, effective for property acquired after June 22, 1984, and before 1988. This change is discussed in Chapter 28, I.

On balance, however, the TRA provisions affecting the disposition of real property are unfavorable. The installment sale reporting rules are amended to require full recognition of recapture income in the year of an installment sale, regardless of the amount of payments in that year. A new recapture rule is provided for disposition of §1231 property, such as real property used in a trade or business, requiring that capital gain under §1231 be recharacterized as ordinary income to the extent of ordinary losses under §1231 in the preceding five years. The installment sale and §1231 recapture rules are analyzed in Chapters 26, III, and 28, III, respectively.

The §1031 like-kind exchange rules, under which gain is not recognized on the transfer of property to the extent like-kind property is received in exchange, have been amended by the TRA in two respects. First, the TRA overrules case law that allowed tax-free like-kind exchanges of partnership interests. Second, the TRA restricts the period within which a like-kind exchange may be completed. These changes are described in Chapters 37, IV, and 29, II. Chapter 37, as well as Chapter 36, also describes the many other changes in the area of the taxation of partnerships; the partnership is one of the most common forms of owning real property, and the TRA changes to partnership taxation are extensive.

V. Compliance

The TRA enacts three compliance measures relating to real estate transactions. First, the TRA generally imposes a withholding obligation on the purchaser of a U.S. real property interest from a foreign owner. This withholding requirement is analyzed in Chapter 63. Second, the Act requires information reporting by persons who, in connection with a trade or business, receive mortgage interest payments exceeding $600 on a mortgage. The TRA also imposes information reporting requirements on lenders who foreclose or learn that property securing debt has been abandoned. For a discussion of the latter two new reporting requirements, *see* Chapter 43, II, C.

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CHAPTER 43

AMENDMENTS RELATING TO COMPLIANCE PROVISIONS

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I. Introduction

A. Background

One of the major aims of the Tax Equity and Fiscal Responsibility Act of 1982 [1] (TEFRA) was the improvement of taxpayer compliance. To this end, TEFRA strengthened various criminal and civil penalties, such as increasing the maximum fine for tax evasion from $10,000 to $100,000 ($500,000 for corporations) in §7201, and imposing an additional civil fraud penalty under §6653 equal to 50 percent of the interest payable on the portion of an underpayment attributable to fraud. TEFRA also enacted various new penalties, such as an immediately assessable $500 penalty [2] imposed on taxpayers filing frivolous returns in order to discourage the many protest returns that were inundating the system.

The 1982 Act also sought to broaden and render more effective another traditional method of inducing taxpayer compliance, information reporting. For example, in order to increase the reporting of tip income by employees, new tip reporting requirements were imposed on employers in §6053. In response to the growing so-called underground economy, the broker return rules of §6045 were revised to clarify that brokers engaged in barter transactions were subject to those rules.

Finally, the 1982 legislation sought to utilize what is perhaps the most effective compliance measure, withholding. TEFRA enacted in §§3451-3454 a mandatory 10-percent withholding tax on interest and dividends.[3] This withholding endeavor proved unsuccessful, however, as it met with considerable popular resistance. It was repealed early in the 90th Congress by the Interest and Dividend Tax Compliance Act of 1983, leaving the withholding measure ineffective as if it had never been enacted,[4] although a remnant survives in the form of the backup withholding rules of §3406.[5]

B. Overview of TRA Changes

The Tax Reform Act of 1984 [6] continues the TEFRA policy of seeking to raise revenues through new or improved compliance measures. The Act adds or strengthens various reporting and penalty provisions although, not surprisingly, it does not add to the existing withholding rules in the domestic area [7] except for certain technical changes to backup withholding.

The Act also focuses on another compliance tool, substantiation. One substantiation measure, buried in the section of the Act concerning luxury automobiles and listed property, that will affect many business taxpayers commencing in 1984 is to stiffen the substantiation requirements of §274(d) by requiring the maintenance of adequate "contemporaneous records" [8] rather than merely "adequate records" or "sufficient evidence corroborated by (the taxpayer's) own statement." This stiffer substantiation rule will apply with respect not only to listed property but also to travel and entertainment expenses previously subject to §274(d). More rigorous substantiation will also be required in the case of charitable contributions of property whose claimed value exceeds $5,000; the Act [9] directs the Treasury to issue regulations no later than the end of 1984 to require taxpayers making such gifts to obtain a qualified appraisal of the property.

Among the major additions in the reporting area, the Act mandates the furnishing of returns with respect to mortgage interest received in a trade or business,[10] cash payments of more than $10,000 received in a trade or business,[11] certain foreclosures and abandonments,[12] and partnership exchanges where unrealized receivables are involved.[13]

In conjunction with the new substantiation and reporting requirements, the Act adds to or amends various existing penalty provisions to enforce the new requirements. The return preparer penalty of Code §6695 is amended to impose a $25 penalty whenever a return preparer fails to advise the taxpayer of the §274(d) substantiation requirements and obtain written confirmation that such requirements were met.[14] Also, for purposes of the negligence penalty, the TRA adds a presumption that failure to comply with the §274(d) substantiation requirements was negligence.[15] The over valuation penalty of §6659 is revised [16] to provide a penalty equal to a flat 30 percent of the tax liability understatement where a claimed charitable valuation is 150 percent or more of the correct value, and to limit the Service's authority to waive this penalty except where a qualified appraisal was obtained. The Act also amends the general penalties for failure to properly file information returns and information statements, found in Code §§6652 and 6678.[17]

Perhaps the area receiving the greatest amount of attention under the TRA compliance provisions is the tax

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shelter. The TRA enacts Code §6111 [18] to require for the first time the registration of tax shelters with the Internal Revenue Service. Under Code §6112, organizers and sellers of a "potentially abusive tax shelter" must maintain investor lists.[19] The Act also enacts two new penalties, §§6707 and 6708, to enforce the new registration and investor list requirements.[20] Temporary regulations in question-and-answer form implementing these new provisions have already been issued by the Service.[21]

The next section of this Chapter will review all of the Act compliance provisions, commencing with the new tax shelter registration and investor list requirements. Ensuing sections of this Chapter will analyze the revised, simplified estimated tax rules for noncorporate taxpayers and the new church audit procedures.

II. Analysis of the TRA Compliance Provisions

A. Tax Shelter Registration

1. Statutory Outline

Section 6111(a) requires any tax shelter organizer to register the shelter with the Secretary (in such form and in such manner as the Secretary prescribes) not later than the day on which interests in the shelter are first offered for sale. Upon registration, the Service will furnish to the tax shelter a registration number which, under §6111(b) must be furnished to each investor in the shelter and must be used by the investor on the investor's individual return.

Section 6111(c) defines a tax shelter as any investment with respect to which it can reasonably be inferred that gross deductions (treating 200 percent of any credits as deductions) will exceed the investor's investment by more than 2-1 at the end of any year within the first five years. Further, the shelter must be required to be registered under federal or state security laws, must be sold pursuant to a securities exemption where notice is required, or must be a substantial investment ($250,000 and five investors).

Section 6111(d) defines a tax shelter organizer as either (1) the person principally responsible for organizing the tax shelter or (2) certain other persons participating in the organization, management, or sale of the shelter.

Under §6111(e), the Secretary is authorized to prescribe regulations relating to certain registration requirements, including the authority to prescribe exemptions from the registration requirements.

Section 6707 provides a penalty of (i) $500, or, if greater, (ii) the lesser of 1 percent of the aggregate amount invested or $10,000. A penalty of $100 is prescribed for each failure to furnish a tax shelter identification number, and a $50 penalty is imposed for each failure to include the registration number on an individual return.

2. Definition of Tax Shelter

Registration of an investment is not required unless it is in fact a "tax shelter". Under §6111 an investment must meet two requirements in order to be classified as a tax shelter:

> (1) the investment must be one where a person could reasonably infer, from representations made, or to be made, in connection with any offer for sale of any interest of the investment, that the tax shelter ratio for any investor may be greater than 2 to 1 as of the close of any of the first five years ending after the date on which the investment is offered for sale; and
>
> (2) the investment must be either required to be registered under a federal or state securities law or sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating securities; alternatively, is satisfied if there is a substantial investment.

a. Tax Shelter Ratio

For purposes of the first requirement, the tax shelter ratio, with respect to any year, is the ratio that the aggregate amount of deductions and 200 percent of the credits which are represented as potentially allowable to an investor for all periods up to (and including) the close of any year, bears to the investment base for the investor as of the close of that year.[22]

The temporary regulations under §6111 [23] take the expansive view that deductions for purposes of the ratio are the amount of gross deductions and other similar tax benefits potentially allowable without reduction by any gross income to be derived or expected from the investment. Similarly, "credits" are the gross amount of credits potentially allowable without regard to any possible tax liability resulting from the investment or any potential credit recapture. A deduction or credit may be considered to be represented as potentially allowable through explicit representations made in connection with the offering for sale of an interest in the investment. For example, an advertisement stating that "purchase of restaurant includes trade fixtures (5-year write-off and investment tax credit)" is an explicit representation of tax benefits.[24] Once an explicit representation is made all associated deductions or credits will be inferred.[25] If the amount of the deduction is not specifically represented, it should be reasonably estimated based on economic value or economic projections. The temporary regulations provide that reasonable estimate must assume use of the most accelerated allowable ACRS deductions.[26]

Interest incurred in connection with the investment and explicitly represented as being potentially allowable must be taken into account. A deduction, however, such as a loss deduction from worthlessness, that is not intended need not be taken into account.[27]

The investment base for any year is the total amount of money and the adjusted basis of other property (reduced by any liability to which the other property is subject) that must be unconditionally contributed or paid to the tax shelter on or before the close of the year by the investor.[28] The investment base does not include any cash borrowed from the organizer or any other interested party, or any person related to such persons, unless the cash must be unconditionally repaid by the investor by the close of the year for which the determination is being made.[29] Also excluded is any amount borrowed from an unrelated person if the loan was arranged by a participating (or related) person, unless such amount must be unconditionally repaid by the close of the year.[30] The investment base must further be reduced by any direct or indirect borrowing from a lender located outside the U.S. of which a participating (or related) person knows or has reason to know.[31] Lastly,

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amounts held for the benefit of investors in liquid assets, such as marketable securities or checking accounts, must be excluded.[32]

If the relationship of the gross deductions, as computed above, to the investment base, as determined above, is greater than 2 to 1 at the close of any of the first five years with respect to even one investor in the investment, the investment meets the first half of the tax shelter definition.[33]

b. Regulated Investments; Substantial Investments

The second half of the tax shelter definition requires the investment either to be registered under any federal or state law regulating securities, such as the Securities Act of 1933, or to be exempt from federal or state securities registration by reason of the filing of a notice with a federal or state securities agency.[34]

Alternatively, the second part of the tax shelter definition will be satisfied if the investment is a "substantial investment". An investment is substantial if the aggregate amount that may be offered for sale to all investors exceeds $250,000 and five or more investors are expected to invest.[35] Under the temporary regulations,[36] the aggregate amount offered for sale is considerably broader than the investment base as it includes the fair market value of all property contributed, in contrast to the adjusted basis used for investment base purposes, and the principal amount of all debt received in exchange for interest in the investment, regardless of whether the debt proceeds are included in the investment base.

In appropriate circumstances, investments may be aggregated in order to determine whether the $250,000 amount is exceeded and whether there are at least five investors. Investments will be aggregated if they are similar investments offered by the same person or related persons.[37] The temporary regulations illustrate this principle with the following example adopted from the Conference Report of the Act.[38]

> *Example*: An investment sponsor develops similar arrangements involving eight different partnerships, each investing in separate but similar assets (such as master recordings), each with a different general partner and each with three different limited partners. If each partner will invest $11,000, there will be 32 investors, one general partner plus three limited partners times 8 partnerships, creating an aggregate investment of $352,000 (32 partners times $11,000). Each partnership will constitute part of a substantial investment. Moreover, if representations are made that $1,000 in credits and $3,000 in deductions will be available to each limited partner in the first year, and the limited partners have invested only $1,000 cash with the balance financed through $10,000 in nonrecourse obligations, the tax shelter ratio is 5 to 1 and the sponsor must register all the partnerships.

3. Registration Exceptions

Under the authority contained in §6111(e)(3), the temporary regulations provide two exceptions to the registration rules. First, the regulations except sales of residences primarily to persons expected to use the residences as their principal place of residence.[39]

Observation: That the regulations specifically set out personal residences as an exception is interesting not because it is in any way surprising but because it indicates the Service's view that the registration requirements are so expansive they could encompass home sales.

Second, the sales or leases of tangible personal property (except master sound recordings, motion picture or television films, video tapes, lithograph plates, or other property relating to a literary, musical, or artistic composition) by the manufacturer (or affiliated member) of the property primarily to persons who are expected to use the property in their principal active trade or business are excepted from the registration requirements.[40]

4. Who Must Register Tax Shelter and When

Once it is determined that an investment is a shelter and that it is not excepted from the registration requirement, the person responsibile for registering the shelter and the date by which it must be registered must be determined.

The shelter must be registered by the tax shelter organizer, who may be one of several people. In general, the tax shelter organizer is the person principally responsible for organizing the tax shelter (the "principal organizer").[41] If this person does not register the tax shelter on the day on which an interest in the shelter is first offered for sale, any other person who participated in the tax shelter's organization will be treated as a tax shelter organizer. If none of these persons register the shelter by that first day, then any person who participates in the tax shelter's management at a time when the shelter is not registered will be treated as a tax shelter organizer. If the shelter still remains unregistered and a person who participates in the sale of interests at a time when the person knows or has reason to know that the shelter has not been registered, then that person will be treated as a tax shelter organizer.[42]

Practitioners should note that preparation of any of the documents or materials relating to the tax shelter, such as the preparation of a tax opinion, financial statement, or appraisal can be classified as participation in the organization of the tax shelter, but such activity will be excluded as participation if the person performing the act is not related and does not participate in any of the profits or risks of the shelter. For example, an unrelated attorney who charges a flat hourly fee for the preparation of SEC registration documents will not be treated as participating in the tax shelter organization. However, if that same attorney charged a fee equal to one percent of the value of the units in the shelter sold, the attorney would be considered a participant.[43]

Management of the shelter includes such acts as managing the shelter assets, directing the shelter's business activity, or acting as general partner.[44] A manager who is unrelated to the principal organizer and whose compensation is not contingent on shelter performance will not be treated as participating in the organization of the tax shelter.[45]

A person who sells or solicits sales of interests in the tax shelter participates in the sale of the tax shelter. No exclusion is provided such participants based on their being unrelated and their not receiving contingent compensation

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with respect to the shelter. Presumably the reason for the denial of the exclusion stems from an assumption that all sales of interests will be on a commission basis and, therefore, dependent on the successful sales of the interests.

A person can be treated as a tax shelter organizer even though that person does not make any representations concerning tax benefits if that person knows or has reason to know that representations of tax benefits have been made.[46]

A principal organizer or participant in the organization of the tax shelter must register the shelter by the day on which the first offering or sale of the interests in the tax shelter occurs, unless a designation agreement is in effect in which a designated organizer is responsible for registering the shelter by that first day.[47] A manager of a tax shelter is responsible for registering an unregistered shelter by that first day, or if later, by the day on which the manager's participation in management of the shelter commences.[48] A seller of a tax shelter interest must register an unregistered shelter at the time the seller knows or has reason to know of the failure to properly register. If no registration number is received by the seller within 30 days after the seller first offers tax shelter interests, the seller is deemed to know that a registration has not occurred. This 30-day rule is significant because it implies that the Service will screen shelter registration returns rapidly, perhaps allowing the Service time to seek an injunction or notify investors regarding a shelter it views as abusive.[49]

Managers and sellers can be the parties to a designation agreement along with a principal organizer and other participants in the organization under which one person is designated as the tax shelter organizer responsible for registering the shelter.[50] However, a designation agreement will not relieve a person classified as a tax shelter organizer from the requirement of registering a shelter where the designated organizer fails to do so.[51]

5. Miscellaneous Rules

Within seven days of receipt of a tax shelter registration number from the Service, the tax shelter organizer must provide a copy of the notice to the principal organizer or to any persons who the shelter organizer knows or has reason to know are participating in the sale of shelter interests. A designated organizer must also provide a copy of the notice within seven days to all persons who signed the designation agreement.[52]

Once a shelter has been registered the registration is effective for the year of registration and all subsequent years; amendments to the registration statement need not be filed even though the underlying facts concerning the shelter have changed.[53] However, if a shelter is resyndicated, registration must be made anew unless the tax shelter organizer for the original sale is also the organizer for the resyndication and the facts pertaining to the resale were reflected in the original registration application.[54]

A shelter is registered by filing a completed Form 8264, Application for Registration of Tax Shelter.[55] Separate 8264 forms may be required for multiple investments that are aggregated in determining whether there is a substantial investment.[56] A timely mailed Form 8264 will constitute a timely registering of the shelter.[57]

The registration number for a shelter must be furnished to the purchasers of interests in the shelter by sellers of the interest. It must be furnished at the time of sale or, if later, within seven days after the seller or transferor of the interest receives the registration number. For interests sold in a tax shelter before September 1, 1984, the effective date of the registration requirement, the registration number must be furnished to all investors who acquired their interests before the effective date by December 31, 1984.[58]

The Service has prescribed in the temporary regulations the form of notice for communicating the registration number to purchasers.[59] This notice must include the name and address of the shelter, the taxpayer identification number, the registration number, and certain legends informing the investors (i) where and when the registration number must be used, (ii) that Form 8271, Investor Reporting of Tax Shelter Registration Number, must be attached to the return reporting shelter deductions or credits, and (iii) that issuance of the registration number does not in any way constitute Service approval of the investment or claimed tax benefits.

6. Penalties

Under §6707(a), a tax shelter organizer who fails to register a shelter on or before the date appropriate for that organizer or who files false or incomplete information with respect to the registration is liable for a penalty equal to the greater of $50 or one percent of the aggregate amount invested in the tax shelter (up to a maximum $10,000). There is a $10,000 maximum penalty if there was intentional disregard of the registration requirements. On the other hand, the failure to register or to file the proper information may be excused for reasonable cause.[60] A principal organizer or a participant in the organization of a tax shelter is subject to the penalty under §6707(a) by failing to file by the day on which interest is first offered even though a manager or seller subsequently registers the tax shelter.[61]

Under §6707(b)(1), any person required to furnish the registration number who fails to do so is subject to a $100 penalty for each such failure. A $50 penalty is imposed under §6707(b)(2) on any person who fails to include the registration number on a return where the number is required. This latter penalty will not, however, by imposed if the failure is due to reasonable cause.

7. Effective Dates

New §§6711 and 6707 apply to any tax shelter, any interest in which is first sold to any investor after August 31, 1984.[62] Under a transitional rule,[63] in determining whether an investment is a tax shelter by reason of substantial investment test, only offers for sale after August 31, 1984, will be taken into account. Under the temporary regulations, an investment will be considered a substantial investment if there are expected to be five or more investors on or after September 1, 1984, and the aggregate amount for sale on or after that day is expected to exceed $250,000. Amounts received from sales before September 1, 1984 are not taken into account in computing the amount of the penalty for failure to register.[64]

Note: The temporary regulations, 306.6707-1T, Answer 5, excuse the penalty for failing to register a shelter when

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required during September 1984 if the shelter is registered on or before September 30, 1984.

If a seller is required to furnish a registration number by December 31, 1984, to investors who bought interests in the shelter before September 1, 1984, the liability for the failure to furnish the registration number under §6707(b)(1) is deemed to arise on December 31, 1984.[65]

B. Maintenance of Investor Lists for Potentially Abusive Tax Shelters

1. Statutory Outline

Section 6112(a) requires any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter to maintain a list (i) identifying each person who is sold an interest in the shelter and (ii) containing such other information which may be required in regulations. Under §6112(b), a potentially abusive shelter is any shelter for which registration is required under §6111, or any entity, investment plan or arrangement, or other plan or arrangement of a type the Secretary determines by regulations as having a potential for tax avoidance or evasion.

Section 6112(c) requires any person obliged to maintain a list of investors to make that list available for inspection upon request. This list must be retained for seven years unless otherwise provided in regulations. If lists are required of two or more persons, only one person will be required to maintain the list under regulations to be prescribed.

Under §6708, a person who fails to maintain an investor list in accordance with §6112 is liable for a penalty of $50 for such failure, unless the failure is due to reasonable cause and not to willful neglect. The maximum penalty for any calendar year will not exceed $50,000.

2. Potentially Abusive Shelter — Definition

Perhaps in recognition of the expansive definition of registration-required tax shelters under §6111, as implemented by the §6111 temporary regulations, the Service in the temporary regulations under §6112 provides that the §6111 definition will be the only definition of potentially abusive tax shelter for the present.[66] In declining to exercise the authority to classify other arrangements as potentially abusive, the Service stated that the extent, if any, to which it would elaborate on the definition would be left for future regulations.[67]

3. Organizers and Sellers

a. Definitions

Under §6112, organizers of potentially abusive tax shelters and sellers of such shelters are required to maintain an investor list. The temporary regulations provide that the organizer, for this purpose, is the person who is a principal organizer of the tax shelter for purposes of §6111.[68] Sellers for purposes of the list requirement are as follows:

(1) any organizer, underwriter, broker, or dealer (or similar person who transfers any interest in the tax shelter);

(2) any agent who negotiates the transfer of any tax shelter interest for the tax shelter, any organizer, or any other person described in the preceding paragraph (1); and

(3) any investor who transfers any tax shelter interest.[69]

A tax shelter interest is defined as including the right to participate in a tax shelter by reason of (i) a partnership interest, a shareholder interest, or a beneficial interest in a trust, (ii) any interest in property (including a leasehold interest), or (iii) the entry into a leasing arrangement or a consulting, management, or other agreement for the performance of services.[70]

b. Organizer Lists

An organizer is required to list those persons who acquire interests in the tax shelter by reason of (i) a transfer of an interest made by the organizer or through an agent of the organizer, (ii) any transfer of an interest made by the tax shelter or through an agent of the shelter, (iii) any transfer of an interest made by or through a person related to the organizer or the tax shelter (within the meaning of §168(e)(4)), (iv) any transfer of an interest of which the organizer is informed, and (v) any other transfer of which the organizer knows or has reason to know.[71] Moreover, an organizer has a duty to make reasonable inquiry with respect to transfers of interests in the tax shelter made by a seller who acquired the interest from (1) the organizer (2) related persons, (3) the tax shelter or (4) a person related to the tax shelter. The organizer is liable for the breach of this duty which results in the omission of a name or names on the organizer's investor list.[72]

c. Seller Lists; Designation Agreements

A seller must list the identity of each person who acquired an interest in the tax shelter from the seller or, if the seller is an agent, each person who acquired an interest through the seller.[73] Organizers and sellers may, in a writing signed by all parties involved, designate one organizer to maintain the investor list required under §6112.[74] Sellers and organizers who are signatory to a designation agreement will not be subject to the §6708 penalty for failing to maintain an investor list, provided that the seller or organizer (i) submits to the designated person all of the information that the organizer or seller otherwise would be required to maintain on a list, and (ii) provides each investor with a notice setting forth the investor list requirements should the investor transfer his interest in the shelter subsequently.[75] If a designated person fails to maintain the list, the designated person is liable for the §6708 penalty.

The notice requirement to inform investors of their duty to maintain a list applies as well to sellers who do not sign designation agreements. The notice must advise that the list requirement can be satisfied by incorporating information respecting subsequent sales with the list maintained by the seller.[76]

4. List Format

An organizer or seller may maintain an investor list on paper, card file, magnetic media, or in any other form provided the method of maintaining the list enables the Service to determine without undue delay or difficulty the following information:

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(1) the name of the tax shelter and its registration number;

(2) the taxpayer identification number (TIN), if any, of the shelter,

(3) the name, address, and TIN of each person required to be included on the list;

(4) the number of units acquired by each person included on the list;

(5) the acquisition date of each interest;

(6) the name of the person from whom the interest was acquired, if the interest was not acquired from the person maintaining the list; and

(7) the name and address of each agent of the person maintaining the list.

If an investor maintains the list, only requirements (1), (3), and (5) must be included.[77]

5. Retention and Availability Requirements

The list must be retained for seven years following the date on which the last acquisition of an interest required to be included on the list is made; in certain instances the period may be longer.[78] If the organizer or seller is a corporation or partnership that is dissolved or liquidated before the end of the seven-year or longer period, the list must be retained by the person under state law responsible for winding up the affairs of the partnership or corporation. If state law does not specify any person, the directors of the corporation or general partners of the partnership shall be responsible.[79] The list must be made available upon request to the Service as soon as practicable but in no event later than 10 calendar days after request, which need not be in the form of an administrative summons.[80]

6. Penalties

Under §6708, any person who fails to observe the list requirements is subject to a $50 penalty for each failure unless the failure is due to reasonable cause and not willful neglect. Each omission of a person required to be identified on the list is treated as a separate failure, for example, if 100 persons are omitted, the person responsible for the list will be liable for a $5,000 penalty under Temp. Regs. 301.6708-1T, Answer 1. The penalty may also be imposed for failure to include all of the required information with respect to an investor includible on the list.[81] In addition, even if the list is properly maintained, the failure to supply the list to the Service within 10 days will give rise to the penalty. In this circumstance the penalty will equal $50 multiplied by all investors included on the list that was not furnished.[82] The maximum penalty for any calendar year is $50,000. Separate $50,000 limitations, however, exist with respect to each separate shelter for which the list must be maintained.[83]

7. Effective Date

Section 6112 and the related penalty under §6708 apply to any tax shelter interest which is first sold to any investor after August 31, 1984.[84] Accordingly, if interests in a tax shelter are sold both before and after August 31, 1984, the investor list need be maintained only with respect to interests sold by the organizer after August 31, 1984.[85]

C. New Return Requirements for Cash Receipts, Foreclosures and Abandonments, Partnership Exchanges, and Donated Property Dispositions

1. Statutory Outline

The Act adds §§6050H, 6050I, 6050K, 6050J, and 6050L to require the filing of information returns with respect to the following cases: (i) certain mortgage interest received in a trade or business, (ii) substantial cash receipts in a trade or business, (iii) certain foreclosures and abandonments of property securing indebtedness, (iv) exchanges of partnership interests with unrealized receivables, and (v) certain dispositions of donated property.

Under §6050H(a), any person engaged in a trade or business who, in the course of the trade or business, receives from any individual at least $600 of mortgage interest for any calendar year must file an information return. Section 6050H(b) sets forth the requirements for the contents of the return. Under §6050H(c), a governmental unit, and any agency and instrumentality thereof, is made subject to these return requirement rules. Section 6050H(d) requires that an information statement be sent to each individual reported on the return. Section §6050H(e), defines "mortgage" for purposes of §6050H. Section 6050H(f) provides that only the first person receiving interest that is reportable must file the information return.

Section 6050I(a) provides that any person engaged in a trade or business who in the course of that business receives more than $10,000 in cash in one transaction (or two or more related transactions) must file an information return meeting the requirements of §6050I(b). Section 6050I(c) sets forth the exceptions to the return requirement, the principal exception being for cash reportable under the Bank Secrecy Act. Under §6050I(d), foreign currency is treated as cash for purposes of §6050I. Section 6050I(e) requires the furnishing of an information statement to any person who will be included in the information return.

Section 6050J(a) requires the filing of an information return by any person who, in connection with a trade or business conducted by such person, lends money secured by property and who (i) in full or partial satisfaction of any indebtedness acquires an interest in such property or (ii) has reason to know that such property has been abandoned. Under §6050J(b), the return requirement does not apply to any loan to an individual secured by an interest in tangible personal property that is held for personal purposes. The information return must meet the requirements set out in §6050J(c). Section 6050J(d) extends the information return requirement to governmental units. Under §6050J(e), information statements must be furnished to those persons with respect to whom an information return is filed. Under §6050J(f), the Secretary is authorized to prescribe regulations extending the return requirement to other dispositions.

Section 6050K(a) requires a partnership to file an information return, except to the extent provided in regulations, if there is an exchange described in §751(a) of any interest in the partnership during any calendar year. Under §6050K(b), information statements must be furnished to the transferor and transferee in such an exchange. Under §6050K(c), the transferor in a §751(a) exchange is re-

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quired to notify the partnership of the exchange, and the partnership is not required to file an information return until such notification.

Under §6050L, if a donee of any charitable deduction property disposes of such property within two years after receipt, the donee must file an information return, and, under §6050L(c), an information return with respect to such a disposition must be furnished to the donor at such time and in such manner as prescribed in regulations. Section 6050L(b) defines "charitable deduction property" as any property (other than publicly traded securities) for which a charitable deduction was claimed under §170 if the claimed value of property (plus all similar items) exceeds $5,000.

Failure to satisfy the foregoing information return or information statement requirements may result in the imposition penalties under §6652, relating to information returns, or §6678, relating to information statements.

2. Mortgage Interest Reporting

a. General

A lender or other person who, in the course of a trade or business, receives at least $600 of mortgage interest from any individual for any calendar year is required to file an information return.[86] According to the Conference Report,[87] the $600 threshold for reporting will apply on an obligation by obligation basis; if interest is received on two different obligations secured by the same real property, it need not be aggregated into one report but may be reported separately. Thus, for example, if a lender holds first and second mortgages from the same individual secured by the same property and receives $1,000 of mortgage interest on the first mortgage and $550 on the second mortgage for a calendar year, mortgage interest reporting appears to be required only with respect to the first mortgage.

Reporting is required only with respect to mortgages on real property.[88] In addition, regulations may provide exceptions from this reporting requirement where such exceptions are consistent with effective reporting of mortgage interest and the matching of the reports with a specific line on the tax return.[89] For example, regulations may provide an exception from reporting interest paid on credit cards secured on real property if such interest is most likely to show on returns as interest on credit cards rather than home mortgage interest.[90] However, the regulations may not except any interest reporting on Schedule A as home mortgage interest.[91]

Under §6050H(f), if mortgage interest is received by one person on behalf of a second person, only the person first receiving the interest must make an information return, unless regulations provide otherwise.

The information return requirements apply to governmental units, such as housing agencies that provide mortgages with the proceeds of mortgage subsidy bonds, without regard to the trade or business requirement.[92]

In addition to the information return requirement, an information statement must be provided to each individual with respect to whom an information return must be filed.[93]

b. Form and Contents of Return

Under §6050H(b), the information return must be in the form prescribed by the Secretary and contain (i) the name and address of the individual from whom the mortgage interest is received, (ii) the amount of the interest received for the calendar year, and (iii) such other information as may be prescribed. Presumably, the Secretary will require the use of forms 1096 and 1099.[94] Providing a copy of Form 1099 to the mortgage interest payor will presumably satisfy the information statement requirement of §6050H(d).[95]

Although not specified in the statute, the payor's taxpayer identification number will likely be an additional item that must be furnished on the information returns and statements. The Conference Report [96] states the expectation that recipients of mortgage interest will require the payor to furnish his taxpayer identification number as part of the mortgage loan approval or closing process for mortgage loans entered into after 1984. The Report further states that, for mortgage loans in existence on December 31, 1984, it is anticipated that regulations will require mortgage interest recipients to request, at least once a year, the payor's taxpayer identification number unless the recipient already has that number in its accounting system. These requests for taxpayer identification numbers may be included in the recipient's regular mailings of either payment coupon booklets or annual statements to the payor, and separate mailings will not be required unless the recipient does not otherwise contact the payor at least once each year.

The Conference Report [97] additionally states that the first request for the taxpayer identification number must be made as soon as practicable and in no event later than the first mailing by the recipient to the payor in 1985. Recipients will be required to notify payors that the Service requires the payor to furnish its taxpayer identification number in order to verify the payor's mortgage interest deduction and that a $50 penalty may be imposed if the payor fails to furnish such number. Any payor who makes these annual requests for taxpayer identification number will not be subject to penalty for failure to include the number because of the payor's failure to supply the requested number.

Lastly, the Conference Report [98] states that it intends the Secretary to coordinate the information statement requirement with other requirements, such as those of Federal mortgage programs, that similar statements be furnished, so that duplicative reporting is minimized.

Note: In the effective date provisions,[99] relief from the imposition of any penalty under §6652 is granted for any failure to supply a taxpayer identification number with respect to amounts received before January 1, 1986, on any mortgage obligation in existence on December 31, 1984.

3. Reporting of Substantial Cash Transactions

a. General

Any person engaged in a trade or business who receives, in the course of the trade or business, more than $10,000 in cash or foreign currency in one or more related transactions must report it to the Service and provide the

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payor with a statement.[100] Reporting is required even if the receipt of the cash does not constitute income in the trade or business of the recipient and regardless of whether consideration is returned for the cash or whether cash is received for the recipient's account or the account of another.[101] For example, the receipt of cash in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, the purchase of gambling chips, or any similar transaction will be subject to reporting.[102]

Reporting is required with respect to two or more related transactions if the total cash received for those transactions exceeds the $10,000 threshold. The Conference Report furnishes the following example of the related transaction rule.[103]

> *Example:* Assume that an individual purchases an $8,000 item and a $1,500 item at an auction. The auction house adds a 10 percent commission and 5 percent local sales tax. The individual pays the total $10,972.50 bill in cash. The auction house must report that transaction even if two separate bills of $9,240 and $1,732.50 are presented for each item.

b. Form and Contents of Returns and Statements

Under §6050I(b), the return must be in the form prescribed by the Secretary and must contain (i) the name, address, and taxpayer identification number of the person from whom the cash was received, (ii) the amount of cash received, (iii) the date and nature of the transaction, and (iv) such other information as may be required.

The information statement to be furnished to the payor must contain (i) the name and address of the person making the information return and (ii) the total cash received by the person making the information return.[104] The information statement must be provided to the payor on or before January 31 of the year following the calendar year for which the information return must be filed.[105]

c. Exceptions

Information returns are not required on cash payments that are received (i) in a transaction reported under the Bank Secrecy Act (31 U.S.C.), if the Secretary determines that the report under this provision would duplicate the Bank Secrecy report, or (ii) by certain specified financial institutions described in the Bank Secrecy Act (31 U.S.C. §5312(a)(2)(A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S)). Those entities that had been exempted by the Treasury from Bank Secrecy reporting, such as certain dealers in precious metals, stones, or jewels, pawn brokers, loan or finance companies, insurance companies, and travel agencies, will be subject to the Act's return requirements.[106] If these exempted entities are subsequently required to report under the Bank Secrecy Act, the Secretary can provide that a duplicative return under §6050I need not be made.

The Conference Report [107] states that it understands the Treasury is considering extending certain Bank Secrecy Act reporting to casinos and other establishments. The Report provides that the Secretary can eliminate any duplicative reporting requirement under §6050I to take into account the extension of Bank Secrecy Act reporting requirements.

4. Foreclosures and Abandonments Security

a. General

Under §6050J(a), an information return must be made by any person who, in connection with a trade or business, lends money secured by property, and who later either acquires an interest in the property in full or partial satisfaction of the indebtedness or has reason to know the property has been abandoned. In addition, under §6050J(b), an information statement must be furnished to the borrower owning the property that was subject to the reporting requirement.

Under temporary regulations that have been issued implementing §6050J (Temp. Regs. §1.6050J-1T) a person need not be engaged in the trade or business of lending money in order to be subject to the reporting requirements of §6050J.[108] For example, if an automobile dealer lends money to a purchaser in order to purchase an automobile, and that auto is security for the loan, the dealer would be subject to the reporting requirement. Similarly, an oil promoter who lends money to an investor to enable the investor to invest in the oil well, which is security for the loan, would be subject to the reporting requirement. In the case of pools, fixed investment trusts, or similar arrangements by which undivided beneficial interests or participations in an indebtedness are offered, the trustee, record owner, or person acting in similar capacity is subject to the reporting requirements; the owners of such undivided beneficial interests or participations are not subject.[109] Similarly, in the case of corporate, tax-exempt, or other bond issues, the owners or holders of a bond issue are not required to report; the reporting obligation is placed on the trustee or person acting in similar capacity.[110]

Under §6050J(b), the return requirement does not apply to any loan (i) made to an individual and (ii) secured by an interest in tangible personal property that is neither held for investment nor used in a trade or business. However, the temporary regulations require reporting if such personal property is held for both personal use and business use.[111] Reporting is also required with respect to indebtedness secured by a personal residence since the residence is real property and not personal property.[112]

If a lender knows that property customarily held for personal purposes will be used for business or investment, the lender is subject to the reporting requirements.[113] A lender is considered to know such information if the information is included on the records of the lender or an agent pertaining to the loan, or is known to the lender or the agent's officers, partners, principals, or employees, but only if such information was acquired in the course of their ordinary business activities on behalf of the lender. For example, if the borrower notes on the loan agreement or disclosure statement an intention to use the property in his business, the lender is subject to the reporting requirement. Similarly, if the borrower notifies the lender of an intention to convert the property from personal to business use, the lender is subject to the reporting requirement.[114] For purposes of the reporting requirement, a lender may rely on a system established by the lender to classify loans according to the use of property securing the loan if the classification system is designed and maintained to ensure accuracy in identifying the use of the property.[115]

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A lender is considered to acquire an interest in property that is security for indebtedness on the earlier of the date title is transferred to the lender or the date possession and the burdens and benefits of ownership are transferred to the lender. If local law provides an objection period within which the borrower and other appropriate parties may object to the lender's proposal to retain the property in satisfaction of the indebtedness, the lender's interest is deemed to be acquired on the date the objection period expires. Similarly, if the lender purchases the property at a foreclosure or an execution sale, the lender is treated as acquiring an interest in the property on the later of the date of the sale or the date the borrower's right of redemption, if any, expires.[116]

The lender's taking possession of the property for limited purposes, such as completing construction, will not be treated as the acquiring of an interest in the property.[117] However, the acquisition of an interest in a partnership, trust, or other entity that holds assets securing the loan is treated as the acquisition of an interest in the underlying assets or property, and the reporting requirements apply to the acquisition of the interest in the partnership, trust, or other entity.[118]

If a third party purchases the property securing the loan at a foreclosure, execution, or similar sale, the lender is still required to report. If the proceeds of such sale are applied to satisy all or any portion of the lender's loan, or if the lender's security interest foreclosed upon is terminated, reduced, or otherwise impaired by reason of the sale, the lender will be treated as having reason to know that the property has been abandoned as of the date of the sale.[119]

For purposes of the reporting requirements, an abandonment is deemed to occur when "the objective facts and circumstances indicate that the borrower intended to and has permanently discarded the property from use." [120] Whether a lender has reason to know that property securing a loan has been abandoned will be determined under all the facts and circumstances concerning the property's status.[121] A lender becomes subject to the information return requirement as of the date the lender knows or has reason to know that the property has been abandoned.[122] However, if the lender reasonably expects to commence foreclosure, execution sale, or similar proceedings within three months of having reason to know that the property has been abandoned, the lender must report as of the date he acquires an interest in the property or the date a third party purchases at a foreclosure, execution, or similar sale.[123]

Example: On December 31, 1985, a lender learns that property securing its loan has been abandoned and reasonably expects to commence foreclosure proceedings within three months. If the lender does not in fact commence foreclosure proceedings by March 31, 1986, the lender's obligation to report arises on this day. Although the lender must provide information on the abandonment as of the date the lender first had reason to know of the abandonment (December 31, 1985), the information return with respect to the abandonment need not be filed with the Service before February 28, 1987, and a statement furnished to the borrower before January 31, 1987.[124]

Where the lender subsequently transfers his interest in the indebtedness to another person, such as to the Federal National Mortgage Association, only the subsequent holder is subject to the reporting requirement, in this case the Federal National Mortgage Association.[125] However, if multiple lenders have loaned money secured by the same property, all the lenders are subject to the reporting requirement if one lender forecloses upon the property and the other lenders know or have reason to know that a foreclosure has occured that terminates, reduces, or otherwise impairs their security interests in the property.[126]

b. Return Contents

The information return required by §6050J must be made on forms 1096 and 1099, except that the return preparer may use a form containing provisions substantially similar with those of forms 1096 and 1099 if the preparer complies with revenue procedures relating to substitute forms.[127] The return must contain the following information:

(i) the name and address of the borrower with respect to this secured indebtedness;

(ii) the borrower's taxpayer identification number;

(iii) a general description of the property;

(iv) whether the borrower is personally liable on the loan;

(v) the date on which the lender acquired an interest on the property or first knows, or has reason to know, that the property has been abandoned;

(vi) the amount of indebtedness outstanding at the time of acquisition or the time the lender knows or has reason to know that the property has been abandoned;

(vii) the amount of indebtedness satisfied by the acquisition, if an acquisition;

(viii) if the borrower is personally liable, the fair market value of the property at the time of acquisition or at the time of abandonment;

(ix) any other information as may be required by forms 1096 and 1099.[128]

If the borrower is a partnership, only the taxpayer identification number of the partnership must be reported.[129]

If there is more than one borrower on a single secured loan, a separate return must be made with respect to each borrower on that loan unless the lender knows that the borrowers hold the property as tenants by the entirety or as community property.[130]

The requirement that the return contain a general description of the property is satisfied by including information that sufficiently identifies the property. For real property, the property's address will suffice unless it is unavailable or would not sufficiently identify the property, in which case a legal description must be provided. For personal property the type, make, and model (where applicable) of the property should be provided. However, in the case of a single loan secured by several items of personal

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property. a general description consists of the type and category of the pieces acquired or abandoned, such as office equipment where the loan is secured by desks and typewriters.

In general, each acquisition and abandonment required to be reported by a lender for a taxable year must be reported on a separate return. But if a single loan secures more than one piece of property, separate returns will not be required when a person acquires an interest in, or knows or has reason to know the abandonment of, more than one piece of property that is security for the single loan in a taxable year. Instead, one return must be made for all the acquisitions and one return for all the abandonments of the property that is a security for such a loan for the taxable year.[132]

c. Time for Filing Return

An information return with respect to an abandonment or foreclosure during the calendar year must be filed on or before the February 28 of the year following the calendar year in which the acquisition of an interest in the property occurs or in which the lender knows or has reason to know of the abandonment of the property.[133] The return must be filed with the appropriate Internal Revenue Service Center.[134] The information returns must be filed on magnetic media to the extent required by §6011(e).[135]

d. Information Statement

The borrower with respect to whom an information return is filed must be supplied an information statement, mailed to the borrower at the borrower's last known address, no later than the January 31 of the year following the calendar year in which the acquisition or abandonment of property occurs.[136] The information statement must include the name and address of the person required to make the information return or the name and address of the governmental unit or agency subject to the return requirement. In addition, the information provided on the information return must be included as well as a legend that such information is being reported to the Service.[137] The information statement requirement may be satisfied by furnishing the borrower a copy of the Form 1099 that is filed with the Service.[138] In the case of multiple borrowers, a separate information statement must be furnished to each borrower with respect to which a separate return is required under §6050J.[139]

A person required to file returns may request an extension of up to 30 days within which to furnish information statements to borrowers if good cause for the request can be shown.[140] The extension request must be in writing, addressed to the director of the Service Center where the information returns must be filed, must contain a concise statement of the reasons for requesting the extension, and should be filed not earlier than September 30 of the year in which the acquisition of an interest in the property occurs, or during which the lender knows or has reason to know of the abandonment of the property, and not later than the January 15 of the following year.[141]

e. Foreign Borrowers

The reporting requirements do not apply if the property securing the loan is located outside the U.S. and at any time before the lenders required to report, the borrower furnishes the lender with a statement, signed under penalty of perjury, that the borrower is an exempt foreign person. A borrower is an exempt foreign person if the borrower (i) is not a U.S. citizen or resident, or U.S. corporation or other U.S. entity, (ii) is not subject to the provisions of §877, and (iii) at the time the statement is furnished, is not, or reasonably expects not to be, engaged in a U.S. trade or business during the current year in connection with the loan or property securing the loan.[142] If the borrower ceases to be an exempt foreign person, the lender must be notified in writing within 30 days of this change in status and the exemption from the reporting requirement will no longer apply.[143]

5. Reporting of §751(a) Partnership Exchanges

Under §6050K, the transferor partner must promptly notify the partnership of the sale or exchange of a partnership interest involving unrealized receivables or substantially appreciated inventory. Upon notification, the partnership is required to file an information return stating the name and address of the transferee and transferor involved in such exchange and such other information as may be prescribed in regulations.[144] In addition, information statements must be supplied to the transferor and transferee partners in such an exchange showing the name and address of the partnership filing the information return and the information shown on the return with respect to the transferor and transferee.[145] The information statements must be supplied on or before the January 31 following the calendar year for which the information return is made.[146]

A partnership is not required to make an information return until notified of the exchange.[147]

6. Reporting of Dispositions of Charitable Deduction Property

If the charitable donee of any "charitable deduction property" sells, exchanges, or otherwises disposes of such property within two years of receipt, the donee must make a return showing the following information:

(i) the name, address, and taxpayer identification number of the donor;

(ii) a description of the property;

(iii) the date of the contribution;

(iv) the amount received on disposition; and

(v) the date of disposition.[148]

Section 6050L(b) defines "charitable deduction property" as any property (other than publicly traded securities) for which a charitable deduction under §170 was claimed if the claimed value of the property (plus the claimed value of all similar items of property donated by the donor to one or more charitable donees) exceeds $5,000. Under §6050L(d), publicly traded securities are defined as securities for which market quotations are readily available on an established securities market as of the date of the charitable contribution of the securities.

The charitable donee is required to furnish a copy of the return to the donor at the time and in the manner as may be prescribed in regulations.[149]

The Conference Report [150] states that regulations are to provide that the donor (as part of the donor appraisal

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requirements for which regulations must be issued) must (i) submit the appraisal summary to the donee for the donee's acknowledgement signature, and (ii) inform the donee of any donation of similar items made during the same year. The donee's acknowledgement signature on the summary appraisal is not to be construed as indicating the donee's agreement with or acceptance of the amount claimed for the donated property on the appraisal summary.[151]

7. Penalties

The Act [152] amends the penalty provisions of §6652(a) and §6678(a) to apply those penalties for a failure to meet the information return requirements or information statement requirements of the foregoing new reporting provisions. The penalty under §6652(a) for the failure to file the appropriate return is equal to $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty will not be imposed if the failure is due to reasonable cause and not to willful neglect.

If there is intentional disregard of the information return requirements, the $50,000 limitation will not apply.[153] Moreover the penalty is raised to $100 with respect to each failure to satisfy the information return requirements relating to (i) mortgage interest under §6050H, (ii) cash receipts under §6050I, and (iii) foreclosures and abandonments under §6050J.[154] In the case of the intentional disregard of the return requirements respecting partnership exchanges under §6050K and dispositions of charitable deduction property under §6050L, the minimum penalty will be equal to 10 percent of the aggregate amount of the items required to be reported.[155]

The penalty for failing to furnish the information statements required of persons who must be reported on information returns is equal to $50 per failure, subject to a maximum of $50,000.[156] The penalty may be executed if the failure is due to reasonable cause not to willful neglect.[157]

A penalty may also be imposed under §6678(c),[158] on the transferor of a partnership interest who fails to notify the partnership of the §751(a) exchange, unless the failure is due to reasonable cause and not to willful neglect. The penalty is equal to $50 for each failure to give notice.

Observation: Section 6678(c) provides for the imposition of the penalty for failing to "furnish the notice required by §6050K(c)(1) on the date prescribed therefor." However, §6050K(c)(1) provides merely that the transferor of the partnership interest must "promptly notify" the partnership without specifying a precise date for notice. Presumably, regulations will prescribe a date beyond which notice to a partnership will not be deemed "prompt".

8. Effective Dates

The §6050H requirements for reporting mortgage interest generally apply to amounts received after December 31, 1984.[159] However, as previously mentioned, no penalty will be imposed under §6652 as to any obligation in existence on December 31, 1984, for any failure to supply a taxpayer identification number with respect to amounts received before January 1, 1986.[160]

The §6050I reporting requirement for substantial cash receipts applies to amounts received after December 31, 1984.[161]

The return requirements relating to foreclosures and abandonments of security under §6050J apply with respect to acquisitions of property and abandonments of property after December 31, 1984.[162]

The return requirements relating to §751 partnership exchanges under §6050K apply with respect to exchanges after December 31, 1984.[163]

Lastly, the reporting requirements of §6050L for dispositions of charitable deduction property apply to contributions of such property made after December 31, 1984, in taxable years ending after such date.[164]

D. Other New or Amended Reporting Provisions

1. Individual Retirement Accounts (IRAs)

The Act [165] amends §408(i), relating to the reports that must be filed by trustees and issuers of IRAs, to require that the report must identify the years to which the IRA contributions relate. The Conference Report states that the trustee may require that the owner of the IRA certify as to which year a contribution relates and that the trustee may rely on that certification except in unusual circumstances.[166]

The Conference Report [167] further provides that the date by which the trustee's report must be provided to the Service and the periods to which the report relates are to be specified in regulations. It is intended that generally trustees will be required to report only once a year on the aggregate total contributions relating to a particular taxable year, but regulations may provide for more frequent reporting if it is appropriate to do so. The date by which such reports must be provided to the Service is left to the regulations; the reports could be required by the end of May on all IRA contributions relating to the taxable year with respect to which the individual's tax return was due on the preceding April 15.

In addition to the foregoing revision of the IRA reporting requirement, the Act [168] increases the penalty in §6693(a) for failing to provide IRA reports from $10 to $50.

The Act amendments apply to IRA contributions made after December 31, 1984, except that the increase in the penalty applies to failures occurring after July 18, 1984.[169]

2. Information Statements With Respect to Short Sales

The Act [170] adds new §6045(d) to require a broker who (i) transfers securities to a customer for use in a short sale or similar transaction, and (ii) receives (on behalf of the customer) a payment in lieu of a dividend, tax-exempt interest, or such other items which may be prescribed in regulations, to furnish the customer with a written statement identifying the payment as being in lieu of the dividend, tax-exempt interest, or such other item as prescribed. The reason for this new information statement requirement is that neither the dividend exclusion of §116 for individuals nor the dividends-received deduction of §243 for corporations is available with respect to payments in lieu of dividends. Moreover, since payment in lieu of tax exempt interest is not interest, an exclusion under §103 is also not available. Because no reporting requirement existed under pre-TRA law, customers whose securities were borrowed by a broker to enable other customers to complete

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short sales (generally securities held in margin accounts) were not informed of the borrowing and they continued to exclude or deduct the in lieu payments.

Observation: Since the 85-percent dividends-received deduction of §243 is a considerable tax benefit to corporations, it is quite likely that corporations will be reluctant to agree to the use of securities in the margin accounts to complete short sales in the future, unless they are in some way compensated for the tax benefit lost by the receipt of an in lieu of payment rather than the dividend itself. The $100 dividend exclusion of §116 is, obviously, a less substantial benefit and may not be of as great concern. However, even if it is assumed that brokers do not have a legal duty to apprise customers of the tax consequences of payments in lieu of dividends, it is probably advisable that brokers inform their customers of the consequences in order to promote good customer relationships.

In addition to the information statement requirement, the Secretary is authorized to prescribe regulations to require the broker to file an information return including the information contained in the information statement. The Conference Committee [171] states that it is expected the Secretary will exercise this authority for all types of payments for which information could be useful. The Committee further states that the Secretary should also provide that no return regarding dividend payments need be made if it unnecessarily duplicates any return required to be made under this new reporting rule.

The new information statement requirement applies to payments received after December 31, 1984.[172]

3. *State and Local Refunds*

Under §6050E, state and local governments are required to report to the Service all tax refunds greater than $10, and they must furnish an information statement reporting the amount of the refund to the taxpayer in the January of the year following the year of the refund. The Act [173] amends this provision to provide that an information statement will not be required if it is determined (in the manner provided by the regulations) that the recipient of the refund did not claim itemized deductions in a taxable year giving rise to a refund. The Conference Report [174] observes that all refunds, whether made to itemizers or non-itemizers, must continue to be reported to the Service. The Report further states that it anticipates that reporting to the Service will not be burdensome on states since most states have already entered into information exchange agreements that provide for the furnishing of this information to the Service. The Report urges the Secretary to consider terminating any information exchange agreement under §6103 with any state that does not report refunds to the taxpayer.

The relaxing of the information statement requirement applies to payments or refunds, and credits and offsets made, after December 31, 1982.[175] However, the Conference Report [176] states the expectation that no punitive action will be taken against any state or local government, or officer or employee thereof, who failed to provide to taxpayers the information statement required under §6050E before January 1, 1985.

4. *Return Information to Beneficiaries of Estates and Trusts and to Shareholders of S Corporations*

Section 6034A, added by the Act,[177] requires that the fiduciary of any estate or trust making the return for the estate or trust required under §6012(a) for any taxable year to furnish, on or before the date on which the return is filed, a statement containing the return information required by the Secretary to each beneficiary (i) who receives a distribution from the estate or trust with respect to the taxable year, or (ii) to whom any item with respect to such taxable year is allocated.

Moreover, the Act [178] adds §6037(b), relating to returns of Subchapter S corporations, to require Subchapter S corporations required to file a return for any taxable year to furnish a copy of such return information as may be required by regulations to each person who is or was a shareholder at any time during such taxable year.

Further, the Act [179] amends the §6678(a) penalty for failure to furnish information statements, extending that penalty to a failure to provide return information to beneficiaries or Subchapter S shareholders as required by §6034A or §6037(b), respectively. The §6678(a) penalty is $50 for each return information statement not furnished up to a maximum of $50,000.

These provisions are effective for taxable years beginning after December 31, 1984.[180]

5. *Amendments to the Tip Reporting Requirements*

Under §6053(c), as added by TEFRA,[181] a large food or beverage establishment must allocate to employees as tips the excess of 8 percent of gross receipts over tips reported by the employees to the employer. The Service can reduce the 8 percent figure to 5 percent where the Service determines that the percentage of gross receipts constituting tips is less than 8 percent. A large food or beverage establishment is one customarily employing more than 10 employees on a typical business day during the preceding calendar year.

The Act [182] makes several liberalizing changes in the tip reporting requirements. First, §6053(c)(3) is amended to provide that either the employer or a majority of the employees of the employer may petition the Service for a reduction in the percentage of gross receipts required to be allocated, and to provide that the minimum percentage required to be allocated is reduced from 5 to 2 percent. It should be noted, however, that the Conference Report states the expectation that an establishment would ordinarily not be able to prove entitlement to the 2-percent rate.[183]

Moreover, §6056(c)(4) is amended to provide that in testing for whether an establishment is subject to the tip reporting requirements, a person owning at least 50 percent of the value of the stock of the corporation operating the establishment shall not be treated as an employee.

The TRA also mandates that the Secretary prescribe regulations within one year of the date the TRA was enacted, July 18, 1984, describing the applicable record-keeping requirements for tipped employees.[184]

These TRA amendments apply to calendar years beginning after December 31, 1982.[185]

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6. Miscellaneous Reporting Amendments

The Act [186] amends §6042(b), relating to the exceptions from the dividend reporting requirements of §6042(a), to except from reporting distributions or payments to any person described in §6049(b)(4).

The Act [187] amends the broker return requirements of §6045(c) to provide that a broker can include any governmental unit and any agency or any instrumentality thereof. However, no penalty will be imposed with respect to any governmental unit required to file a return by reason of the foregoing amendment for any payment before January 1, 1985.

These two amendments are effective as if they had been included in the TEFRA provisions to which they relate.[188]

E. Modifications Affecting Penalties and Interest

1. Increase in Promoter Penalty

Under §6700(a), a promoter who, in connection with an organization or sale of a tax shelter, made false or fraudulent statements or gross valuation overstatements on a material matter was subject to a penalty equal to the greater of $1,000 or 10 percent of the gross income derived or to be derived by the promoter from the shelter. The Act [189] raises this penalty to the greater of 20 percent of the gross income derived or to be derived from the shelter or $1,000.

This amendment is effective on July 19, 1984.[190]

2. Injunction Against Aiding or Abetting Tax Liability Understatement

Under §7408(a), the Secretary may request that a civil action be brought to enjoin any person engaging in conduct subject to penalty under §6700, such as the promoter or seller of a tax shelter who makes false statements in connection with the shelter. The Act [191] amends §7408 to provide that injunctions may be sought against persons subject to penalty under §6701. Section 6701 subjects to penalty any person who (i) aids, procures, or advises with respect to the preparation or presentation of any portion of the return, affidivat, claim, or any other document in connection with any tax matter, (ii) knows that such portion will be used in connection with any material tax matter, and (iii) knows that such portion, if used, will result in an understatement of tax liability of another person.

The reason for expanding the scope of the §7408 injunction was a concern that §6700 may be read too narrowly to preclude application of §6700 after the shelter had been organized, thereby preventing injunctions for such activities as providing false partnership returns.[192] The inclusion of the reference to §6701 in §7408 eliminates this concern.

The Conference Report states that no inference should be drawn that the general injunctive power of the district courts under §7402(a) is in any way limited by the injunctive relief provided under §7408 or the relief provided under §7407 to enjoin income tax preparers. The Report expressed its approval of a case that reached this result, *U.S. v. Landesberger*, 692 F.2d 501 (8th Cir. 1982).[193]

The amendment to §7408 is effective on July 19, 1984.[194]

Note: Because the Claims Court does not have jurisdiction to issue injunctions under §7408, the Act [195] amended §7422 to provide that no action may be brought in the Claims Court for a refund or credit of the §§6700 and 6701 penalties.[196]

3. Revisions in the Valuation Penalty

a. Background

Section 6659 provides for a penalty on valuation overstatements by individuals, closely held corporations, and personal service corporations. The penalty is computed in the following manner. If the claimed valuation is 150 percent or more, but not more than 200 percent, of the correct value, the penalty is equal to 10 percent of the tax liability understatement attributable to the overvaluation. If the claimed valuation is 200 percent or more, but not more than 250 percent, of the correct value, the penalty is equal to 20 percent of tax liability understatement. If the claimed valuation exceeds 250 percent of correct value, the penalty is equal to 30 percent of the tax liability understatement.

This penalty may be imposed only if the tax liability underpayment attributable to the valuation overstatement is at least $1,000 and only if the property has been held for no more than for 5 years.[197] In addition, the Service may waive all or part of the penalty if the taxpayer can establish a reasonable basis for the valuation claimed on the return and that the claim was made in good faith.[198]

The penalty applies to overvaluations only; it does not apply to undervaluations made for estate or gift tax purposes.

b. Overvaluation Penalty Amendments

The Act makes three changes relating to valuation penalties. First, §6659(c) is amended [199] to eliminate the exception to the application of the penalty for property held for more than five years.

Second, §6659(f) [200] prescribes special rules for valuation overstatements on "charitable deduction property". Under §6659(f)(1), the penalty will equal 30 percent of the tax liability understatement attributable to the overvaluation where the claim valuation is 150 percent or more of the correct value. Further, §6659(f)(2) limits this Service's authority to waive the overvaluation penalty with respect to charitable deduction property unless it is determined that (i) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and (ii) the taxpayer made a good faith investigation of the value of the contributed property, in addition to obtaining the appraisal.

For purposes of the foregoing special rules, "charitable deduction property" is defined as any property for which the taxpayer has claimed a charitable deduction under §170, other than securities for which market quotations were readily available on an established securities market as of the date of the contribution.[201] The terms "qualified appraiser" and "qualified appraisal" will be defined in regulations to be prescribed under §170(a)(1).[202]

c. Valuation Understatement Penalty

Finally, the Act [203] adds a new penalty for valuation understatements for purposes of estate or gift taxes. Section

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6660 provides for an addition to tax in the case of an estate or gift tax underpayment attributable to a valuation understatement that is 66⅔ percent or less of the correct value. This penalty is computed as follows. If the claimed valuation is 50 percent or more but not more than 66⅔ percent of the correct value, the penalty is equal to 10 percent of the tax liability understatement attributable to the incorrect valuation. If the claimed valuation is 40 percent or more but less than 50 percent of the correct value, the penalty is equal to 20 percent of the tax liability understatement. If the claimed valuation is less than 40 percent of the correct value, the penalty is equal to 30 percent of the tax liability understatement.

The penalty will not be imposed if the underpayment is less than $1,000 for any taxable period (or, in the case of the estate tax, with respect to the estate of the decedent).[204] The Service may waive the penalty if the taxpayer establishes that there was a reasonable basis for the valuation claimed and that such claim was made in good faith.[205]

d. Effective Date

The foregoing new valuation provisions apply to returns filed after December 31, 1984.[206]

4. Penalty for Instituting Frivolous Tax Court Proceedings

Under §6673, as amended by TEFRA,[207] if a taxpayer institutes or maintains an action in the Tax Court primarily for delay or if the taxpayer's position in the Tax Court proceedings is frivolous or groundless, the Tax Court is empowered to award damages to the U.S. of up to $5,000. TEFRA raised the maximum damage award from $500 to $5,000. This increase applied with respect to any action or proceeding in the Tax Court commenced after December 31, 1982.[208]

The Act[209] amends the effective date provisions of TEFRA to provide that the $5,000 maximum can be awarded against taxpayers with proceedings in the Tax Court as of 120 days after the enactment date of the Act (September 15, 1984), even though the suit may have been commenced on or before December 31, 1982.

5. Criminal Penalty for Fraudulent Withholding Certificate or Failure to Supply Information

Section 7205(a) imposes a criminal penalty on any individual who willfully supplies false or fraudulent information, or who willfully fails to supply information, with respect to withholding exemption certificates. This criminal penalty is to be imposed in lieu of any other penalty, except the civil penalty provided by §6682. A similar criminal penalty is imposed on any individual who willfully makes a false certification in connection with backup withholding on interest and dividends.

The Act[210] amends §7205 to delete the language that this penalty is in lieu of any other penalty and to substitute that this penalty is in addition to any other penalty. Thus, for example, a criminal penalty for tax evasion under §7201 may be sought even though the §7205 penalty is also possible. The Conference Report[211] states that no inference should be drawn concerning the correct intepretation of pre-TRA law on this issue. The Report further states that to the extent that *U.S. v. Williams*, 644 F.2d 696 (8th Cir. 1981) might be considered contrary authority, the rationale of that decision no longer applies.

The foregoing amendment of §7205 is effective for actions and failures to act occurring after July 18, 1984.

6. Penalty for Failure to Supply TIN for Alimony Payments

Section 215(c), as amended by the Act,[212] provides that regulations may be prescribed under which any individual receiving alimony or separate maintenance payments must furnish the taxpayer identification number to the individual making such payments. Further, the individual making such payments may be required to include the tax identification number on the individual's return for the taxable year in which such payments are made. These reporting rules are designed to ensure that the payor's deduction for an alimony payment is matched by a corresponding inclusion in the recipient's income.

Under §6676(c) as added by the Act,[213] any individual who fails to comply with the regulations prescribed under §215 either to furnish the taxpayer identification number to another person or to include another person's taxpayer identification number on the individual's return at the prescribed time will be liable for a penalty of $50 for each such failure. This penalty may be excused if it is shown that such failure is due to reasonable cause and not to willful neglect.

The new reporting and penalty rules are generally effective with respect to divorce or separation instruments executed after December 31, 1984. It should be noted that the foregoing new provisions were enacted as part of divorce simplification section of the Act, which is fully analyzed in Chapter 13.

7. Penalty for Failure to Comply With OID Information Requirements

Under §1275(c)(1),[214] regulations may be prescribed requiring that any debt instrument with original issue discount (OID) show the amount of the OID and the issue date. Section 1275(c)(2) further provides that, in the case of any issue of publicly offered debt instruments having OID, the issuer must, under regulations to be prescribed, furnish the following information: the amount of the OID, the issue date, and such other information with respect to the issue as may be required in regulations.

Section 6706[215] imposes a penalty of $50 on the issuer for each instrument with respect to which there is a failure to show the information required to be set forth on the instrument under §1275(c)(1). Any issuer who fails to comply with the requirements of §1275(c)(2) by the prescribed date (determined with respect to any extension of time for filing) is liable for a penalty equal to 1 percent of the aggregate issue price of the issue (up to a maximum of $50,000), unless the failure is due to reasonable cause and not willful neglect.[216] The §6707 penalty is an assessable penalty not subject to deficiency procedures.[217]

The §6706 penalty is generally applicable to taxable years ending after July 18, 1984.

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8. Penalty for Failure to Notify Certain Pension Recipients

Under §3405, withholding is required on pensions, annuities, and nonperiodic distributions from employer deferred compensation plans, unless the recipient elects not to have withholding. Section 3405(d)(10)(B) requires the payor of a periodic payment or nonperiodic distribution to provide a recipient with notice of the election not to withhold.

Section 6652(i), added by the Act,[218] imposes a penalty on the payor for failure to furnish the notice required by §3405(d)(10)(D) at the prescribed time in an amount equal to $10 for each such failure. The total penalty that can be imposed on a payor for all such failures during any calendar year shall not, however, exceed $5,000. The failure may be excused if it is due to reasonable cause and not willful neglect. If a penalty is imposed under this section, it must be paid on notice and demand of the Secretary and in the same manner as tax.

Section 6652(i) is effective as if it had been included in the pension withholding provisions as enacted by TEFRA. The TEFRA withholding provisions were generally effective for payments made after December 31, 1982.[219]

9. Failure to Request Change in Accounting Method

Section 446(e) requires the taxpayer to obtain the consent of the Service before changing a method of accounting for tax purposes. According to the Senate Finance Committee Report,[220] some taxpayers using improper accounting methods have argued that no requirement exists that they request permission to change from the improper to a proper accounting method and, therefore, they assert the Service's failure to consent to an accounting method change as a defense to, for example, the negligence penalty.

To remedy this potential abuse, the Act [221] adds new §446(f) to provide that, if the taxpayer does not request the Service's consent to a change in accounting method, the absence of the Service's consent to a change in accounting method will not be taken into account (i) to prevent the imposition of any penalty or addition to tax or (ii) to diminish the amount of such penalty or addition to tax.

Comment: Under Regs. §1.481-1(a)(2), a taxpayer is not to take into account any §481 adjustment (an adjustment made to prevent double inclusions in income or double deductions stemming from an accounting method change) attributable to pre-1954 years. The rule of this regulation applies, however, only if the change in accounting method is not initiated by the taxpayer. Thus, for a Service-initiated change, a taxpayer may permanently exclude from income any positive §481 adjustment attributable to pre-1954 years. Section 461(f) will pose a dilemma to taxpayers who have used a method of accounting since before 1954 that is now determined to be improper. This new provision clearly requires taxpayers to initiate the change in order to prevent the imposition of penalties for use of the improper method. On the other hand, if the taxpayer initiates the change under this provision, the taxpayer will likely lose the benefit of the exclusion for any §481 positive adjustment attributable to pre-1954 years during which the improper method was employed.

The Conference Report [222] states an understanding that the Service's general practice is to permit a taxpayer who has not been notified of an audit and who wishes to change from an improper accounting method to a proper method for its taxable year that includes the date of enactment of §461(f) (July 18, 1984) but is precluded from doing so because the deadline for requesting a change for its current taxable year has passed, is generally not subject to a penalty arising from use of the improper method in the current taxable year. This is so, provided the taxpayer requests permission to change methods as soon as practicable, but in no event later than the due date (with extensions) of the taxpayer's return for its current taxable year.

Section 461(f) applies to taxable years beginning after July 18, 1984.[223]

10. New Interest Provisions

a. Increased Interest Rate for Tax-Motivated Transactions

Under §§6601 and 6621, a taxpayer must pay interest on underpayments of tax at a rate generally equal to the prime rate, compounded daily. Section 6621(d), added by the Act,[224] provides for an increased rate of interest, equal generally to 120 percent of the prime rate, on any substantial underpayment of tax attributable to "tax-motivated transactions". Under §6621(d)(2), an underpayment is substantial if the amount of underpayment for the year attributable to one or more tax-motivated transactions exceeds $1,000.

A tax-motivated transaction for purposes of §6621(d) is any one of the following:[225]

(i) Any valuation overstatement of 150 percent or more;

(ii) Any loss or any investment credit disallowed by reason of the at-risk rules;

(iii) Any straddle (as defined in §1092(c) without regard to §1092(d)(e)); and

(iv) Any use of an accounting method specified in regulations as possibly resulting in substantial distortions of income for any period.

Note: The Conference Committee [226] anticipates that regulations may consider the following deductions and other claimed tax benefits to arise from accounting methods that may result in a substantial distortion of income:

(i) Farm syndication deductions disallowed under §464;

(ii) Prepaid interest deductions disallowed to a cash method taxpayer under §461(g);

(iii) Interest deductions disallowed for exceeding the effective rate of interest, such as under the rule of 78s;

(iv) Improper deductions for syndication expenditures;

(v) Deductions disallowed under the related party rules of §267(a)(2) with respect to taxpayers' having different accounting methods;

(vi) Failure to treat deferred rental payments in accordance with new §467, as added by the Act; and

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(vii) Prepaid expense deductions of tax shelters disallowed under new §461(i), as added by the Act.

The foregoing transactions are not the only transactions that can be classified as tax motivated for purposes of §6621(d); regulations may be issued specifying other types of transactions that will be treated as tax motivated. These regulations must take into account the ratio of tax benefits, the cash invested, the methods of promoting the use of this type of transaction, and other relevant considerations.[227]

Any regulations prescribed with respect to accounting methods or other tax motivated transactions will apply only to interest occurring after a date specified in the regulations, which must be after the date on which such regulations are prescribed.[228]

Section 6621(d) provides that, in the case of any Tax Court proceeding for a redetermination of the deficiency, the Tax Court will also have jurisdiction to determine the portion (if any) of the deficiency that is a substantial underpayment attributable to tax motivated transactions.

Section 6621(d) applies with respect to interest accruing after December 31, 1984.[229]

Observation: After concluding its description of §6621(d), the Conference Committee[230] reviews various steps Congress has taken to assist the Tax Court in reducing its backlog of cases, such as the provisions for awarding damages in frivolous suits and the tax straddle rules. The Committee believes these provisions should suffice to enable the Tax Court to manage its docket. The Committee then goes on to state that the Service also has responsibility in reducing this backlog, observing that the Service's settlement policy should be fair and flexible, and that only appropriate cases should be litigated. Significantly, the Committee expresses its approval of the Service's recent change in policy of not routinely settling tax shelter cases by permitting taxpayers to deduct out of pocket expenses, calling this a "constructive change in policy". Of greater significance is the Committee's statement that the Service should impose, without hesitancy in appropriate circumstances, the available penalties. The Committee noted in particular that the negligence and fraud penalties are not currently being applied in a large number of cases where they would be appropriate. Given this statement, practitioners should not be surprised if the Service begins asserting the application of penalties more aggresively hereafter.

b. Interest on Certain Penalties

Section 6601(e) generally provides for interest on penalties and additions of tax only from the date of notice and demand to the date of payment. However, an interest element is added to the negligence and fraud penalties under §6653 taking into account the period from the last day prescribed by law for the payment of tax to the date of the assessment of the tax (or the date of payment of tax, if earlier).

The Act[231] revises §6601(e)(2) to provide for the imposition of interest on the amount of the following penalties, commencing with the due date of the return:

(i) The failure to file penalty of §6651(a)(1);

(ii) The gross valuation overstatement penalty of §6659;

(iii) The estate state and gift valuation understatement penalty of §6660; and

(iv) The substantial understatement penalty of §6661.

The foregoing revision of §6601(e)(2) applies to interest accruing after July 18, 1984, except with respect to additions to tax for which notice and demand is made before such date.[232]

F. Miscellaneous Compliance Amendments

1. Backup Withholding Amendments

The Act makes a number of amendments to the backup withholding rules §3406. First, the Act[233] amends §3406(e)(1) to provide that the Treasury may require a recipient of payments potentially subject to backup withholding to furnish the recipient's taxpayer identification number under penalties of perjury only with respect to dividends, interest, patronage dividends, and amounts subject to broker reporting. This amendment codifies the position taken in the temporary regulations implementing the backup withholding rules.[234] Certification under penalties of perjury may not be required for other reportable payments; however, the Treasury may require the certification of a taxpayer identification number despite this restriction after the Treasury notifies the payor that the taxpayer identification number furnished by the recipient is incorrect.[235]

Second, the Act[236] sets forth the circumstances under which a broker must notify a payor that a recipient, who has acquired a readily tradable instrument through the broker, is subject to backup withholding. Under §3406(d)(2), as amended by the Act, the broker must notify the payor if, (i) the payee fails to furnish his taxpayer identification number to the broker in the manner required under §3406(a)(1)(A), (ii) the Secretary notifies the broker before the acquisition that the taxpayer identification number furnished by the payee is incorrect, (iii) the Secretary notifies the broker before the acquisition that the payee is subject to backup withholding, or (iv) the payee does not provide certification under penalties of perjury to the broker.

Third, §3406(c) is amended by the Act[237] to allow the Service to inform a payor enough of the reasons why a recipient is being placed on backup withholding to enable the recipient and payor to know how withholding can be stopped. According to the Conference Report,[238] the Service will notify the payor at the time notice is sent that the payee is subject to backup withholding and that backup withholding is being imposed either because the taxpayer identification number furnished by the payee is incorrect or because of notified payee underreporting. The Service, however, cannot disclose the nature or the details of the payee's underreporting.

Fourth, the Act[239] provides rules for the treatment of estates and trusts under the backup withholding provisions. Section 643(d) provides that an estate or trust and its beneficiaries should allocate any credit for backup withholding based on the manner in which the entity and its beneficiaries take into account the payment with respect to which backup withholding has occurred. Any backup withholding credit allocated to a beneficiary must be included

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in the beneficiary's income and the estate or trust is allowed a deduction in an amount equal to the credit allocated to the beneficiaries.

Finally, the Act [240] provides a separate set of backup withholding type rules for pension withholding. Section 3405(d)(12) provides that, if the recipient of a payment subject to pension withholding fails to furnish a taxpayer identification number to the payor in the manner required by the Secretary, or the Secretary notifies the payor before any payment or distribution that the taxpayer identification number furnished by the recipient is incorrect, any election out of pension withholding by the recipient will be disregarded. Moreover, the rule that a recipient is treated as a married individual claiming three exemptions for purposes of pension withholding will not be followed with the result that the recipient will be treated as a single individual claiming no exemption if no withholding exemption certification is in effect.[241] The Conference Committee states that it anticipates a recipient's Social Security number will be considered to have been properly furnished so long as, before January 1, 1985, the recipient provides the number in a manner acceptable to the payor.[242] If the recipient has previously furnished the number in response to a request relating to pension withholding or backup withholding, or if the payor has otherwise obtained the number, the number is considered to have been properly furnished. On or after January 1, 1985, the Social Security number must be furnished in the manner prescribed by the Secretary, for example, under penalties of perjury.

These amendments are generally effective as if they had been included in the Interest and Dividend Tax Compliance Act of 1983,[243] which was effective for payments made after December 31, 1983.[244] The Act amendment restricting certification to interest, dividends, patronage dividends, and amounts subject to broker reporting is effective July 18, 1984.[245] The new pension withholding provisions are effective for payments or distributions after December 31, 1984, unless the payor elects to have the amendment apply to payments or distributions before 1985.[246]

2. Limitations Period Extended for Contributions to Capital

Under §118(b), a regulated public utility is not required to include an amount that is a "contribution in aid of construction" in income if the contribution is not included in the utility's rate base for rate-making purposes and if it is expended before the end of the second taxable year following the year of receipt. If not so expended, it is includable in the utility's income for the year of receipt.

Section 118(c), added by the Act,[247] extends the statute of limitations for the year in which a payment described in §118(b) is received. Under §118(c)(1), the period for assessing any deficiency attributable to any part of such a contribution will not expire before the end of three years from the date the Service is notified by the utility (in the manner prescribed by the Service) that (i) the utility has expended the contribution, (ii) the utility does not intend to spend the contribution, or (iii) the utility has failed to spend the contribution within the required period. Under §118(d)(2), the deficiency may be assessed before the expiration of the 3-year period set forth in §118(c)(1), notwithstanding any other provision of the Code that would otherwise prevent assessment.

Section 118(c) is effective for expenditures with respect to which the second taxable year following the year of receipt ends after December 31, 1984.

3. New Substantiation Requirements

The Act provides new substantiation rules for charitable contributions of property. The Act also amends §274(d) to impose a stricter substantiation requirement with respect to such expenses as travel and entertainment expenses, automobiles, and other listed property.

III. Penalty for Underpayment of Estimated Tax by Individuals [Act §§411-414] — Code Section 6654 Revised

A. Introduction

1. Existing Section 6654

a. Background

Existing §6654 [248] imposes a penalty on individuals who do not pay their quarterly estimated income tax payments by the due dates. The penalty is basically a nondeductible interest charge based on the rate for underpayment of income tax in §6621 — currently 11 percent. It is calculated from a due date until (i) the payment is made, or (ii) until the original due date of the return (generally April 15 for calendar year individuals), if that is earlier. Quarterly installment payments for calendar year individuals are due on April 15, June 15, and September 15 of that year and January 15 of the following year. Income taxes withheld, whether on wages, pensions, annuities, interest or dividends, are deemed payments of estimated income tax.

No underpayment generally occurs if estimated income tax payments made by a due date equal 20 percent (16.67 percent for farmers and fishermen) of the income tax due in the current year times the number of quarterly payments required to be made by that due date. If the general rule indicates that an underpayment has occurred, there are four exceptions currently available so that an individual may avoid this penalty.

The most commonly used exception excuses the penalty if the estimated payments of an individual by the date of a required payment equal 25 percent of his income tax liability in the immediately preceding year (which must have included 12 months) times the number of required payments due at that time. There also is a small amount exception which waives the penalty if the taxpayer's current income tax liability less the income taxes withheld does not exceed $400 ($500 in 1985 and thereafter).

The penalty is waived if the estimated payments by a due date equal 20 percent (16.67 percent for farmers and fishermen) of the tax on actual annualized income earned in the months before the due date times the number of installments due. There is an exception for individuals who have made estimated payments which equal 90 percent of the income tax due on the income earned in the months prior to the due date of the installment. Finally, the penalty is excused if the estimated payments equal the taxpayer's income tax liability calculated using the facts and income from the preceding taxable year but using the rate and exemptions applicable to the current taxable year.

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The Commissioner does not have the discretion to waive the penalty. There are no estimated tax payments required for the alternative minimum tax.[249]

b. Reasons for Change

The House Ways and Means Committee indicated that its objective in revising the estimated tax provisions was to equalize the treatment of taxpayers who had income tax withheld from their wages and those who made estimated income tax payments.[250] Thus the alternative minimum tax was added as a tax for which estimated payments must be made. The Congress intended to simplify the Internal Revenue Code so it consolidated all the provisions relating to estimated tax payments in one section and eliminated two of the more complex exceptions to the underpayment of estimated taxes.[251]

Congress appeared concerned that a penalty could be imposed where a delay in a required payment was caused by extreme hardship and wanted to give the Internal Revenue Service the discretion to waive the penalty. The Treasury Department indicated that any waiver provision should be strictly limited since the penalty represents merely an interest charge and without the penalty there will be no interest charged on the delayed amount.[252]

2. Revenue Ruling 83-111

Effective January 1, 1984, the Internal Revenue Service had proposed to change the crediting of income tax overpayments from a prior year to estimated tax payments in the current year.[253]

That change would prohibit individuals (or corporations) from applying overpayments shown on a tax return to any quarterly installment payments required prior to the time they filed an income tax return electing to apply the overpayment to such installment payments. Thus, an individual who qualified for an automatic four month extension for filing his income tax return and did not file that return until August 1 could not apply that overpayment shown on that return to the installment payments due April 15 or June 15.

Revenue Ruling 83-111 revoked Rev. Rul. 77-475,[254] which had held that an income tax overpayment could be applied to an installment due prior to the time a tax return was filed. However, the Second Circuit Court held in *Avon Products, Inc. v. U.S.*,[255] that if a corporation applies an overpayment of income tax to an estimated tax installment and the Internal Revenue Service later determines that the corporation did not have as large an overpayment as it originally claimed, interest on the underpayment runs from the date the corporation filed its return electing to apply the overpayment to estimated tax payments and not from the date on which the installment of estimated tax was due. The effect of this decision was to preclude the Internal Revenue Service from collecting any interest on an underpaid estimated tax installment from the date the installment was due until the date on which the tax return was filed. Accordingly, the Service revised its ruling position to prevent the Government from losing any interest on installment payments paid from income tax overpayments.

B. Overview

1. Summary of Revision

The revision of §6654 is intended to simplify the structure of the estimated income tax requirements. It basically consolidates a number of existing statutory provisions while making the following basic changes. The final two penalty exceptions noted above, those which considered 90 percent of the actual tax due by the date of the installment and the tax based on the prior year's income using current years rates and exemptions, have been repealed. Estimated payments will now be required for the alternative minimum tax.

The Internal Revenue Service will have the discretion to waive this penalty in certain cases which involve extraordinary circumstances, such as the destruction of books and records, and the taxpayer's death, serious illness, disability or retirement. The Act includes a provision which overrules Rev. Rul. 83-111 and allows an individual who has automatically extended the due date for filing his return to apply any overpayment on his return to estimated payments due before the return is filed. Various provisions relating to estimated taxes of individuals contained in §§6015, 6073 and 6153 are repealed because they have been incorporated in §6654.

A proposal contained in an early tax simplification bill to delay the payment of the June 15 required installment until July 15 was opposed by the Treasury Department and was not enacted.[256]

2. Effective Date

The new provisions are generally effective for taxable years beginning after December 31, 1984. However, the waiver provision becomes effective for taxable years beginning in 1984 and the overruling of Rev. Rul. 83-111 is effective as of January 1, 1984.

C. Detailed Analysis

1. Individuals Covered

Individuals who have income which is not subject to income tax withholding or those whose withholding does not substantially cover their income tax liability are required to make four quarterly payments to cover their current year income tax liability. In determining the amount of installment estimated payments required, the amount of taxes withheld on wages, pensions, annuities, dividends, and interest are deemed payments of estimated taxes.[257] Accordingly, taxpayers whose sole source of income is from wages and other payments which are subject to withholding are subject to this penalty only if they are significantly underwithheld.[258] In addition, if the difference between the tax shown on an individual's return and the amount of his withholding is less than $500 ($400, for taxable years beginning after December 31, 1983 and before January 1, 1985), no penalty will be imposed.[259]

Observation: Persons whose withholding covers their income tax liability with respect to items on which income tax is withheld generally will not be subject to estimated income tax payments if income upon which there is no withholding does not exceed $1,000.

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2. Due Dates for Required Quarterly Installments

Individual taxpayers are required to make four payments of estimated tax in each taxable year. If an individual's tax year ends on December 31, his payments are due April 15, June 15 and September 15 of the current taxable year and January 15 of the following taxable year.[260] An individual who files his income tax return and pays the full amount of tax due by January 31 of the following taxable year is excused from making the fourth (but not any prior) quarterly payment.[261] If an individual has a fiscal taxable year, the payments are due on the 15th day of the fourth, sixth, ninth and thirteenth months following the beginning of the taxable year.[262] Like a calendar year taxpayer, a fiscal year taxpayer who files his income tax return and pays the tax due by the last day of the first month in the following taxable year will be excused from making the fourth quarterly estimated payment.[263]

3. Amount of Required Quarterly Installments

In the revision of §6654, there are three alternatives available to an individual in determining the amount of each required quarterly installment. An individual may use one exception for one installment and a different one for another installment. Each of these alternatives depends on a determination of tax. For purposes of §6654, taxes include the income tax imposed by Chapter 1 of the Code including all credits against the income tax other than the credit for income taxes withheld in §31.[264] Taxes also include the self-employment tax imposed on the individual and the alternative minimum tax.[265]

The required estimated payment of an individual will be the lesser of Alternatives 1 or 2 below unless the individual can establish that the installment required by Alternative 3 is smaller.[266]

a. Alternative 1 — 80 percent of Current Income Tax

The first alternative requires four equal quarterly installments of 20 percent of the tax shown on the individual's current income tax return, or if no tax return is filed, then 20 percent of the actual tax due for such year.

Note: If the individual selects this alternative, he will owe the remaining 20 percent of the income tax on the original due date for his income tax return.

b. Alternative 2 — 100 percent of Prior Year Income Tax

The first alternative may be of little use to many individuals in planning the amount of their estimated payments because they may not be able to accurately project their income tax for the current year many months prior to its end. Accordingly, many individuals will rely on paying 25 percent of the amount shown on their prior year income tax return.[267] To qualify for this alternative, an individual must have filed an income tax return for the prior year and that taxable year must have consisted of 12 months.[268]

c. Alternative 3 — Annualization of Current Income Tax

The final alternative involves a very complex determination of the taxable income, alternative minimum taxable income and adjusted self-employment income of an individual during the months prior to the due date of an installment.[269] Generally, the individual must determine the amount of income he would earn in a complete year if his earnings were identical to the incomes he earned in the months before the required payment is due. Since the Ways and Means Committee Report indicates that there is no change intended in the annualization of taxable income and adjusted self-employment income, the existing regulations under §6654 will probably control that calculation.[270]

Comment: There is no guidance as to a method of annualizing alternative minimum taxable income. It would be consistent with the rules for annualizing taxable income that an individual must annualize the components of alternative minimum taxable income (*i.e.*, adjusted gross income, items of tax preference, net operating losses, itemized deductions and trust throw-back distributions) based on all transactions occurring in the months prior to the due date of an installment.

The individual then computes the three taxes on the projected annual income. The required installment for the period is determined by (i) multiplying 20 percent times the annualized amount of the taxes; (ii) multiplying that product by the number of the installment (*i.e.*, 1st, 2nd, 3rd or 4th); and (iii) subtracting the amount of all previous required installments from that product.

The Act includes a provision which "recaptures" the benefit of annualization in any subsequent required payment. When individuals use the annualization alternative, they also must calculate the reduction in payment from using this alternative (*i.e.*, the difference between the required payment determined by annualizing income and the lesser of the first two alternatives). The next required payment which is not determined by annualization will be increased by the reduction from prior periods when the individual used annualization.[271]

Note: This requirement will insure that individuals with cyclical income do not pay less than 80 percent of current year income taxes or 100 percent of the preceding year income taxes. For example, an individual with no income in the first three months of the taxable year will not make a first quarterly estimated payment. If he or she does not use the annualization method in any subsequent quarter, that individual would have only paid 60 percent of his current income tax liability or 75 percent of his prior year liability if there was no recapture provision. This type of avoidance was not allowed under §6654 before this revision and could have allowed individuals in these exceptional cases, to substantially defer payment of income taxes.

Comment: The extreme complexity of these calculations, especially when the alternative minimum tax is applicable, may discourage use of this alternative.

4. Period of Underpayment

The period of an underpayment begins on the last due date for an installment and continues until the installment is paid or until the original due date of the return, whichever is earlier.[272]

5. Amount of Underpayment

An underpayment occurs when the amount of the installment paid on or before a due date is less than the

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required quarterly payment.[273] As in prior law, the amount of income tax withheld on wages, pensions, annuities, interest and dividends will also be counted as estimated income tax payments for purposes of determining if the penalty is due. In addition, the Internal Revenue Service can promulgate regulations under which excess windfall profits taxes may be used as estimated tax payments. Unless the taxpayer proves otherwise, one-fourth of the withholding will be deemed paid on the required date for each installment.[274]

If a taxpayer so desires, he can prove the date and amount of each withheld amount and have those amounts credited against his estimated tax liability on the actual date on which the amounts were withheld. The individual may elect to determine the actual date of withholding for estimated payment purposes for wages and not elect to make that determination for withholding on other income (*i.e.*, backup withholding on interest and dividends and withholding on pension and annuity payments) and vis versa.[275]

Comment: It appears that an individual may generally wish to exercise this option. Now that the ordering of payments is first credited to the oldest obligation, an individual can reduce the underpayment more quickly by making this election. For example, if an individual underpaid his installment due April 15 by $600 and has $200 of taxes withheld on the first day of each month, his underpayment will be reduced to $400 on May 1 and $200 on June 1. Under prior law, the $600 of income taxes would first be credited to the liability on June 15 and then any excess would be applied to the outstanding underpayment.

If there is an underpayment of tax in a prior installment, the payment in the current quarter is first applied to the oldest unpaid obligation and then to the more recent underpayments.[276] This is a change from prior law where payment of an installment on a due date was first applied to the current installment and then to deficiencies in prior installments.

Comment: As noted in the immediately preceding comment, this change can help reduce an individual's underpayment more quickly.

6. Calculation of Penalty

The penalty equals the §6621 rate for the period of the underpayment (11 percent per annum until January 1, 1985) multiplied by the amount of the underpayment.[277]

Example: If an individual omits his fourth installment payment due on January 15, 1984, in the amount of $2,000, the penalty is calculated as follows:

$1/15/84 - 4/15/84 = 90$ days

Interest Rate = 11 percent [278]

$\$2000 \times .11 \times 90/365 = \$54.25$

7. Waivers of Penalty

The statute defines several situations which the Congress considers to involve extreme hardship and, accordingly, an inappropriate time to impose the penalty. If there is a casualty, disaster or other unusual circumstance where the imposition of the penalty would "be against equity and good conscience," the Internal Revenue Service will have the discretion to waive the penalty. Such a waiver should be available if an individual's books and records are destroyed by fire or other casualty. The death or serious illness of the taxpayer should satisfy the standard for waiving the penalty. An individual who substantially overstates his income tax liability on his current year return should not be subject to the penalty.[279]

Those persons who are newly retired or disabled may be excused from the estimated tax underpayment penalty if the Internal Revenue Service determines that the individual had a reasonable cause and did not willfully neglect the payment. There is no real guidance from the Congress as to how it intends this waiver provision to operate. Typically, the year in which an individual retires, either because of age or disability, is a year in which his tax liability fluctuates greatly. This fluctuation may arise from lump sum termination benefits and may be the first time the individual is subject to estimated tax requirements. The Internal Revenue Service will have the discretion to determine if the individual willfully neglected the installment payment obligation and it may apply this section in a narrow or a broad fashion. Because of this discretion, a taxpayer will not want to use this exception in planning his estimated tax payments.

The conferees also indicated that an individual who applies an overpayment on his return to his estimated tax payments and whose overpayment is applied against a nontax liability should have the penalty waived if he did not receive notice of the offset prior to the due date for the estimated payment.[280]

8. Special Rules for Farmers and Fishermen

Farmers and fishermen are subject to less stringent standards for making estimated payments than other individual taxpayers. A person is considered a farmer or fisherman in a taxable year if his gross income from farming or fishing (including oyster farming) in that taxable year, or as shown by his tax return in the preceding taxable year, is at least two-thirds of his gross income from all sources.[281]

These individuals are only required to make a single estimated payment on January 15 of the following taxable year (or the 15th day of the first month after the end of a fiscal taxable year).[282] The amount of the required installment must equal at least two-thirds (instead of 80 percent) of the current year income tax due. Alternatively, a farmer or fisherman may make a single estimated payment equal to his prior year income tax liability. The annualization alternative available to other taxpayers is not of any benefit to farmers or fishermen since they are only required to make a single payment.

Calendar year farmers and fishermen are exempt from the estimated tax payment requirements if they file their income tax returns and pay their entire tax liabilities by March 1 of the year in which their returns are due.[283]

9. Short Taxable Years

The Commissioner has the discretion to prescribe regulations for determining the estimated payments due in short taxable years.

Comment: The existing regulations under §§1.6654-3, 1.6153-3, and 1.6015(g)-1 will likely be used to determine the estimated tax payments due during a taxpayer's short

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taxable year. If the existing format is used, the payments would be made as follows:

Months In Short Period				
At Least		But Less Than	Number of Payments	Dates of Payments - Generally
0	-	4	0	
4	-	6	2	15th day of 4th month and of 1st month of succeeding year
6	-	9	3	15th day of 4th and 6th months and of 1st month of succeeding year
9	-	12	4	15th day of 4th, 6th and 9th months and of 1st month of succeeding year

10. Credit of Tax Overpayments as Estimated Tax Payments

The Act overrules Rev. Rul. 83-111, which the Internal Revenue Service released in the mid-1983.[284] Thus, an individual may still apply an overpayment of income tax to a quarterly required payment due prior to the time the individual's return is filed.

Example: A calendar year taxpayer may request an automatic extension to file his individual income tax return for four months after the due date (August 15) if he pays an estimate of the full amount of tax due on April 15. If the taxpayer does not file his income tax return until August 15, he can still apply the overpayment to the estimated tax payments on April 15 or on June 15 even though he will not make the election to do so until the return is filed on August 15.

The Internal Revenue Service had intended to apply Rev. Rul. 83-111 to estimated payments made after December 31, 1983. The effective date of this provision (taxable years beginning in 1984) will mean that Rev. Rul. 83-111 will not apply to any individual.

11. Miscellaneous Amendments

This section also repeals the requirement contained in §§6015, 6073, and 6153 that individuals must file declarations of estimated taxes with the Internal Revenue Service.[285]

IV. Restrictions on Church Tax Inquiries and Examinations

A. Background

For historical and Constitutional reasons, organizations claiming to be "churches" occupy a privileged status under the internal revenue laws. Organizations organized and operated exclusively for religious purposes are exempt from tax under §501(a) [286] and contributions made to a church or a convention or association of churches are deductible under §170(a) and §170(c).[287] Organizations claiming church status enjoy considerable latitude in the granting of tax exempt status. "Religious activities" assume a wide variety of forms. Most churches regard their financial records and membership lists as highly confidential. They are not required to furnish, to the IRS periodic statement of income and expenses as are most other persons, including many classes of charitable organizations.[288] As a result, once an organization has acquired tax exempt status as a church, its operations are shielded from IRS scrutiny unless and until the IRS makes a demand on the church for the production of its books and records. Such a demand may be made under the sweeping powers accorded the IRS under §7602 (authorizing the use of administrative summonses) of any person for the purpose of investigating the tax liability of any person. This power has very few restrictions, and is liberally interpreted by the courts.[289] Such power may be used by the IRS virtually at its whim so long as it is in pursuance of the investigation of civil tax liability of any person (including tax exempt organizations). In the case of churches, however, Congress felt that some restrictions should be placed on this authority, since unbridled IRS access to church books and records and other confidential or sensitive data might be viewed as coming uncomfortably close to governmental interference with the free expression of religious beliefs.

The 1969 Tax Reform Act (P.L. 91-172) extended to churches a tax on unrelated business income and imposed annual reporting requirements on most other tax exempt organizations. Section 121(f) of the 1969 Act [290] added to §7605(c) by restricting the examination of churches. The subsection provided that no examination of books of account of a church (or convention or association of churches which were also exempted from annual reporting) was to be made to determine whether it may be engaged in carrying on an unrelated business or may be subject to the tax imposed by §511 unless a high ranking IRS officer (no lower than a regional commissioner) "believes that such organization may be so engaged and so notifies the organization in advance of the examination." It was further provided that no examination of the religious activities of such an organization was to be made "except to the extent necessary to determine whether such organization is a church . . . and no examination of the books of account of such an organization shall be made other than to the extent necessary to determine the amount of tax imposed by this title." This language was interpreted by the IRS in Regs. §301.7605-1(c)(2). Under them, a church's books could be examined (after notice) to the extent necessary to determine its qualification under §501(c)(3) as organized and operated exclusively for religious purposes, or as an organization contributions to which are deductible under §§170, 545, 556, 642, 2055, 2106 and 2522. Such examination was also authorized to obtain information concerning payments to other persons who are taxable and to determine the amount of tax, if any, imposed by the Code on such organization. These regulations also provided that no examination was to be made unless believed necessary by a regional commissioner.

The administration of these statutory and regulatory provisions and their interpretation by the courts gave rise to numerous problems. The form and contents of the notice required was unclear, as was the time as of which it was required. Summonses were almost routinely issued to investigate initial or continuing qualification of organizations claiming church status for tax exemption and exemption

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from reporting requirements. Contentions were made by churches that their books of account could not be examined for this purpose under the statute (whose wording was far from a model of clarity on this point). It was unclear, also, whether §7605(c) placed any restrictions on church examinations where the IRS was investigating an individual taxpayer claiming deductions for contributions to a church or, as became a widespread tax evasion device, that he had no taxable income since he has assigned all of his earnings to the church under a "vow of poverty." Mail order ministries and related schemes by persons so "ordained" involving the conveyance of their homes and cars to their wholly controlled "churches" while continuing to reside in the homes as "parsonages" using purported salaries as ministers for living expenses, became a serious compliance problem. Aside from the belief and notice by regional commissioner requirement (which, as pressure to deal with noncompliance grew, became a mere formality) one question posed was what was meant by the phrase "to the extent necessary?" Did this in any way restrict the scope of a summons issued in the investigation of a church's qualification for exempt status? It was argued by some that §7605(c) was not a restriction of but an addition to the IRS's investigatory powers since it specifically authorized investigation into a purported church's religious activities.

In one leading case involving the investigation of a "family church" scheme, summonses were issued to both the "pastor" of the church and to the church in investigating (1) whether the church qualified as an exempt organization, (2) whether contributions to it were deductible under §170(c)(2) (defining charitable contribution in terms of the characteristics of the recipient), (3) whether the church was taxable under §§511-514 (tax on unrelated business income), and (4) whether the pastor was individually liable for any tax on payments and other benefits received from the church.[291] The lower court held that no restrictions applied under §7605(c) to the summons issued to the pastor individually, even though the information sought would reveal how much of the church's income inured to his benefit and would thus have a bearing on its exempt status. It did, however, limit the scope of the summons issued to the church to a stricter "need to know" standard. The court of appeals held that the §7605(c) limitations apply only to the investigation of unrelated business activity and income as distinguished from qualification for exempt status under §501(c)(3). It rejected the argument that the investigation of the church's religious activities constituted the establishment of religion prohibited by the Constitution. While affirming the restrictions of §7605(c) on the scope of examination of unrelated business activity, the court upheld the summons insofar as it required the production of all the church's books and records, correspondence files, lists of officers, directors, trustees, or ministers, specimens of publications, names of other persons ordained, evidence of sacerdotal functions, documents reflecting the "creeds, precepts, doctrines, practices and disciplines" espoused, and information relating to "vows of poverty." This decision is typical and most other circuit courts of appeal appear to hold similar views.[292]

Congress decided that the purposes and intent of §7605(c) were unclear, as evidenced by the regulations cited above and the numerous court decisions, conflicting on some points, interpreting the statute. Act §1033(a) effectively repeals §7605(c), replacing it by a cross reference to §7611 (enacted by Act §1033(b)) defining the restrictions applicable to the examination of churches. The vastly expanded and quite elaborate rules set forth in §7611 represent an effort to deal with the often delicate Constitutional issues involved in this area while allowing the IRS ample authority to compel the production of documents where necessary to enforce compliance in an area which has become notorious for providing havens for tax evasion and avoidance.

B. Overview

Act §1033(a) adds to subchapter A of chapter 78 (relating to discovery of liability and enforcement of title) §7611 (after redesignating §7611 as §7612). Act §1033(c) strikes out all of §7605(c), replacing it by a cross reference to §7611. Under §7611, the Commissioner is prohibited from beginning a "church tax inquiry" before fulfilling two sets of requirements referred to as the "reasonable belief requirements" and the "notice requirements." [293]

1. The "Belief" and "Notice" Requirements

The "reasonable belief" requirements are met if an "appropriate high level Treasury official" reasonably believes that the church:

> (a) May not be exempt, by reason of its status as a church, from tax under §501(a), or
>
> (b) May be carrying on an unrelated trade or business (within the meaning of §513), or otherwise engaged in taxable activities.[294]

The "inquiry notice requirements" [295] are met if before the beginning the inquiry, the Secretary provides written notice to the church of the inquiry. The contents of the notice are set forth in §7611(a)(3)(B). It must include:

> (i) An explanation of why the inquiry is being made and its general subject matter; and
>
> (ii) A general explanation of relevant administrative and Constitutional provisions, the right to a conference before any examination of records, and the Code provisions relating to the inquiry.

2. The "Church Tax Examination:" Notice Requirement and Scope

Only when the above requirements have been satisfied, may an examination be made, but such examination may be made only:

> (a) In the case of church records, to the extent necessary to determine the liability for and the amount of any tax imposed by the Code; and
>
> (b) In the case of religious activities, to the extent necessary to whether an organization claiming to be a church is a church for any period.[296]

Any "examination notice" must be provided to the church and to an appropriate IRS regional counsel 15 days before the beginning of the examination. Also, the church must be given reasonable time to participate in a conference (to be described in §7611(b)(3)), but only if the church requests such conference before the examination

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begins. This examination notice must be provided to the church no earlier than the 15th day after the date on which the church was provided the inquiry notice. The examination notice must contain a copy of the inquiry notice, a description of the records and activities to be examined, an offer to have a conference between the church and the IRS in which it will be attempted to resolve any IRS concerns relating to the examination, and copies of all documents collected or prepared by the IRS for use during the examination (but only those whose disclosure is required by the Freedom of Information Act.) [297]

The regional counsel receiving a copy of the examination notice may, if he chooses, submit to the regional commissioner an advisory objection to the examination.

Once an examination has begun, after compliance with the above described formalities, the examining agent may proceed to examine all books and records relevant to the inquiry so long as the restrictions of §7611(b)(1) are observed; he is not limited to the documents described in the examination notice.[298]

3. Periods Within Which IRS Must Take Action

A church examination must be completed and a final determination made with respect to the matters examined within two years from the examination notice date.[299] Where a notice of inquiry is not followed by an examination notice, the inquiry must be completed and a final determination made within 90 days from the notice date.[300]

These periods are suspended for any period during which: (1) judicial proceedings brought by the church relating to the examination are pending or on appeal, (2) such a proceeding brought by the Secretary to compel compliance by the church with reasonable requests made in the course of church examination are pending or on appeal, (3) the IRS is prevented from taking any action in the examination by reason of a judicial order issued under §7609 (referring to an action brought under the third-party recordkeeper provisions by the taxpayer under investigation to quash a summons). The periods are also suspended for any period in excess of 20 days (but not exceeding six months) in which the church fails to comply with reasonable demands for the production of records or other information. The church and the IRS may agree upon a suspension.[301]

4. Approval by Regional Counsel Needed to Revoke Exempt Status or Determine Deficiency

In addition to these restrictions on examination, the statute also provides that the IRS may determine that a church is not exempt under §501(a) as described in §170(c), or determine a deficiency against the church. Additionally, the IRS may assess any assessable penalty against the church only if the appropriate regional counsel determines in writing that the above described formalities have been complied with by the IRS and also approves, in writing, of the proposed action.[302]

5. Limitations Periods

Section 7611(d)(2) contains special rules relating to the limitations periods. Where the IRS revokes the church's exempt status under §501(a), any deficiency (other than a deficiency based on §511) may be assessed only for the three most recent taxable years ending before the examination notice date. If a church is not exempt under §501(a) for any of these three years, the deficiency may be determined for the six most recent years.

Where the audit results in the determination that there is a deficiency in respect to the unrelated business tax imposed by §511, an assessment may be made with respect to the six most recent years ending before the examination date.

These limitations periods are not to be construed as extending any limitations period otherwise applicable.[303]

6. Stay of Enforcement Proceedings

In the event of an action brought by the U.S. to enforce a summons issued to a church, the enforcement proceedings are to be stayed if there has not been substantial compliance with the notice, conference, and approval requirements set forth above until the court finds that all practicable steps have been taken to correct such noncompliance.[304] The periods for completion of the inquiry or examination and the making of final determinations under subsection (c)(1) (*i.e.*, the 90 day and 2 year periods) are not suspended during the period for such stay.

7. Limitation of Grounds for Resisting a Summons

No suit is to be maintained and no defense may be raised in any proceeding (other than the assertion of noncompliance with the notice, conference, and approval requirements) by reason of noncompliance by the Secretary with the provisions of §7611.

8. Five Year Rule

Where a church examination or inquiry by the IRS is completed and does not result in a revocation, notice of deficiency, or assessment of a penalty, or in a request by the IRS for a significant change in operational practices of the church (including the adequacy of accounting practices), then no other inquiry or examination may begin within five years from the date of the notice of examination or notice of inquiry (whichever is appropriate) unless approved by the Assistant Commissioner for Employee Plans and Exempt Organizations or such inquiry or examination does not involve the same or similar issues involved in the preceding inquiry or examination. For purposes of the preceding sentence, an inquiry or examination is to be treated as completed no later than the expiration of the time limits set forth in §7611(c)(2).[305] The five year period commences on the date of the notice of inquiry or of examination, whichever is appropriate.[306] The implications of the §7611(f) rules are discussed below in C.

9. Rules Relating to Declaratory Judgment Proceedings

For purposes of §7428 (providing for declaratory judgments relating to status and classification of organizations under §501(c)(3), etc.) a revenue agent's final report (in a church audit) is to be considered as a "determination of the Secretary" under §7428(a)(1), and a church receiving such report will be considered as having exhausted the administrative remedies available to it for purposes of §§7428 and 7430.[307]

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10. Definitions

Subsection (h) of §7611 contains the following definitions:

(1) "Church": (a) any organization claiming to be a church, and (b) any convention or association of churches.

(2) "Church tax inquiry": any inquiry to a church (other than an examination) to serve as a basis for determining whether the church is exempt under §501(a) or is carrying on a unrelated trade or business or other taxable activities.

(3) "Church tax examination": any examination for purposes of making a determination described in (2) of church records pursuant to a request or summons, or of the church's religious activities.

(4) "Church records": all corporate and financial records, minute books, and lists of members and contributors.

Not included: records acquired pursuant to a §7609 (third-party recordkeeper) summons or from any governmental agency.

(5) "Inquiry notice date": the date the notice with respect to a church inquiry is provided under subsection (a).

(6) "Examination notice date": the date the notice with respect to a church tax examination is provided under subsection (b).

(7) "Appropriate high-level IRS official": the Secretary or his delegate of rank no lower than a "principal IRS officer for a region".

Section 7611 does not apply to:

(a) Any criminal investigation;

(b) Any inquiry or examination relating to the tax liability of any person other than a church;

(c) Termination and jeopardy assessments (§§6851 and 6861);

(d) Any willful attempt to evade tax; or

(e) Any knowing failure to file a return of tax imposed by the Code.

11. Extension of Subpoena Authority

Section 7428 is amended by adding subsection (d) providing that in any action brought under §7428 in the district court for the District of Columbia, a subpoena requiring the attendance of a witness at a trial or hearing may be served at any place in the United States.[308]

C. *Detailed Analysis*

1. General

The statutory provisions outlined above are obviously a compromise between the need for dealing with widespread noncompliance or tax avoiders attempting to exploit the privileges of bona fide religious organizations and the concern of churches and church groups regarding what is perceived as unjustifiable IRS access to and scrutiny of financial records as well as unwarranted investigations into religious beliefs. The statute makes it clear that the IRS may, after certain conditions have been complied with, examine a church's records to the extent necessary to determine whether it may be liable for any tax, and examine its religious activities to the extent necessary to determine whether the organization qualifies as a "church."

2. "Church Tax Inquiry" and "Church Tax Examination" Requirements

The requirement of §7605(c) that a regional commissioner must believe an organization to be engaged in unrelated business activities and notify the organization of such belief before an examination could begin was a rather vague one. It was unclear whether this was also required (belief and notice) before an examination of the organization's religious activities. Under the new statutory provisions, before a summons can be validly issued to an organization claiming status as a "church" (presumably both for purposes of §501(c)(3) and §170(c)), the IRS must take a number of preliminary steps, clearly defined, within stated time limits. If these steps have not been taken, any action to enforce the summons may be stayed until such steps have been taken. The possible consequences of such a stay will be discussed below.

First, an IRS officer, not below the rank of regional commissioner, must receive in writing an opinion, containing the relevant facts and circumstances, that a given purported church "may not be exempt, by reason of its status as a church, from tax under §501(a)." [309]

Observation: Section 501(a) exempts from tax organizations described in subsections (c) as (d). Neither of these subsections mentions the term "church." The term "church" is used only in §170(b)(1)(A) which lists the organizations a charitable contribution to which may be deducted up to 50 percent of the contribution base of a taxpayer. "Charitable contribution" is defined in §170(c) again without mention of the term "church." The terms used in §§501(c)(3) and 170(c)(1)(2), in almost identical language, are "a corporation, trust, or community chest, fund or foundation", "organized and operated exclusively for religious ... purposes." If an organization does not qualify under §501(a) by reason of its failure to qualify under §501(c)(3) (*i.e.*, it is not organized and operated exclusively for religious purposes), it cannot qualify under §170(c). This is undoubtedly what is referred to in the language of §7611(a)(2)(A).

This opinion must alternatively (or may, in addition) provide ground for believing that the organization may be carrying on an unrelated trade or business (as defined by §513) or some other taxable activity.

Secondly, the regional commissioner must find such opinion credible. The statute does not require, but one may infer that some written memorandum of the regional commissioner's reaction to this opinion must be recorded.

The next set of requirements preliminary to a church tax examination is the sending to the church a "notice of inquiry." It appears to be contemplated that at this stage, the church will be given an opportunity to reply to the notice of inquiry, although this is not clear. In any event, the statute clearly contemplates the cessation of these

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procedures after the notice of inquiry has been sent and before a notice of examination has been provided.[310] After the notice of inquiry, the IRS must wait for 15 days before taking the next step, the sending of a notice of examination to both the church and the appropriate regional counsel. The statute describes what information the inquiry notice must contain,[311] as well as what the notice of examination must include:[312] a copy of the inquiry notice, a description of the records sought, an offer of a church-IRS conference, and a copy of all documents relating to the examination which the IRS would have to disclose in proceedings under the FOIA. Reasonable time must be given the church to prepare for a conference if one is elected (such conference is not mandatory if the church declines the offer). Only after the conference, if one is held, but no earlier than 15 days after the examination notice, an appropriate IRS summons may be issued to the church. Also, regional counsel has 15 days after receipt [313] of the copy of the notice of examination provided him to lodge an advisory objection to such examination. It is to be inferred that the summons may not issue until such recommendation has been reviewed by the IRS and action of some kind taken rejecting the objection.

3. Scope of Examination

The examination, once these preliminary steps have been taken, may then be initiated. Such examination under §7611(b)(1) may be made only in the case of church records, to the extent necessary to determine the church's liability for any tax, and, in the case of religious activities, to the extent necessary to determine whether an organization claiming to be a church is a church for any period.

Observation: Thus, the statute contemplates that church *records* may be examined to determine whether the church is liable for any tax. This would, of course, include its tax exempt status, its sources of income, its payments or provision of benefits to any other person(s), any profit making activities carried on by it, etc. *Religious activities* may also be examined to determine whether it qualifies as a "church." This would also bear on the question of tax exemption as well as the deductibility of any contributions made to it. Such activities could include the holding of services, the existence of some creed, doctrines, body of beliefs, etc. which qualify as "religious". It could also include the ordaining of ministers, the identity and number of communicants, and the like. This area of inquiry is apparently viewed as being distinct from the church's financial operations. Query whether the church's records may not be relevant to an examination of its religious activities. Can the records be demanded by a summons in aid of examining religious activities? Note that the term "records" is used in §7611(b)(1)(A) in lieu of the "books of account" referred to in form §7605(c), and is defined by subsection (h) as "all corporate and financial records kept by a church, including corporate minute books and lists of members and contributors." [314] Such records could, obviously, reveal information not only relating to unrelated business income but to payments or receipts which might provide grounds for revocation of the church's §501(c)(3) exemptions.

4. Time Limitations on Inquiries and Examinations

Once a notice of inquiry has been provided, and it is not followed up by a notice of examination within 90 days, the IRS must complete the inquiry and "make a final determination with respect thereto" within such 90 day period.[315] Unless this period is suspended, under the provisions of §7611(c)(2), a notice of examination provided after the 90 day period has elapsed is apparently invalid.[316] Also, once a notice of examination has been duly provided, the investigation or examination must be completed, and a final determination made with respect thereto, within two years after the examination notice date.[317]

Various suspension periods for the two year and 90 day periods are provided, as set forth within the Overview, in §7611(c)(2).

5. Regional Counsel Approval Required

Upon the completion of the examination, there is yet another procedural hurdle to be passed. Before the IRS makes its final determination that an organization is not a church that (i) is exempt under §501(a).[318] or (ii) is described in §170(c),[319] or send a deficiency notice for any tax involved in a church tax examination, or assess any assessable penalty (*i.e.*, the penalties prescribed by subchapter B of chapter 63 which may be assessed without regard to the deficiency procedures of §6211 et seq.), it is first necessary for the appropriate regional counsel to determine in writing that there has been substantial compliance with the requirements of §7611 and, further, that he approves of the IRS final determination, also in writing.[320] This is referred to below as a §7611(d)(1) approval. Revocation letters, deficiency notices, and penalty assessments without it may give rise to a stay of judicial proceedings. *See* 7, below.

6. Special Limitations Periods

Section 7611(d)(2) sets forth limitations periods applicable to the assessment of any taxes resulting from a church examination. These are set forth in the Overview and need no additional explanation.

7. Stays of Enforcement Proceedings

Where a church refuses or fails to comply with an IRS summons issued in a church tax examination, and the Government brings a summons enforcement action, where the church files a motion for a stay of the proceedings relying on failure to comply with §7611 as grounds for its noncompliance, it is limited to asserting that there has not been substantial compliance by the IRS with (1) the notice requirements of §7611(a) and (b) (inquiry and examination notices), (2) the conference requirement of §7611(b)(3)(A),[321] or (3) the approval requirement of §7611(d)(1) (if applicable).

Note: Approval under (d)(1) is required only after the examination has been completed and before an IRS final determination is made. This will hardly ever, it would seem, be an issue in an action to enforce a summons issued in the course of an examination. The stay, if the court finds the church's assertions have merit, is to be granted until the court finds that all practicable steps have been taken to correct the noncompliance. During the period of such stay the 2 year period within which an examination, once initiated, must be completed, is not suspended during such stay.[322] As explained below, this is the basis of the sole sanction imposed on the IRS for its failure to substantially comply with §7611.

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8. The 5 Year Rule

Section 7611(f) provides that if a church tax inquiry or examination is completed and does not result in a revocation, notice of deficiency, or assessment of a penalty, or in a request by the Secretary for an significant change in the operational practices of the church (including the adequacy of accounting practices) no other inquiry or examination is to begin within "the applicable 5 year period," unless approved by the Assistant Commissioner, Employee Plans and Exempt Organizations or such inquiry or examination involves different issues from those previously considered.

For purposes of this subsection, an inquiry or examination shall be treated as completed no later than the expiration of the applicable period under §7611(c)(1). The "applicable 5 year period" means the 5 year period "beginning on the date the notice taken into account for purposes of (c)(1) was provided. For purposes of the preceding sentence, the rules of subsection (c)(2) shall apply." [323]

Putting all of these statutory provisions together, the following rules will apply:

> Where a notice of inquiry is provided and is not followed up within 90 days by a notice of examination (with the 90 day period to be suspended as provided in subsection (c)(2)), the 5 year period commences from the date of the notice of inquiry. Generally, no new notice of inquiry (required preliminary to an examination) may be provided for a period of 5 years from the date of the inquiry notice. Similarly, where a notice of examination is provided, and within 2 years from the date of such notice, the IRS has not issued a deficiency notice or revocation letter or assessed a penalty, the 5 year period during which no new examination may be commenced begins with the date of the examination notice.

There are some exceptions. First, where, after an inquiry or examination notice, the IRS timely (within the 90 day/2 year period) informs the church that its operational or accounting procedures or methods are unacceptable, the 5 year period does not commence. The church will presumably be given an opportunity to make the needed corrections, but the IRS may commence the examination procedures (beginning with an inquiry notice) at any time. Secondly, the provisions suspending the 90 day/2 year periods will apply for this purpose. Thirdly, where a summons enforcement action is brought, and the taxpayer makes a credible claim that the IRS has failed substantially to comply with the statutory requirements, as explained above, and a stay is granted, the 90 day or (much more likely) 2 year period is not suspended. Thus, if a good faith effort to follow these procedures is not made, and a stay is granted in the enforcement action, the IRS may find itself barred from commencing a new examination for 5 years, a sufficiently severe sanction to insure that there is IRS compliance with the §7611 procedures. The church, on the other hand, may not avail itself of the IRS failure to comply with §7611 for any other purpose; its sole remedy is to bring about a stay of any judicial proceedings to enforce a summons.

9. Examinations of Persons Other than Churches

The provisions of §7611 apply only to the examination of churches. They do not apply to the examination of persons claiming deductions for contributions made to organizations claiming to be churches or who have received payments in money or in kind from such organizations and who have not claimed church status (primarily individuals). The Conference Committee Report [324] states that the conferees intend that inquiries or examinations relating to the tax status or liability of persons other than the church (including contributors to the church) will not be subject to §7611. These may include, according to the report: (1) determinations regarding the inurement of church funds to an individual or organization which may result in the denial of such person's deduction for charitable contributions to the church, (2) determinations that the income of such an individual has been assigned to the church or that contributions have been excessive, (3) determinations regarding a vow of poverty of an individual followed by a transfer of property or an assignment of income or services to the church. The report states, "The IRS may inquire of a church regarding these matters without being considered to have commenced a church tax inquiry and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements [of §7611]." Such inquiries and examinations must be limited to the facts and circumstances relevant to the individuals' tax liability. Thus, the IRS may examine church records to determine, for example, transfers of money or property made to the individual under investigation, his use of church property for personal purposes. Likewise, a church's records could be examined to determine whether an individual has assigned income to the church, in connection with his donation of property or transfer of a business to the church. On the other hand, the IRS, without compliance with §7611, cannot examine a list of contributors or members in the possession of the church for the purpose of ascertaining its overall financial structure merely because such structure may be relevant to the church's qualification as a tax exempt entity and, therefore, indirectly relevant to the deductibility of an individual's contributions in general. The IRS is cautioned not to attempt to use examinations of individuals as a means for bypassing §7611, but it is added that the repeated refusal of a church to respond to inquiries regarding an individual's tax liability will be grounds for initiating a church tax inquiry.

The committee comments that routine IRS questions addressed to a church will not be considered a church tax inquiry for §7611 purposes. These might include questions as to whether an information return or returns have been filed, or compliance with employment tax withholding etc.[325] The church may also be requested to aid the IRS in locating third-party (*e.g.*, bank) records, including the church's chartered name, state and year of incorporation, location of bank deposits, etc. without complying with §7611. Failure to respond to such inquiries may be grounds for commencing a church tax inquiry.

It is emphasized that in view of the widespread use of claimed church status to evade tax, the §7611 procedures are not applicable to cases involving failures to file a return

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or willful attempts to evade or defeat taxes, or any other tax avoidance schemes utilizing what are claimed to be religious organizations, including mail order ministries and store front churches.

10. Failure to Comply with §7611 Not a Defense

The Committee Report affirms the comments made in the detailed analysis that a church's only remedy for IRS violation of the §7611 procedures is the stay to be granted in any enforcement action where there has been a substantial failure (with IRS good faith efforts to comply to be taken into account) to comply with the notice, conference, and approval requirements (as explained above) which may result in barring further IRS examination for the 5 year period. Failure to follow §7611 procedures may not be raised as a defense against the enforcement of a summons or the revocation of a church's tax exempt status. Further, the conferees intend that a church not be able to litigate "the issue of the reasonableness of the assistant commissioner's belief" in approving the commencement of a church tax inquiry.

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[1] P.L. 97-248.
[2] §6702.
[3] §§3451 through 3456.
[4] P.L. 98-67, §102.
[5] Enacted by P.L. 98-67, §104.
[6] P.L. 98-369.
[7] *But see* Chapters 62 and 63 of this portfolio for changes affecting foreign taxpayers.
[8] Act §179(b)(1).
[9] Act §155.
[10] §6050H, added by Act §145.
[11] §6050I, added by Act §146.
[12] Code §6050J, added by Act §148.
[13] Code §6050K, added by Act §149.
[14] Code §6695(b), as amended by Act §179(b)(2).
[15] Code §6653(h), added by Act §179(b)(3).
[16] Act §155(c).
[17] *See, e.g.*, Act §148(b), amending §§6652(a)(1) and 6678(a) to apply those penalties to a failure to file a foreclosure return as required by §6050J.
[18] Act §141.
[19] Added by Act §142.
[20] Act §§141(b), adding Code §6707, and Act §142(b), adding Code §6708. In addition to these two penalties, Act §143, increases the penalty on the promoter of an abusive tax shelter from 10 percent of gross income the promoter receives to 20 percent of such gross income; Act §144, amends Code §6621 to provide an increased interest rate on underpayments exceeding $1,000 attributable to "tax motivated transactions".
[21] T.D. 7964, 49 Fed. Reg. 32712 (August 15, 1984), issuing regulations under §§6111 and 6707; T.D. 7969, 49 Fed. Reg. 34200 (August 29, 1984), issuing regulations under §§6112 and 6708.
[22] §6111(c)(2).
[23] Temp. Regs. §301.6111-1T, Answer 6.
[24] *Id.*, Answer 8.
[25] *Id.*, Answer 9.
[26] *Id.*
[27] *Id.*, Answers 11 and 12.
[28] *Id.*, Answer 13.
[29] *Id.*, Answer 14.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*, Answer 15.
[34] §6111(c)(1)(B); Regs. §301.6111-1T, Answers 17, 18, 19, and 20.
[35] §6111(c)(4).
[36] Regs. §301.6111-1T, Answer 21.
[37] *Id.*, Answer 22.
[38] *Id.*; Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess., 979-980 (1984).
[39] Temp. Regs. §301.6111-IT, Answer 24.
[40] *Id.*
[41] §6111(d)(1)(A).
[42] Regs. §301.6111-IT, Answer 26.
[43] *Id.*, Answers 28 and 30.
[44] *Id.*, Answer 29.
[45] *Id.*, Answer 30.
[46] *Id.*, Answer 32.
[47] *Id.*, Answer 34.
[48] *Id.*, Answer 35.
[49] *See* §7408.
[50] Regs. §301.6111-1T, Answer 38.
[51] *Id.*, Answer 39.
[52] *Id.*, Answer 41.
[53] *Id.*, Answers 44 and 45.
[54] *Id.*, Answer 46.
[55] *Id.*, Answer 47.
[56] *Id.*, Answer 48.
[57] *Id.*, Answer 49.
[58] *Id.*, Answers 51 and 52.
[59] *Id.*, Answer 53.
[60] *See* Regs. §301.6707-1T, Answer 4, stating that this is a question of fact.
[61] Regs. §301.6707-1T, Answer 2.
[62] Act §141(d)(1).
[63] Act §141(d)(2).
[64] Regs. §301.6611-1T, Answer 60.
[65] Act §141(d)(3).
[66] Temp. Regs. §301.6112-1T, Answer 4.
[67] *Id.*
[68] Temp. Regs. §301.6112-1T, Answer 5, referring to the definition in Temp. Regs. §301.6111-1T, Answer 27.
[69] Temp. Regs. §301.6712-1T, Answer 6.
[70] *Id.*, Answer 7.
[71] *Id.*, Answer 8.
[72] *Id.*, Answer 9.
[73] *Id.*, Answer 9.
[74] *Id.*, Answer 11.
[75] *Id.*, Answer 13.
[76] *Id.*, Answer 14.
[77] *Id.*, Answers 16 and 17.
[78] *Id.*, Answer 19.
[79] *Id.*, Answer 20.
[80] *Id.*, Answer 21.
[81] Temp. Regs. §301.6708-1T, Answer 1.
[82] *Id.*, Answer 2.
[83] *Id.*, Answers 4 and 5.
[84] Act §142(d).
[85] Temp. Regs. §301.6112-1T, Answer 22.
[86] §6050H(a).
[87] H.R. Rep. No. 861, *supra* at 986.
[88] §6050H(e).
[89] H.R. Rep. No. 861, *supra*, at 986.
[90] *Id.*, at 986-987.
[91] *Id.*, at 987.
[92] §6050H(c).
[93] §6050H(d).
[94] *Cf.*, Temp. Regs. §1.6050J-IT, Answer 25, prescribing the use of forms 1096 and 1099 for the reporting of foreclosures and abandonments.
[95] H.R. Rep. No. 861, *supra*, at 986.
[96] *Id.*, at 987.
[97] *Id.*
[98] *Id.*
[99] Act §145(d)(2).
[100] §6050I(a), (d), and (e).
[101] S. Rep. No. 169, 98th Cong., 2d Sess., 430 (1984).
[102] *Id.*
[103] H.R. Rep. No. 861, *supra*, at 988.
[104] §6050I(e).

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[105] *Id.*
[106] H.R. Rep. No. 861, *supra.*
[107] *Id.*
[108] Regs. §1.6050J-IT, Answer 2.
[109] *Id.*, Answer 3. Only one return and statement must be filed with respect to each loan or other evidence of indebtedness included under such arrangements.
[110] *Id.*, Answer 4. Only one return or one statement must be filed with respect to a bond issue.
[111] *Id.*, Answer 6.
[112] *Id.*, Answer 7.
[113] *Id.*, Answer 8.
[114] *Id.*
[115] *Id.*, Answer 9.
[116] *Id.*, Answer 10.
[117] *Id.*, Answer 11.
[118] *Id.*, Answer 12.
[119] *Id.*, Answer 15.
[120] *Id.*, Answer 17. Answer 18 states that this definition of abandonment is not to apply for purposes of determining whether the borrower is entitled to an abandonment loss.
[121] *Id.*, Answer 19.
[122] *Id.*, Answer 20.
[123] *Id.* However, if the lender does not commence such proceedings within the three-month period, the lender must report the abandonment as of the close of the three-month period. *See* Answer 21.
[124] *Id.*
[125] *Id.*, Answer 22.
[126] *Id.*, Answer 23.
[127] *Id.*, Answer 25.
[128] *Id.*, Answers 26 and 27.
[129] *Id.*, Answer 28.
[130] *Id.*, Answer 29.
[131] *Id.*, Answer 30.
[132] *Id.*, Answer 31.
[133] *Id.*, Answer 33.
[134] *Id.*, Answer 34.
[135] *Id.*, Answer 35.
[136] *Id.*, Answers 36, 37, and 40.
[137] *Id.*, Answer 38.
[138] *Id.*, Answer 39.
[139] *Id.*, Answer 41.
[140] *Id.*, Answer 42.
[141] *Id.*,
[142] *Id.*, Answer 16.
[143] *Id.*
[144] §6050K(a).
[145] §6050K(b).
[146] *Id.*
[147] §6050K(c).
[148] §6050L(a).
[149] §6050L(c).
[150] H.R. Rep. No. 861, *supra*, at 997.
[151] *Id.*
[152] Act §§145(b), 146(b), 148(b), 149(b), and 155(b)(2).
[153] §6652(a)(3)(B).
[154] §6652(a)(3)(A)(iii).
[155] §6652(a)(3)(A)(i).
[156] §6678(a).
[157] *Id.*
[158] Added by Act §149(b)(3).
[159] Act §145(d)(1).
[160] Act §145(d)(2).
[161] Act §146(d).
[162] Act §148(d).
[163] Act §149(d).
[164] Act §155(d)(1).
[165] Act §147(a).
[166] H.R. Rep. No. 861, *supra*, at 989.
[167] *Id.*
[168] Act §147(b).
[169] Act §147(d).
[170] Act §150.
[171] H.R. Rep. No. 861, *supra*, at 991.
[172] Act §150(b).
[173] Act §151(a).
[174] H.R. Rep. No. 861, *supra*, at 992.
[175] Act §151(b).
[176] H.R. Rep. No. 861, *supra.*
[177] Act §714(q).
[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] TEFRA §314(a).
[182] Act §1072.
[183] H.R. Rep. No. 861, *supra*, at 1275.
[184] Act §1072(b).
[185] Act §1072(d).
[186] Act §714(d).
[187] Act §714(e).
[188] Act §715.
[189] Act §143(a).
[190] Act §143(c).
[191] Act §143(b).
[192] S. Rep. No. 169, *supra*, at 434.
[193] H.R. Rep. No. 861, *supra*, at 984.
[194] Act §143(c).
[195] Act §714(g).
[196] H.R. Rep. No. 861, *supra*, at 1224.
[197] §6659(c)(d).
[198] §6659(e).
[199] Act §155(c)(1)(A).
[200] Added by Act §155(c)(1)(B).
[201] §6659(f)(3)(A).
[202] §6659(f)(3)(B)(C).
[203] Act §155(c)(2)(B).
[204] §6660(d).
[205] §6660(e).
[206] Act §155(d)(2).
[207] P.L. 97-248, §292(b), increased the penalty from a $500 maximum to $5,000 maximum, effective with respect to any action or proceeding in Tax Court commenced after December 31, 1982.
[208] TEFRA §292(d)(2)(A).
[209] Act §160, amending TEFRA §292(e)(2).
[210] Act §159.
[211] H.R. Rep. No. 861, *supra*, at 1,001.
[212] Act §422(b).
[213] Act §422(c).
[214] Added by Act §41(a).
[215] Added by Act §41(c).
[216] §6706(b).
[217] §6706(c).
[218] Act §714(j)(3).
[219] TEFRA §334(a).
[220] S. Rep. No. 169, *supra*, at 450.
[221] Act §161.
[222] H.R. Rep. No. 861, *supra*, at 1,002.
[223] Act §161(b).
[224] Act §144(a).
[225] §6621(d)(3).
[226] H.R. Rep. No. 861, *supra*, at 984.
[227] §6621(d)(3)(B).
[228] §6621(d)(3)(C).
[229] Act §144(c).
[230] H.R. Rep. No. 861, *supra*, at 985.
[231] Act §158(a).
[232] Act §158(b).
[233] Act §152.
[234] *See* Temp. Regs. §35(a).9999-1.
[235] S. Rep. No. 169, *supra*, at 456.
[236] Act §722(h)(1).
[237] Act §722(h)(2).
[238] H.R. Rep. No. 861, *supra*, at 1224.
[239] Act §722(h)(3).
[240] Act §722(h)(4).
[241] H.R. Rep. No. 861, *supra*, at 1225.
[242] *Id.*
[243] Act §722(h)(5)(A).
[244] P.L. 98-67, §104.
[245] Act §152(b).
[246] Act §722(h)(5)(B).
[247] Act §163(a)(3).

[248] All references to sections in Part III of this chapter are to the Internal Revenue Code of 1954 as amended to include the Tax Reform Act of 1984 (the "Act"), and the regulations thereunder.
[249] Regs. §1.6654-1(a)(4).
[250] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., 1488 (1984).

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[251] Joint Committee on Taxation, "Description of H.R. 3751: Tax Law Simplification and Improvement Act of 1983," 98th Cong., 1st Sess. 7 (Comm. Print 1983).
[252] Statement of Ronald A. Pearlman before the Committee on Ways and Means on H.R. 3475, 98th Cong., 2d Sess. (Treasury Release July 25, 1983).
[253] Rev. Rul. 83-111, 1983-2 C.B. 245.
[254] 1977-2 C.B. 476.
[255] 588 F.2d 342 (2nd Cir. 1978).
[256] [*See* Joint Committee on Taxation, "Description of H.R. 3751: Tax Law Simplification and Improvement Act of 1983," 98th Cong., 1st Sess. 7 (Comm. Print 1983); Statement of Ronald A. Pearlman before the Committee on Ways and Means on H.R. 3475, 98th Cong., 2d Sess. (Treasury Release July 25, 1983).]
[257] §6654(e)(1).
[258] §6654(a).
[259] §6654(e)(i).
[260] §6654(c)(2).
[261] §6654(h).
[262] §6654(j)(1).
[263] §§6654(h) and (j)(1).
[264] The credit against the income tax for income tax withheld is already considered an estimated tax payment and it is appropriate that it not be considered here. *See* §6654(g).
[265] §6654(f).
[266] §6654(d)(2)(A).
[267] §6654(d)(1)(B)(ii).
[268] If an individual (who is a United States citizen or resident) does not have a tax liability in his preceding taxable year, which consisted of 12 months, then he has no obligation to make quarterly installment payments. §6654(e)(2).
[269] §6654(d)(2)(B)(i). For example, the individual must determine the income tax attributable to the months of January, February, and March for the payment due April 15.
[270] *See* Regs. §§1.6654-2(a)(2)(i)(A) and (ii), respectively.
[271] §6654(d)(2)(A)(ii).
[272] §6654(b)(2).
[273] §6654(b)(1).
[274] §6654(g).
[275] §6654(g).
[276] §6654(b)(3).
[277] §6654(a)(1).
[278] Interest is not compounded in calculating this penalty. *See* Rev. Proc. 83-7, 1983-1 C.B. 583, §5.
[279] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., 1489 (1984) and S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess., 506-7 (1984). Waiver in this situation is recommended since the amount of estimated payments may depend on the tax shown on the return as initially filed. If the return overstates income, at least a portion of the penalty should be waived to reflect the reduction in the required payment if the return had shown the correct amount of tax.
[280] H.R. Rep. No. 861, 98th Cong., 2d Sess., 1115-6 (1984). Such offset will generally include past-due child support or nontax federal debts which offsets are authorized by §6402(c) and (d), respectively. Subsection (d) was added by §2653 of the TRA of 1984.
[281] §6654(f)(2).
[282] §6654(i)(1)(B).
[283] §6654(i)(1)(D).
[284] 1983-2 C.B. 245.
[285] Act §412(a).
[286] §501(c)(3).
[287] Up to 50 percent of the taxpayer's contribution base for the taxable year. §170(b)(1)(A)(i).
[288] Churches, unlike most other tax exempt organizations, are not required to annually file a Form 990 "Return of Organization Exempt from Income Tax," §6033(a)(2)(A); Regs. §1.6033-2(g)(i).
[289] *See* the leading case, *U.S. v. Powell*, 379 U.S. 48 (1964). The IRS may, under its summons power compel the production of any documents which *may be* relevant to a proper investigation.
[290] A section about which the Joint Committee's General Explanation is silent.
[291] *U.S. v Dykema*, 666 F.2d 1096 (7th Cir. 1981).
[292] *See U.S. v. Coates*, 692 F.2d 629 (9th Cir. 1982); *U.S. v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979). The Fifth and Eighth Circuits take a somewhat more restrictive view.
[293] §7611(a)(1)(A) and (B).
[294] §7611(a)(2).
[295] §7611(a)(3).
[296] §7611(b)(1).
[297] §7611(b)(3)(A)(i) through (iv).
[298] §7611 (b)(4).
[299] §7611(c)(1)(A).
[300] §7611(c)(1)(B).
[301] These suspension provisions are contained in §7611(c)(2).
[302] §7611(d)(1).
[303] The limitations provisions are contained in §7611(d)(2)(A) through (C).
[304] §7611(e)(1).
[305] §7611(f)(1).
[306] §7611(f)(2).
[307] §7611(g).
[308] Act §1033(b).
[309] §7611(a)(2)(A).
[310] §7611(c)(1)(B).
[311] §7611(a)(3)(B).
[312] §7611(b)(3)(A).
[313] As noted in the Overview, the statutory references to notice use the term "provided." From the context of the statute and other statutory language (*e.g.*, §7611(b)(3)(C)) the various time periods would appear to commence upon receipt of the notices rather than the date of mailing.
[314] §7611(h)(4)(A).
[315] §7611(c)(1)(B).
[316] *See* 8, "The Five Year Rule," below.
[317] §7611(c)(1)(A). "Examination notice date" is defined in §7611(h)(6) as is "inquiry notice date" in §7611(h)(5) for purposes of these limitations rules as the date the notice is "provided," again inferrably meaning receipt by the person notified.
[318] It may qualify as a "church" for the purposes of §7611, but not be operated exclusively for religious purposes.
[319] It may be exempt under §501(c)(3), but on grounds other than its religious activities.
[320] §7611(d)(1).
[321] §7611(e)(1) and (2).
[322] §7611(e)(2).
[323] §7611(f)(2).
[324] H.R. Rep. No. 861, 98th Cong., 2d Sess. at pp. 1111 through 1114.
[325] A more complete list of what may be considered "routine" inquiries is contained in the report.

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Chapter 44

ADMINISTRATIVE AND PROCEDURAL PROVISIONS

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I. Introduction

The provisions of the 1984 TRA to be discussed below relate to a variety of matters, mostly those concerning the more efficient operation of the Treasury Department, the payment and collection of taxes, and the administration of the internal revenue laws.

II. Explanation of Provisions

A. Deposits of Taxes

The mode or time for the collection of taxes not specifically provided for in the Code (such as employment taxes and payments of estimated taxes) are provided by regulations issued under §6301. Section 6302(c) authorizes the Secretary to designate various enumerated depositories or financial agents of the U.S. to receive taxes at such times and under such conditions as the Secretary may prescribe. Section 7502 (included in Chapter 77—Miscellaneous Provisions) sets forth the general rule that timely mailing is to be treated as timely filing of returns, claims, statements and other documents required to be filed and payments required to be made within a prescribed period. Under this rule, if a payment is to be made on a certain date, it is treated as so made if, as evidenced by a U.S. postmark stamped on the envelope or other container, it was mailed on or before such date. Subsection (e) of §7502 extends this rule to deposits of taxes required to be made under regulations prescribed under the authority of §6302(c). Under §7502(e), a deposit is considered as timely made if the date of mailing falls on or before the second day before the prescribed date for making payment if placed in the mail with sufficient postage and properly addressed to the appropriate depository.

Section 157(a) of the Act amends §7502(e) by adding paragraph (3) providing that this rule does not apply to any deposit of $20,000 or more by any person required to deposit the tax more than once a month. As to such persons, therefore, the deposit will be treated as untimely where the funds are not actually deposited with the depository on or before the date prescribed, irrespective of the date such deposit was mailed. This amendment applies to deposits required to be made after July 31, 1984.[1]

B. Review of Jeopardy Assessments

Section 7429 of the Code provides for the prompt review by the Secretary at the request of a taxpayer of any termination or jeopardy assessment made under the provisions of §6851 or §6861. Where the Secretary upholds the assessment, §7429(b) allows the taxpayer to bring a civil action in an appropriate U.S. district court for a determination as to whether or not the making of the assessment was reasonable and the amount so assessed is appropriate under the circumstances. Under paragraph (2) of §7429(b), the district court's determination must be made within 20 days after the action was commenced. There is no provision relating to service of process on the U.S. Where such service is not properly effected in time to give the Government an opportunity to present its case, the 20 day time limit unduly prejudices the Government. Act §446(a), effective as to actions commenced after July 18, 1984, adds to §7429(b)(2) a sentence providing that if the court determines that proper service on the U.S. was not made within 5 days of the commencement of the action, the running of the 20 day period is not to begin before the date on which proper service was made on the U.S.

C. Extension of Limitation Period for Assessment of Tax Shown on Amended Return

Section 6501(a) sets forth the general rule that the amount of any tax for any taxable year must be assessed within 3 years of the date the return for such year was filed (whether or not timely filed). Subsection (c) of §6501 provides a number of exceptions to this general rule (false return, no return, extension by agreement, etc.). Under these rules, where an amended return is filed on, or within a day or two of, the last day of such 3 year period, showing additional tax due for the taxable year, the IRS will not have time to make the appropriate assessment, with the result that the IRS is barred from collecting such additional tax and is also barred from asserting any civil penalty for the failure to report such tax liability and make timely payment (except in cases where the fraud penalty is properly imposed despite the amended return). Act §447(a) remedies this technical defect by adding to §6501(c) paragraph (7) providing that where any written document, signed by the taxpayer, and showing additional tax due for the taxable year, is filed within 60 days before the expiration of the 3 year period, the assessment period does not expire until 60 days after the date on which such document was received by the IRS.

This amendment applies with respect to any documents received by the IRS after July 18, 1984.

D. Defaulted Guaranteed Drafts Used for Tax Payments

Section 6311(b)(1), relating to the payment of taxes by check or money order, provides that where a check or money order tendered in payment of a tax is not duly paid, the person tendering such instrument remains liable for the tax and for all penalties and interest as if such tender had

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never been made. In other words, such instrument is treated as a nullity. In the case of a certified, treasurer's or cashier's check, or money order, §6311(b)(2), prior to amendment by the TRA provided that, in addition to the application of the rule provided by paragraph (1) (taxpayer ultimately liable), the U.S. has a lien on all of the assets of the maker of such instrument (bank, trust company, etc. on which drawn) for the amount of the instrument. This claim is given absolute preference, by the statute, over all other claims against such person of whatever nature.

Act §448(a) amends §6311(b)(2) by extending these same provisions to guaranteed drafts. Where such a draft issued by a financial institution is tendered in payment of a tax and is not paid when presented, in addition to its right to assert its claim against the taxpayer in default, the Government has a claim secured by a lien on all the assets of the financial institution, and its claim against such institution has priority over all other claims. This amendment is effective on July 18, 1984.

E. Technical Corrections to Partnership Audit Provisions

Subchapter C of chapter 63 was added by TEFRA (P.L. 97-248) as one of the Act's major anti-tax shelter provisions, the so-called partnership audit rules (Tax Treatment of Partnership Items; §§6221-6232). This set of rules is somewhat complex, and technical corrections were found necessary to strike out obvious errors as well as better to carry out the intent and purpose of the rules.

TRA §714(p) (part of title VII—Technical Corrections) amending title IV of the Code, makes the following amendments to subchapter C of chapter 63:

There is added to the end of subchapter C §6233 which provides that where an entity files a partnership return for a year and it is later determined that the entity was not a partnership for the year, then, to the extent provided by regulations, the provisions of subchapter C are extended to such entity, its items, and persons holding interests therein. A similar rule is provided for S corporations. (Subchapter D extends the audit procedures of C to S corporations and their shareholders).[2] Also where an entity files a partnership or S corporation return for a year and it is determined that there was no entity for the year, regulations are to provide for the application of rules similar to those described above (*i.e.*, to the extent practicable, the rules of subchapter C or D are to apply).[3]

In addition to §6233, subchapter C is amended by various technical and clerical amendments.

Section 6230(c)(1) is amended by striking out superfluous words "(or erroneously computed the amount of any such credit or refund)."

Section 6231(d)(1) is amended to make it clear that in determining whether a partner who is disposing of his interest in the partnership is entitled to notice of administrative actions taken by the IRS depends on the taxpayer's proportionate interest in the partnership as of the moment immediately before such disposition.[4]

In §6231(f), the obviously erroneous use of the term "deduction" where "loss" was intended is corrected.[5]

Section 6603(q) is amended to add a cross reference: for extension of the period for windfall profit tax items of partnerships, *see* §6229 as made applicable by §6232, and §6613(h) is amended to add a cross reference relating to the period of limitation for windfall profits tax items of partnerships: *see* §6227(a) and subsections (c) and (d) of §6230 as made applicable by §6232.[6]

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[1] Act §157(b).
[2] §6233(a) and (b).
[3] §6233(b)(2).
[4] Act §714(p)(2)(C) amending §6231(d)(1)(A).
[5] Act §714(p)(2)(D).
[6] Act §714(p)(2)(F) and (G).

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CHAPTER 45

NEW PROVISIONS AFFECTING TAX COURT PROCEDURES AND TAX COURT JUDGES

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I. Background

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted to practice before the Tax Court. Such proceedings are generally conducted in a more informal atmosphere and the Court's opinion is final and may not be appealed. Prior to the 1984 Act, small tax cases were generally cases involving $5,000 or less for any one taxable year or period.[1]

Present law provides that the Chief Judge of the Tax Court may assign to the Court's commissioners for hearing and decision any declaratory judgment proceeding, any small tax case proceeding, and any other proceeding where the amount in dispute does not exceed $5,000, subject to such review as the Court may provide.[2]

Prior to amendment by the 1984 Act, §7461 provided that all reports of the Tax Court and all evidence received by the Court were open to public inspection, except that after its decision in a case became final, the Court could permit the withdrawal of documents from the record or make such other disposition thereof as it deemed advisable. Rule 103(a) of the Tax Court's Rules of Practice and Procedure provides that the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense, including an order requiring that a deposition or other written materials be placed under seal, that a trade secret or other information not be disclosed or be disclosed only in a designated way, or that documents or information be filed in sealed envelopes to be opened only as directed by the Court.[3]

Ordinarily, the Tax Court has jurisdiction only to redetermine the correct amount of the deficiency for the taxable year or years of the taxpayer that are before the Court.[4] Under the Act, the otherwise applicable interest rate for periods after 1984 will be increased by 50 percent with respect to tax-shelter items arising with respect to any year. To determine the amount of any deficiency or overpayment attributable to a tax-shelter syndicate item, it will be necessary to compare the deficiency or overpayment as finally determined to the deficiency or overpayment that would have existed if the taxpayer's treatment of the items had been determined to be correct. The difference will be the overpayment attributable to the tax-shelter syndicate items.[5]

Section 6673 gives the Tax Court discretionary authority to award damages of up to $5,000 against taxpayers who institute or maintain proceedings primarily for delay or upon frivolous grounds. TEFRA increased the maximum amount from $500 to $5,000, and provided that the penalty could be asserted when proceedings were "maintained" as well as "instituted" effective for any action or proceeding in the Tax Court commenced after December 31, 1982.[6]

II. Detailed Analysis

A. Increase in Jurisdictional Limits for Small Cases [Act §461]

The Act raises the dollar limit in small tax cases to $10,000.[7]

B. Proceedings Which May Be Assigned to Special Trial Judges [Act §463]

A technical change is made to allow the Chief Judge of the Tax Court to assign any proceeding to a Special Trial Judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, Special Trial Judges will not be authorized to enter decisions in cases assigned pursuant to §7456(d)(4).

C. Special Trial Judges [Act §464]

The title of Tax Court commissioner is changed to "Special Trial Judge."[8]

D. Publicity of Tax Court Proceedings [Act §465]

The Act clarifies that the Tax Court may take any action necessary to prevent the disclosure of trade secrets and other confidential information.[9] This conforms the statute to existing Rule 103(a) of the Tax Court's Rules of Practice and Procedure.

E. Jurisdiction to Determine Whether Any Portion of a Deficiency Is a Substantial Underpayment Attributable to a Tax Motivated Transaction [Act §144(a)]

In order to determine the amount of any deficiency or overpayment attributable to a tax-shelter syndicate item, it will be necessary to compare the deficiency or overpayment as finally determined to the deficiency or overpayment that would have existed if the taxpayer's treatment of the items had been determined to be correct. Consequently, the Act confers jurisdiction on the Tax Court separately to determine whether any portion of a deficiency is a substantial underpayment attributable to a tax motivated transaction after the final determination of the deficiency.[10]

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F. Penalty for Frivolous Proceedings [Act §160]

The Act provides that, in addition to its current application, the penalty under §6673 can be applied to any proceeding before the Tax Court as of 120 days after the date of enactment.[11] This 120-day period enables taxpayers who maintain proceedings before the Tax Court that are potentially subject to damages under §6673 because of this amendment to withdraw or settle those proceedings before the imposition of damages.[12]

G. Effective Dates

The amendment to §7463(a) (increasing the jurisdictional limit for small tax cases) became effective on the date of enactment (July 18, 1984). The amendment to §7456(b) (relating to proceedings which may be assigned to special trial judges) is effective retroactively as if it were enacted as part of the Miscellaneous Revenue Act of 1982 (which became effective October 25, 1982). The amendment to §7456 (changing the name of Commissioners of the Tax Court to Special Trial Judges) became effective on the date of enactment (July 18, 1984). The amendments to §7461 (relating to publicity of proceedings) became effective on the date of enactment (July 18, 1984). Section 6621(d)(4) (conferring jurisdiction on the Tax Court to determine the portion of a deficiency which is a substantial underpayment attributable to tax motivated transactions) will apply with respect to interest accruing after December 31, 1984. The amendment to §292(e)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (permitting application of the penalty for frivolous proceedings to pending Tax Court proceedings) applies to cases pending in the Tax Court 120 days after the date of enactment (November 15, 1984 is 120 days after the date of enactment).

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[1] §7463; H.R. Rep. No. 432, 98th Cong., 2d Sess., 1566 (1984).
[2] §7456(d); H.R. Rep. No. 432, 98th Cong., 2d Sess., 1568 (1984).
[3] H. Rep. No. 432, 98th Cong., 2d Sess., 1570 (1984).
[4] §6214(a).
[5] S. Rep. No. 169, (Vol. I), 98th Cong., 2d Sess., 437 (1984).
[6] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 455 (1984).
[7] §7463(a).
[8] §7456.
[9] §7461.
[10] §6621(d)(4).
[11] Act §160, amending §292(e)(2) of the Tax Equity and Fiscal Responsibility Act of 1982.
[12] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 455 (1984).

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Chapter 46

NEW AND REVISED RULES GOVERNING EMPLOYEE FRINGE BENEFITS AND STOCK OPTIONS

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I. New Provisions Affecting Fringe Benefits

A. Introduction

Code §61 [1] defines gross income as including "all income from whatever source derived," including "compensation for services." On several occasions, the Supreme Court has held that §61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." [2] In addition, for purposes of Social Security and Unemployment Insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding, the Code defines wages as all remuneration for employment, including the cash value of remuneration not paid in cash.[3] The regulations issued pursuant to these sections indicate that the value of any non-cash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item.[4]

As a practical matter, over time, a variety of exceptions to the economic benefit test set forth by the Supreme Court have been created. Thus, today the treatment of in-kind compensation is governed not by a broad inclusion rule but by statutory provisions, regulations, and administrative rulings and public practices that create exceptions to the inclusion rule. Before the Act, for example, many fringe benefits had been statutorily excludable from an employee's gross income. Among these so-called "statutory" fringe benefits were: (1) qualified pension, profit sharing, and stock bonus plans; (2) group-term life insurance (under $50,000); (3) accident or health benefits; (4) up to $5,000 of death benefits; (5) group legal services; (6) dependent care assistance; (7) certain benefits provided to members of the Armed Services; and (8) parsonage allowances.[5] Apart from the statutorily excepted benefits, there are large numbers of employee benefits provided in the form of tangible property, services, discounts and other types of non-cash compensation that, as a matter of public perception, constitute non-taxable income.

The erosion of the tax base through the expanding use of these so-called "non-statutory" fringe benefits led the Treasury Department in 1975 to issue a discussion draft of proposed regulations containing rules for determining whether various fringe benefits constitute taxable compensation. The proposed rules would have continued the tax exeptions for many of the then-existing exclusions of non-statutory fringe benefits that were based on judicial authority or administrative practice. However, the rules also would have required the taxation of many employee fringe benefits that had not been taxed previously and that were regarded by the business community as working fringes that should be tax-exempt for all times. The proposed regulations were withdrawn in 1976 following considerable controversy.

Because of its inability to agree on how to approach the controversy, beginning in 1978, Congress enacted a series of moratoriums prohibiting the Treasury Department from issuing regulations under §61 relating to the tax treatment of fringe benefits.[6] The last moratorium, enacted as part of the Economic Recovery Tax Act of 1981, expired on December 31, 1983. In December, 1983, the Treasury provided assurances to Congress that it would not issue any regulations or rulings or change any of its administrative practices to alter the tax treatment of non-statutory fringe benefits before January 1, 1985.[7] This assurance gave Congress an opportunity to enact legislation it had been considering in earnest for over a year.[8]

During the moratorium on the issuance of regulations, the taxation of non-statutory fringe benefits was determined on a case-by-case basis and, as a result of a lack of guidance in the field, taxation of such benefits varied from place-to-place across the U.S. depended on the policy of the particular IRS district in which the taxpayer filed.

Dissatisfied with existing practices and concerned about erosion of the tax base, Congress considered several pieces of legislation during the course of a year-and-a-half and then adopted as part of the Act provisions that specifically treat the income tax aspects (as well as the Social Security and unemployment insurance tax and income withholding) of nonstatutory fringe benefits.

By enacting these fringe benefit rules for income and payroll tax purposes, Congress intended to address three concerns. First, it wanted to accommodate, in many cases, the long-established practices in certain industries whereby employees are provided, either free or at a discount, goods and services which the employer sells to the general public. Congress was aware that, in many instances, business purposes are served by the present practices under which employers provide a broad group of employees the products and services which the employer sells to the public.[9]

Secondly, Congress wished to establish clear guidelines in the area of fringe benefits so that taxpayers in identical situations would no longer be treated differently. Third, Congress was concerned about the fact that, without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than

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cash, new practices might emerge that could shrink the income tax base significantly and further shift a disproportionate tax burden to those individuals whose compensation is primarily or exclusively in the form of cash.[10]

B. *Overview*

1. *Provisions*

The Act excludes certain fringe benefits from a recipient employee's gross income for federal income tax purposes and from the wage base for purposes of income tax withholding, FICA, FUTA, calculating the Social Security benefit base, and the Railroad Retirement Tax. The excluded fringe benefits are those that qualify under categories defined in the bill including (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, and (5) qualified tuition reductions. The Act also contains special exclusionary rules for parking or eating facilities provided to employees, athletic facilities, and the demonstration use of employer-provided automobiles by full-time automobile salespeople. Some exclusions apply to benefits provided not only to the employee but also to the spouse and dependent children of a current employee, or to former employees who left employment due to retirement or disability, and to their widows and dependent children. In the case of many of the categories of fringe benefits, a nondiscrimination rule is applied so that, if benefits are provided to officers, owners or highly compensated employees on a discriminatory basis, the exclusion will not be available to such individuals.

The Act clarifies that, where a benefit does not qualify for exclusion under the Act, the benefit will be considered taxable to the recipient under §61 and §83 (and will be includable in wages for employment tax purposes) at the excess of its fair market value over any amount paid by the employee for the benefits.

2. *Effective Date*

For the most part, the provisions of the bill take effect on January 1, 1985. The tuition reduction exclusion however, applies with respect to education furnished after June 30, 1985 in taxable years ending after that date. This different effective date was added to permit teachers and university employees to finish out the 1984-85 school year before becoming subject to the new rules.

C. *Detailed Analysis*

1. *General Taxation of Fringe Benefits*

The Act added new §§132 and 117(d) to the Code to exclude from income certain fringe benefits that qualify in one of five general categories: (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, and (5) qualified tuition reductions.[11] It also excludes these categories of fringe benefits from employment taxes (including Social Security, Railroad Retirement and Unemployment taxes) and from the income tax withholding rules, and from the Social Security benefit base.[12]

Specifically, §531(d)(1), (3) and (4) respectively, of the Act amend §3121(a) and §209 of the Social Security Act (defining wages for Social Security tax and benefit purposes), §3306(b) (defining wages for purposes of the unemployment tax) and §3401(a) (defining wages for purposes of income tax withholding) by adding paragraphs to each section indicating that the definition of wages will not include any benefit provided to (or on behalf of) an employee if, at the time such benefit is provided, it is reasonable to believe that the employee will be able to exclude the benefit from income under §117 or §132. Section 3231(e), defining compensation for purposes of the Railroad Retirement Tax Act, was similarly amended.[13]

Any fringe benefit not excludable under the Act is treated as gross income. The Act amended §61(a)(1) (defining gross income) to specifically indicate that fringe benefits are items of income.[14] The House and Conference reports emphasize that any fringe benefit that does not qualify for exclusion under the Act (for example, free or discounted goods or services which are limited to corporate offices) and that is not excluded under another statutory fringe benefit provision of the Code is taxable to the recipient under Code §61 and 83, is includable in wages for employment tax purposes. The amount to be included is the excess of the benefit's fair market value over any amount paid by the employee.[15]

Comment: The amendments to §§61, 3121, 3304, 3306 and §209 of the Social Security Act were described in the statute as "clarifying" amendments. Nevertheless, some practitioners argue that, because the specific language including benefits was not there before, there was not sufficient authority under prior law to tax benefits that were tax-exempt by administrative practice. Tax Management understands that standard disclaimer language stating that no inferences as to prior law should be drawn because of the clarifying amendment was inadvertently omitted from the Conference Report but may be picked up in the Blue Book. With the exception of de minimis fringe benefits, §132 does not apply to any fringe benefits that are treated expressly in any other section of Chapter C of the Internal Revenue Code.[16] The Act expressly authorizes the issuance of regulations that are necessary or appropriate to carry out the purposes of §132, thereby lifting the moratorium on fringe benefit regulations. The regulations are to be consistent with the language of the bill and the legislative history as reflected in the House Report and the Statement of Managers. Thus, for example, as stated in the House Report, the Act does not modify the existing rules under which benefits to military personnel, such as subsistence, housing, and uniform allowances are excludable from gross income.[17]

The Act also directs the Secretary of the Treasury to issue regulations concerning the time and manner in which tax will be collected on non-cash fringe benefits.[18] The Conference Report provides guidance concerning the scope of this regulatory authority. It states that, to the maximum extent practicable, the regulations issued by Treasury should provide for collection (or payment) of FICA taxes under §§3101 and 3111 with respect to non-cash fringe benefits in a calendar quarter not later than the time that cash or wages are reported. The regulations may also provide similar rules for the other employment taxes covered by the Act.[19]

Comment: Although the Act has authorized the issuance of regulations in an area that will be very difficult for employers to implement without further guidance, Tax Management understands that, as of August 15, 1984, this

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regulations project is not considered one of the "high priority" regulations to be issued as promptly as possible after passage. Thus, it is highly unlikely that regulations will be issued by the general effective date of the fringe benefit provisions, January 1, 1985.

2. Categories of Excludable Benefits

a. No-Additional-Cost Service

The entire value of a no-additional-cost service is excludable by an employee provided certain nondiscrimination requirements are met.[20]

A no-additional-cost service is any service provided by an employer to an employee (for use by the employee) if the service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services and the employer incurs no substantial additional cost (including forgone revenue) in providing the service to the employee.[21] (Any amount paid by the employee for the service is not considered in determining the employer's cost.)

(1) Employee

The Act defines employee to include persons in addition to those currently and actually employed. With respect to a line of business of an employer, the term employee includes former employees in the line of business who separated from service due to retirement or disability and any widow or widower of an employee who either died while employed by the employer in such line of business or who retired or was disabled following employment in that line of business.[22] The Act also treats spouses and dependent (or orphaned) children of employees as employees.[23] Dependent parents, however, are not dependents for this purpose.

Query: Whether a widow or widower could continue to receive tax-free benefits after remarriage. Regulations may address this issue.

(2) Line of Business

The House Report clarifies that a single employer has more than one line of business if, after aggregating businesses under common control, the products or services the employer sells to nonemployee customers fall into more than one industry group. The report directs that the Treasury, in preparing regulations, may take into account the business segments into which corporations divide themselves for financial reporting purposes or, to refer to the standard industrial classifications used for other governmental purposes.[24]

Under the line of business limitation, an employer that provides airline and hotel services to the general public is considered to consist of two separate lines of business. Thus, employees of the airline business of the employer may not exclude the value of free hotel rooms provided by the hotel business of the employer, and vice versa. The House Report states that the purpose of the line of business limitation is to avoid, to the extent possible, the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to the employees of a small employer with only one line of business.[25] Note, however, that, if an employee provides services that directly benefit more than one line of business of the employer, the individual is treated as performing services in all such lines of business. A chief executive officer, for example, may exclude the value of no-additional-cost services provided by either the airline or hotel line of a business of the employer if he/she provides services which directly benefit both those lines of business.[26]

(3) Employers and Reciprocal Agreements

For purposes of §132, all employees of a group of related employers will be treated as employees of a single employer if the employers are treated as a single employer under §414(b), (c) or (m).[27]

The Act permits reciprocal agreements among unrelated employers in the same line of business so that they can provide no-additional-cost services to each other's employees if certain requirements are met. The service must be provided under a written agreement between the employers and neither of the employers may incur any substantial additional costs in providing the service.[28]

(4) Nondiscrimination

No-additional-cost services must be provided on a nondiscriminatory basis in order for any officer, owner or highly compensated employee of the employer to obtain an exclusion for the benefit. This special nondiscrimination rule requires that the no-additional-cost service be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer and which does not discriminate in favor of officers, owners, or highly compensated employees.[29]

Comment: As in the case of the §125 cafeteria plan nondiscrimination rule, only the highly compensated (officers and owners) are penalized if the rule is violated.

(5) Grandfather Provisions

The Act provides some relief for an employer with several lines of business that had previously permitted employees in one line of business to obtain no-additional-cost fringe benefits from another of its lines of business. If an employer wishes to take advantage of the grandfather provision, the employer must make an election and meet several requirements. First, the employee must have worked in a line of business of the employer which was a line of business of the employer on January 1, 1984. Second, the employer must have offered the no-additional-cost service benefits in that particular line of business to substantially all of the employees in all of its lines of business which existed on January 1, 1984. (The grandfather rule does not apply, however, with respect to no-additional-cost services provided in accordance with reciprocal agreements between employers). Thus, where an election is made and these two requirements are met, all employees of any line of business of the employer which was in existence on January 1, 1984 are treated, for purposes of Code §§132(a)(1) and 132(a)(2), as employees of the particular line of business (which was in existence on January 1, 1984) in which such goods or services are offered for sale by the employer.

If the election is made, it applies on a calendar year basis and applies to the first calendar year following the

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year of election and to all subsequent years unless revoked by the employer. The Conference Report states that a revocation must be made prior to the beginning of the calendar year to which the grandfather rule is meant to apply. The Treasury has been authorized to issue regulations concerning the manner in which the election is to be made. The statute provides that, for purposes of the grandfather rule, all members of the same affiliated group of corporations are treated as one corporation. A group of corporations is an affiliated group if it meets the definition of §1504. Under these rules, a corporation is part of an affiliated group if it is connected through stock ownership with a common parent corporation and provided certain specific percentage of stock ownership rules are met.

Use of the elective grandfather rule is not without potential cost. An employer that elects the grandfather rule may be subject to a 30 percent excise tax. The Act provides that for any calendar year in which the grandfather rule election is in effect, if the aggregate fair market value of all excludable no-additional-cost service benefits and qualified employee discount benefits (whether or not excludable only pursuant to the grandfather rule) provided by the employer during the calendar year to all its employees exceeds 1 percent of total compensation paid to all employees of the employer for the year, a 30 percent excise tax will be imposed on the employer. This tax is not deductible. The Conference Report indicates that the computation takes into account all employees in all lines of business of the employer, including lines of businesses to which the elected grandfather rule does not apply (*e.g.*, where the line of business did not exist on January 1, 1984).

Comment: The special elective grandfather rule which was drafted as an expansion of the non-elective grandfather rule (discussed in C, 2, b, (1), *infra,*) was referred to as the "AT&T and GE" rule because it was added after the non-elective grandfather rule specifically to provide relief to those companies. Ironically, the addition of the 1 percent rule late in the legislative process may, in fact, preclude the relief intended.

(6) Examples

This exclusion, for example, would permit an airline exclusively in the air travel line of business to provide free travel on a standby basis to its own employees provided the service is made available to a reasonable classification of employees and is not utilized disproportionately by owners, officers, or highly paid employees. An employee may exclude the entire fair market value of the free travel under this rule because the service is provided at no substantial additional cost to the employer. In addition, one airline can provide this service to employees of another airline provided there is a written reciprocal agreement between the employers. If the airline also has a hotel line of business, or if the airline is part of an affiliated group of corporations in which a related corporation conducts a hotel business, an employee in the airline line of business would not be permitted to exclude the cost of hotel accommodations provided to him by the company's hotel line of business or by a related company engaged in the hotel business.[30]

The no-additional-cost service rule would also preclude employees of a consumer goods manufacturer who travel for personal purposes on a company plane (even if the plane is making a trip for company business) from excluding the value of the airfare from income because the service is not the type generally provided by the employer to the general public in the line of business in which the employee recipient works.[31]

b. Qualified Employee Discount

(1) General

A second exclusion is provided for qualified employee discounts.[32] The exclusion applies regardless of whether the discount is provided through a reduction in price or a cash rebate.[33] An employee discount is the amount by which the price of goods and services provided to an employee by an employer is less than the price at which the goods or services are offered by the employer to customers who are not employees.[34]

The type of goods or services that may be provided at a discount are those that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.[35] The discounted value of real property and of personal property held for investment are not permitted to be excluded from income.[36] For example, the exclusion would not apply to discounts on employee purchases of securities, gold coins, and residential or commercial real estate.[37] This limitation was adopted because investment property lends itself to sale at close to the same price as the employer would sell to its customers and Congress did not want to provide favorable tax treatment in this situation.[38] Thus, an employee of a brokerage house may purchase stock and receive an excludable discount on the commission, but any discount allowed on the price of the stock itself is not eligible for the exclusion.[39]

The discount exclusion for services is limited to 20 percent of the price at which the services are offered to nonemployee customers.[40] For property, the discount exclusion is limited to a gross profit percentage.[41] The gross profit percentage is the percent that the employer's aggregate profit with respect to such property (i.e. aggregate sales price less aggregate cost to employer) is of the aggregate sale price of the property.[42] The computation of the profit percentage must be made on the basis of all property offered to customers in the line of business in which the employee is performing services and must be based on the employer's experience during a representative period.[43] Although obviously intended to provide some flexibility, "representative period" is not defined in the Act nor does the legislative history provide any guidance as to the meaning of the phrase.

The line of business limitation rules for treatment of a single employer consisting of more than one line of business are the same as those applicable in the no-additional-cost service situation. *See* discussion at C, 2, a, (2), *supra.* The discount exclusion, however, is not available for goods or services provided by another employer, whether or not a reciprocal agreement exists, except where commonly controlled businesses are treated as one employer. Merchandise held for sale in the retail department store line of a business of a firm, for example, is eligible for the discount exclusion if purchased at a discount by an employee of the firm who works in that line of business. Similarly, an employee who works for a manufacturer assembling appliances is eligible

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for the discount exclusion if the employee purchases the assembled appliances from the manufacturer-employer at a discount. On the other hand, if an employee works for a company that consists of more than one line of business, such as a company consisting of a retail department store business, a hotel business, and an electrical component manufacturing business, an employee is eligible for the discount exclusion only for merchandise or services offered to customers in the ordinary course of business in the particular line of business in which the employee works.

The same grandfather rule applicable to no-additional-cost services described in C, 2, a, (5), *infra*, applies to qualifying employee discounts, except that the exclusion for reciprocal agreements between employers is eliminated because such agreements are not permitted generally for qualified discounts under §132(c).[44]

The Act contains a special non-elective grandfather rule for an affiliated group of companies operating retail department stores. For purposes of this grandfather rule, an affiliated group is defined as it is in §1504, without regard to subsections (b)(2) (relating to insurance companies taxed under §§802 or 821) and (b)(4) (relating to corporations as to which a §938 possessions tax credit is in effect for the taxable year). If, as of October 5, 1983, the employees of one member of an affiliated group were entitled to employee discounts (for services as well as for consumer goods) at the retail department stores operated by another member of such group and the primary business of the affiliated group generally is the operation of a retail department store, then, for purposes of applying the qualified employee discount rules of §132(a)(2), the employer will be treated as engaged in the same line of business as any other member of the affiliated group.[45] The excise tax provisions, applicable to the elective grandfather rule discussed in C, 2, a, (5), *supra*, is not applicable here.

Comment: This rule was part of the House bill and was referred to by those involved in the legislative process as the "Sears" rule, since it was adopted to provide relief for Sears employees.

The exclusion is available only where a qualified discount is provided on a nondiscriminatory basis.[46] The rules are the same as those applicable to no-additional-cost service. *See* discussion in C, 2, a, (4), *supra*.

The definition of the employees to whom the discount may be provided is the same as that applicable to no-additional-cost services.[47] *See* discussion in C, 2, a, (1), *supra*.

(2) Special Rule for Leased Sections of Department Stores

For purposes of the qualified discount, the Act permits certain employees who work on the floor of a department store but are not the employees of the operator of the department store to be treated as if they were employees of the operator for purposes of the discount exclusion. The provision applies to a so-called "leased section" of a department store. A leased section of a department store is any part of a department store where over-the-counter sales of property are made under a lease or similar arrangement and where it appears to the general public that individuals making such sales are employed by the person operating the department store.[48] The Act provides that a leased section of a department store, such as a cosmetic counter selling the cosmetics of a particular manufacturer, will be treated as part of the line of business of the person operating the department store and the employees in that leased section will be treated as employees of the person operating the store for purposes of obtaining the benefits of qualified discounts offered by the store to its regular employees.[49]

c. Working Condition Fringe

(1) General

A working condition fringe benefit is any property or service provided to an employee which, if the employee had paid for such property or service, would have been allowable as a deduction under either §162 (ordinary and necessary business expenses) or §167 (depreciation for business property).[50] Such benefits, by virtue of their nature, may be provided only to current employees (and not their spouses or children). The nondiscrimination rules do not apply to these benefits.

Examples of working condition fringe benefits are the value of the use by an employee of a company car or airplane for business purposes. While the use of a company car or plane for personal purposes is not excludable, mere incidental personal use of a company car, such as a small detour for a personal errand, might qualify for exclusion as a de minimis fringe.[51] *See* discussion in C, 2, d, *infra*. Other examples of working condition fringes are employer subscriptions to business periodicals for an employee where the employee requires such periodicals to perform his duties [52] and the provision of bodyguards, or the use of a car and driver for the employee's safety.[53] The payment by an employer of the real estate broker's commission on the sale of an employee's house to assist the employee in moving to another job site for the employer would not be excludable as a working condition fringe because the direct payment of the commission expense by the employee would not have been deductible by the employee as a §162 business expense.[54]

(2) Consumer Product Testing

Although not addressed specifically by the statute, the House Report indicates that the fair market value of the use of consumer goods that are manufactured for sale to nonemployee customers and which are provided to employees for product testing and evaluation outside the employer's office is excluded as a working condition fringe only if each of six requirements are met. First, consumer testing and evaluation of the product must be an ordinary and necessary business expense of the employer. Second, the business reason must necessitate that the testing and evaluation be performed off premises by employees. Third, the item must be furnished to the employee only for purposes of testing and evaluation. Fourth, the item must be made available to the employee for no longer than necessary to test and evaluate its performance and must be returned at the completion of the testing and evaluation period to the employer. Fifth, the employer must impose limitations on the employee's use of the item which significantly reduced the value of any personal benefit to the employee and last, the employee must submit detailed reports to the employer on the testing and evaluation.[55] The fifth requirement is satisfied, for example, if the employer places limitations on

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the employee's ability to select among different models or varieties of products, the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his own expense the same type of item of that being tested, and the employer requires that members of the employee's family generally cannot use the item.[56] The House Report also points out that, if products are furnished under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may be considered in determining whether the goods are furnished for testing and evaluation purposes or for compensation purposes.[57] The Conference Report clarifies that, where an employee pays or reimburses the employer for personal use of the testing item, gross income will not include such personal use.[58]

(3) Demonstration Automobile Use

The Act permits qualified automobile demonstration use as an excludable working condition fringe benefit.[59] Such use is excludable if it primarily facilitates the salesperson's performance of services and if there are substantial restrictions on the salesperson's personal use of the automobile. The salesperson must be a full time salesperson and the use must be in the sales area in which the automobile dealer's sales office is located.[60] The Conference Report states that this exclusion is not available to part-time auto salespersons, mechanics, or the dealer's bookkeeper.[61]

Comment: The House Report states that the exclusion applies to part-time salespersons. The conferees limited the scope of the original provision following an informal survey of practices in local IRS Districts which revealed that, in some Districts, the IRS was requiring that the value of the use of a demonstration automobile by part-time salespersons be included in income.

(4) Parking Privileges

The Act treats employer-provided parking privileges on or near the business premises of the employer as a working condition fringe benefit,[62] and no nondiscrimination requirement is applicable.[63] The nondiscrimination provision that was part of the House bill was dropped in Conference, according to a Treasury official who was present after Senator Long remarked, "We don't want the IRS out there in every parking lot in America."

Comment: Structurally, the parking exclusion was made part of the working condition fringe benefit section of the Act and therefore consideration of whether the parking is deductible under §162 as a business expense might be required. Tax Management understands, however, that the Conferees intended that parking be excluded without respect to the §162 deduction rule.

Comment: Tax Management understands that the Conferees did not intend to sanction arrangements whereby an employee arranged for a reduction in salary in order to receive the parking benefits provided by an employer. Such an arrangement would contravene the new cafeteria plan rules discussed *infra*.

d. De minimis fringe

(1) General

The fair market value of de minimis fringe benefits are excluded from income. The term is defined as any property or service which has such a small value as to make accounting for it unreasonable or administratively impractical.[64] The Act does not incorporate the aggregation language for de minimis benefits found in the House version of the bill, but rather makes reference to the frequency with which similar fringes are provided by the employer to its employees and requires that the frequency be considered among other relevant factors in determining if the benefit is de minimis.[65] De minimis fringe benefits may be provided not only to employees but also to independent contractors and need not meet a nondiscrimination standard.

Comment: This section was carefully drafted to include an exclusion for benefits to independent contractors whereas all other categories of excludable fringe benefits operate only with regard to employees. Thus, for example, the typing of an occasional personal letter for a corporate director who is not an employee would be an excludable de minimis fringe benefit.

Examples of benefits which generally would be excludable as de minimis fringes are the typing of personal letters by an employee's secretary, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare because of overtime work, $15 per month transit passes, traditional holiday gifts of property with a low fair market value, occasional theater or sporting event tickets, coffee and doughnuts, and the occasional use of the company copying machines.[66] The Conference Report states that where an employer exercises sufficient control over the personal use of a copying machine such that substantially all (at least 85 percent) of the use of the machine is for business purposes, the employer may treat any personal use as a de minimis fringe.[67]

(2) Subsidized Eating Facilities

The Act provides for the treatment of certain eating facilities operated by an employer as a de minimis fringe. For such treatment, the facility must be located on or near the business premises of the employer and the revenue derived from the facility must normally equal or exceed the direct operating costs of the facility.[68] Neither the statute nor the legislative history provide guidance concerning what constitutes "direct operating costs" nor is there guidance on how to calculate the benefit for purposes of income reporting when revenues do not at least equal costs.

A nondiscrimination standard is applied to eating facilities. The standard requires that an officer, owner or highly compensated employee may exclude eating facility benefits only if access to the facility is available on a nondiscriminatory basis. That is, on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer and which does not discriminate in favor of employers, owners or highly compensated employees.[69]

Comment: The exclusion for certain eating facility privileges is essentially an all-or-nothing safe harbor. If an employer's direct operating costs are generally covered by revenues received from the facility, any benefits received by employees in the form of a reduction in the cost of food will be excludable. However, if an employer's revenues are lower than its costs in operating the facility, the subsidized value of the meal will be income to the employees. Such a result could cause significant administrative problems in

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determining the amount of a benefit with regard to each employee.

The requirement that revenues at least equal basic cost appears to be inconsistent with Congress' articulated concern that the record-keeping difficulties involved in identifying which employees eat which meals on particular days, as well as the values and costs for each meal are too great and therefore require a general safe harbor provision for eating facilities.[70]

Query: Whether an employer will be permitted to also serve food in its facility to members of the general public.

Tax Management understands that there has been some discussion that the Bluebook drafted by the Joint Committee may address this issue and that employees may not be entitled to an exclusion where the facility is not exclusively for employees even if the revenues raised from the facility equal or exceed the costs involved.

Note that this provision in the Act does not alter the rules under §119 concerning free meals provided on an employer's premises to employees for the convenience of the employer. Such benefits will remain excludable from income to the extent provided under §119.[71]

e. Tuition Reductions

Also excluded from gross income under the Act is any qualified tuition reduction.[72] A qualified tuition reduction is the amount of any reduction in tuition that is provided to an employee of an educational institution (as defined in §170(b)(1)(A)(ii)) for pre-graduate level education at that educational institution or at any other educational institution described in §170(b)(1)(A)(ii).[73] The reduction can also be provided to the broader range of individuals treated as employees under §132(f). *See* C, 2, a, (1), *supra.*

Tuition reductions must meet nondiscrimination standards. Reduction must be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer and which does not discriminate in favor of officers, owners, or highly compensated employees.[74]

Comment: The Act did not adopt a provision in the House bill that would have provided that availability of the benefit only to faculty members is not a discriminatory classification. Although not explicitly dealt with in the Conference Report, statements made during the Conference indicate that the conferees did not believe that a reasonable classification of employees is a classification that includes only faculty members.

This provision applies to qualified tuition reductions for education furnished after June 30, 1985, in taxable years ending after that date.[75]

The Act's tuition reduction provisions do not effect the rules concerning scholarships and fellowships under §117(b). Under prior and present law, gross income does not include scholarships or fellowships, subject to certain limitations, unless the amounts are paid as compensation for services or for studies or research primarily for the benefit of the grand tour. Regs. §1.117-3(a) provides that the remission of the tuition of a child of a faculty member provided by another educational institution under a tuition-exchange plan is considered a scholarship. Note that, while the Act did not follow the House provision which contained an exclusion for graduate tuition reduction provided to teaching and research associates or assistants, the Conference Committee noted that tuition reductions for graduate education remain eligible for exclusion as scholarships under §117(b) if they satisfy the requirements of that provision.[76]

Comment: Tax Management understands that the potential usefulness of §117(b) in many cases will be substantially limited because it requires the inclusion in income of that part of a scholarship or fellowship grant that represents payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the grant.

f. On-Premises Gyms and Other Athletic Facilities

The Act provides a general exclusion from gross income for the value of any on-premises athletic facility provided by an employer to his employees and does not contain a nondiscrimination requirement. An on-premises athletic facility is any gym or other athletic facility that is located on the premises of the employer, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.[77] The term dependent child is defined as it is defined for purposes of qualified employee discounts and no-additional-cost services. *See* discussion in C, 2, a, (1), *supra.*

Comment: The Act did not amend §274(e)(5) containing deduction rules for employer-provided recreational expenses including expenses for recreational facilities. For such an expense to be deductible, the expense must be primarily for the benefit of employees and not for employees who are officers, shareholders or highly compensated. Tax Management understands that the Conferees did not adopt a nondiscrimination rule in conjunction with the employee exclusion rules because they believed that the restrictions on employer deductions for athletic facilities were sufficient. In addition, such nondiscrimination rules would have made taxable to the Senators their use of their new gymnasium.

g. Faculty Housing

The Act does not create new rules with regard to faculty housing. Rather, it generally follows the Senate provisions by imposing a moratorium on the issuance of income tax regulations providing for the inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of either the operating costs paid in furnishing the lodging or the rent received. The moratorium applies only with respect to lodging furnished after December 31, 1983 and before January 1, 1986.[78] Qualified campus lodging is defined as lodging located on or in close proximity to a campus of an educational institution and provided by such institution to an employee or to a spouse or dependent.[79] The educational institution is defined with reference to §170(b)(1)(A)(ii) and dependent is defined within the meaning of §152 of the Code.

The Conference Report warns that no inference should be made by the imposition of the moratorium as to the proper income tax treatment of faculty housing furnished prior to 1984 or after 1985.[80]

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Comment: Tax Management understands that this provision was added in order to stop IRS audit activity with regard to four New England schools. The provision, as worded, does not effect the desired result because the moratorium does not apply to IRS audits of practices underway before 1978. The IRS was involved in auditing the practices at the four schools before 1978.

h. Effective Date

The provisions concerning these new statutory fringe benefits will take effect January 1, 1985.[81] The tuition reduction exclusion, however, applies with respect to education furnished after June 30, 1985 in taxable years ending after that date[82] and the moratorium with respect to qualified campus lodging will apply only with respect to lodging furnished after December 31, 1983 and before January 1, 1986.[83]

II. Amendments Relating to Cafeteria Plans

A. Introduction

1. Legislative Background

In the six months preceeding the passage of the 1984 Tax Reform Act, the federal income tax treatment of benefits provided under Code §125 cafeteria plans became extremely controversial. The controversy began with the issuance of an IRS news release, I.R. 84-22, February 10, 1984. The release formally signaled, for the first time since the enactment of §125 in 1978, the Service's position with regard to many of the innovative arrangements set up by employers under the rubric of §125. I.R. 84-22 indicated that the IRS, after six years without publishing guidance in an actively-developing area, would take a restrictive view concerning what types of arrangements would be permitted under §125 and would retroactively tax benefits received under "ZEBRA" and "flexible spending account" arrangements.

On May 2, 1984, the Service followed I.R. 84-22 by issuing proposed regulations under §125, in question-and-answer format, concerning the tax treatment of cafeteria plans. *See* 394 T.M., *Employee Fringe Benefits.* Essentially, the proposed Regulations incorporated the position the IRS signaled in I.R. 84-22. There was, however, some relief provided as to the proposed retroactive application of the provisions with regard to flexible spending accounts. *See* II, A, 3 *infra.*

Until I.R. 84-22 was issued in February, followed by the proposed regulations in May, it did not appear that Congress would legislate substantially on cafeteria plans in the 1984 TRA. The House bill contained a small provision that would have amended the definition of cafeteria plans to exclude from the list of benefits that could be provided under §125 those that would be excludable from gross income under the fringe benefit provision of the bill.[84] The Senate bill did not contain any provisions concerning cafeteria plans although Sen. Packwood had drafted several proposals. Once the controversy concerning the IRS' position taken in I.R. 84-22 and the proposed regulations intensified, however, Sen. Packwood and Rep. Conable, both key tax writers and members of the Conference Committee considering the House and Senate tax bills, became instrumental in drafting and promoting proposed legislation for adoption by the Conference. This legislation, essentially, would have imposed dollar limits on cafeteria plans and reversed the IRS with regard to the retroactive application of its proposed regulations. In the end, the Conferees adopted provisions that were significantly more streamlined than these comprehensive proposals. To understand the impact of the TRA provisions, it is necessary to examine some of the prevalent pre-TRA practices they were designed to address.

2. Cafeteria Plans and Variations

Cafeteria plans are arrangements under which an employee is given a choice between taxable and non-taxable benefits. Under the existing IRS constructive receipt doctrine, an employee is taxable if he has a *right to receive* taxable benefits regardless of whether, by his own election, he in fact receives non-taxable benefits.[85] Section 125 was enacted as part of the 1978 Revenue Act (P.L. 95-600, §134(a)) to permit employees to choose between taxable and non-taxable benefits without being subject to tax under the constructive receipt doctrine if the non-taxable benefit was chosen.[86]

Under pre-TRA law, the taxable benefits offered under a cafeteria plan were typically benefits such as cash and additional paid vacation. Non-taxable benefits typically included (§79) group-term life insurance, (§105) accident and health insurance, qualified (§120) group legal services and (§129) dependent care assistance programs. In a basic cafeteria plan, a participant must elect the specific benefits to be received before the benefits become currently available. A benefit is deemed to be currently available if the participant is free to receive it currently at his discretion or can receive it currently if an election or notice of intent to receive the benefit is given. Essentially, under the basic type of cafeteria arrangement, the plan puts the employee "at risk" with respect to the non-taxable benefits elected. Thus, if an employee elects reimbursement but incurs no such covered expenses, or incurs such covered expenses in an amount less than the amount of reimbursement selected therefor, the employee must be ineligible for further benefits or payment of any kind under the plan for that year. This type of plan is clearly permitted under the proposed regulations.

A flexible spending account is an account in a cafeteria-type plan that is established for an employee from which the selected benefits are paid. The account typically is funded with a participant's salary reduction contributions from pre-tax income and any unused amounts in the account are nonforfeitable and may be carried over to the following year, returned to the participant in cash, or used for some other purpose. The ability to purchase covered benefits in pre-tax dollars and the flexibility afforded by such arrangements are among the most attractive features of such plans. The proposed regulations, generally, deny such arrangements the benefits of §125(a) (*i.e.*, the avoidance of constructive receipt), although they make it clear that, under appropriate circumstances, §125 cafeteria plans may be funded with salary reduction contributions. *See* discussion of proposed regulations, *infra.*

Another variation on the basic cafeteria plan is a zero balance reimbursement arrangement (ZEBRA). Under this type of arrangement, no fund or account is established for

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the employee at the beginning of the year. Rather, the employer "reimburses" the employee for the expenses of benefits chosen at the end of the year by deducting such expenses from the employee's regular salary. Again, the proposed regulations effectively prevent such arrangements from qualifying under §125. *See* discussion, *infra.*

3. Proposed Regulations

The proposed §125 regulations cover a broad range of cafeteria plan issues. Among the more significant are the following.

a. Salary Reduction Arrangements Permitted

The proposed regulations permit the use of salary reduction contributions to fund §125 cafeteria plans, but indicate that, to avoid constructive receipt, an employee must elect to forego a specified amount of a future year's salary in the year before the salary is actually earned.

b. Use-it-or-Lose-it Rule

The proposed regulations indicate that an employee's ability to carry over unused benefit amounts from one year to a future year is, in effect, a deferral of the receipt of compensation. Because, under §125(d)(2), cafeteria plans may not offer deferred compensation (other than an election to defer salary under a §401(k) cash-or-deferred arrangement) the proposed regulations provide that a plan must contain a "use-it-or-lose-it" rule. Under such a rule, the benefit elected by an employee must be used during the plan year for which it is elected or forfeited if the plan is to qualify under §125. The proposed regulations also indicate that such an election will not be deemed to have been made if the election may be revoked (other than as a result of the occurrence of certain specified events such as marriage, divorce, death or termination of employment.)

c. Nondiscrimination

The proposed regulations indicate that benefits offered under discriminatory cafeteria plans will be taxable to highly paid employees (generally officers, more-than-5-percent shareholders and highly-compensated individuals) on the basis of the maximum taxable benefits that such employees could have elected to receive. Thus, even though such a participant may have selected non-taxable benefits, he will be taxed on the maximum amounts of taxable benefits that he could have chosen under the plan. Employees other than highly-compensated employees will not be taxed as a result of the plan being discriminatory.

For a cafeteria plan to be considered nondiscriminatory under the proposed regulations, three types of non-discrimination requirements must be satisfied. First, the plan must be nondiscriminatory as to benefit availability. Thus, each participant must have an equal opportunity to select non-taxable benefits. Second, the plan must be nondiscriminatory as to benefit selection. thus, the actual selection of non-taxable benefits under the plan must be nondiscriminatory. Highly-compensated employees must not proportionately select greater non-taxable benefits than other participants. Third, the plan must not discriminate in favor of highly-compensated participants in operation. This could occur if the plan's duration is timed for a period during which highly compensated participants would select a particular benefit (e.g., the provision of an orthodonture benefit timed to coincide with the attainment of adolescence by the children of highly-compensated employees).

d. Effective Dates and Transition Rules

The proposed regulations are effective (when finalized) [87] generally for cafeteria plan years beginning after 1978. Several special relief and grandfather-type rules are provided, however, to permit plans to be amended to comply with the rules. For example, a cafeteria plan that failed to satisfy one of the several specified rules for plan years beginning before May 7, 1984, will be deemed in compliance with §125 for past years under the proposed regulations if, by September 4, 1984, the plan is amended to operate in accordance with the rules. Some of the rules that are specified include the rule prohibiting the carryover of unused benefits from one plan year to a subsequent plan year if the participants were neither permitted to carry over the unused benefits for more than one plan year nor to convert them into other benefits that may be carried over into another year. Another such specified rule is the rule limiting the revocability of benefit elections.

B. Overview of New Provisions

The TRA, essentially, provides temporary protection for certain past practices and makes a few substantive changes to the pre-TRA rules. Eventually, however, the TRA provisions permit the proposed regulations to take effect.

The TRA also limits the types of benefits that can be offered under §125 cafeteria plans to cash and fringe benefits that are excludable from gross income under a specific Code section. Further, specifically excluded from the types of benefits that can be offered under cafeteria plans are (§117) scholarships, (§124) van pooling and post-TRA §132 statutory fringe benefits such as tuition discounts. Non-cash taxable benefits may not be offered.

The TRA also added a limit on the amount of benefits that can be provided to key employees within the meaning of §416(i)(1) under a cafeteria plan. Under post-TRA §125(b)(2), no more than 25 percent of the total non-taxable benefits provided under a plan can be provided to key employees in a plan year. If the 25 percent limit is exceeded, key employees will be taxed as though they had received taxable benefits to the maximum extent possible under the plan.

Most significant, however, is the transitional relief provided to existing practices. General transitional relief is provided under TRA §531(b)(5) for cafeteria plans that were in existence on February 10, 1984 (the date of the issuance of I.R. 84-22. The relief allows certain cafeteria plans (including ZEBRA plans) which failed as of February 10, 1984 and continued to fail thereafter to satisfy the proposed regulations to operate through the end of 1984 (or, if earlier, the effective date of any modification of the plan to provide additional benefits) without the application of the proposed regulations. The Act also contains special transitional relief for the forfeiture or "use it or lose it" rule in the proposed regulations. If a plan was in existence on February 10, 1984, it will qualify as a cafeteria plan even though it fails to comply with the forfeiture restrictions in the proposed regulations. This transitional rule, however, requires that the plan be modified before January 1, 1985

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to comply with the restrictions. The transitional relief is not available for benefits provided after July 1, 1985 (or the effective date of any plan modification to provide additional benefits, if earlier). The Act also permits the application of the transitional relief to plans that were not in existence on February 10, 1984 if substantial implementation costs had been incurred by that date.

The Act imposes additional reporting and recordkeeping requirements on employers maintaining cafeteria plans and permits the Secretary of Treasury to select employers who will be required to provide additional information. Act §531(b)(6) mandates that the Secretary of Health and Human Services, in cooperation with the Secretary of Treasury, conduct a study of the effects of cafeteria plans on the containment of health care costs. The report on this study must be submitted to the House Ways and Means Committee and the Senate Finance Committee no later than April 1, 1985.

C. *Detailed Analysis*

1. *Benefits Includable in Cafeteria Plans*

Under pre-TRA law, a cafeteria plan was defined as a written plan under which all participants are employees and the participants may choose among two or more benefits. The benefits that could be chosen could be non-taxable benefits or cash, property and other taxable benefits.[88] Under pre-TRA law, certain statutory fringe benefits could not be included in a cafeteria plan. For example, scholarships and grants (§117), van pooling (§124) and educational benefit plans (former §127 which expired December 31, 1983).

The Act amends the definition of cafeteria plans to indicate that participants may choose among only cash or non-taxable benefits. Thus, unlike prior law, the Act does not permit taxable benefits, with a few minor exceptions discussed *infra*, to be included in a cafeteria plan.

Specifically, the Act amends the definition of cafeteria plans to indicate that participants may choose among two or more benefits consisting of cash and "statutory non-taxable benefits."[89] The Act defines "statutory non-taxable benefits" as any benefit which is not includable in the gross income of the employee by reason of an express provision of the income tax rules of the Code except for benefits excludable under §117 (scholarships and grants), §124 (employer-provided van pooling), §127 (educational benefits), or the TRA's statutory fringe benefits set forth in post-TRA §132.[90]

Statutory non-taxable benefits include (§105) accident and health insurance, (§120) qualified group legal services, and (§129) dependent care assistance programs. Paid vacation is also a non-taxable benefit, provided it cannot be deferred beyond the taxable year or cashed out. The Act expands the scope of benefits includible in a cafeteria plan by indicating that the term "statutory non-taxable benefit" covers §79 group-term life insurance even if it exceeds the $50,000 non-taxable limit of §79(a).[91]

Note: With regard to group term life insurance, only the House Report, picked up by reference in the Conference Report, states that such insurance on the employee's spouse or children will be treated as a non-taxable benefit.[92] There is no statutory language to this effect. Under current regulations, up to $2,000 of group term life insurance for dependents is excludible.[93] Because the Act states that the only tax-free benefits includible in a plan are those that are tax-free by the express provisions of the Act, it is arguable that, absent express statutory language, the $2,000 of dependents' insurance cannot be part of a cafeteria plan.

Comment: The TRA limitations concerning what benefits may be provided in a cafeteria plan will have an impact on those plans that previously included taxable benefits as an alternative to cash. Such benefits as, for example, parking, auto insurance and vacation homes can no longer be offered through a cafeteria plan. Tax Management understands the Treasury sought this limit because of the problems involved in establishing a value for such benefits and difficulty with enforcement.

2. *Limitation on Benefits to Key Employees*

Under pre-TRA law, tax-free benefits available under a cafeteria plan were not excludable from the gross income of a highly-compensated participant if the plan discriminated with regard to eligibility or benefits and contributions.[94] Act §531(b)(3) amends §125(b) to provide that the exception to the constructive receipt doctrine provided by §125(a) not only will not be available to the highly-compensated if the plan discriminates, but also, if more than 25 percent of the aggregate of all benefits provided to employees under the plan are provided to key employees, key employees will be taxed as though they received all available taxable benefits under the plan.[95]

Comment: The Conference Report indicates that in determining the portion of the total nontaxable benefits that is provided to key employees, coverage under a plan (e.g., an accident or a health plan) and not actual expense reimbursements will be counted.[96]

For purposes of this provision, "key employee" is defined under §416(i)(1).[97] Thus, a key employee is an employee who, at any time during the plan year or any of the four preceding plan years, is: (i) an officer of the employer; (ii) an employee having annual compensation from the employer of more than $45,000 (for 1984, i.e., 150 percent of the §415(c)(1)(A) dollar limit) and owning (or considered as owning within the attribution rules of §318), one of the 10 largest equity interests in the employer; (iii) a 5-percent owner of the employer; or (iv) a 1-percent owner of the employer having annual compensation from the employer of more than $150,000.[98]

As previously mentioned, statutory nontaxable benefits provided to key employees may not exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. In computing the amount of statutory nontaxable benefits, the Act provides that §79 group-term life insurance benefits that exceed $50,000 should be excluded.[99]

The Act provides guidance concerning when key employees in a discriminatory plan should include taxable benefits in income. The benefits provided to highly-compensated participants or key employees under a discriminatory plan will be treated as received or accrued in the taxable year of the participant or key employee in which the plan year ends.[100]

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3. Transition Rules for Certain Cafeteria Plans and Benefits

a. General Transitional Rule

The Act provides a general transitional rule for cafeteria plans and benefits offered under such plans if the plan was in existence on February 10, 1984 but failed as of that date (and continued to fail thereafter) to satisfy rules relating to §125 under the proposed regulations. Such plans and benefits will qualify for §125 treatment only until the earlier of January 1, 1985, or the effective date of any plan modification to provide additional benefits after February 10, 1984.[101]

Essentially, as a result of this general transition rule, cafeteria plans (including ZEBRA plans) in existence on February 10, 1984 (the date of the IRS' news release) will be permitted to operate as cafeteria plans through the end of 1984 (or, if earlier, the effective date of any plan modification to provide additional benefits) without regard to the proposed regulations. The Conference Report provides as an example that if, on February 10, 1984, a flexible spending arrangement failed to satisfy the proposed regulation's rules relating to accident or health plans, and thereafter continues to fail such rules because the arrangement provides for the cash-out or carryover of unused amounts at the end of the plan year, the arrangement will be treated as qualifying as an accident or health plan until the earlier of the two transition dates.[102]

b. Special Transitional Rule with Regard to Advanced Election Benefit Banks

Where a benefit offered under a cafeteria plan that was in existence on February 10, 1984 failed on that date (and continued to fail thereafter) to satisfy the rules of §§105, 106, 120 or 129 under the proposed regulations because the employee was assured of receiving amounts available but unused for covered reimbursement during the year without regard to whether he incurred coverage expenses, the benefit will not fail to be a nontaxable benefit solely because of the failure to comply with the proposed regulations. Relief is provided only with respect to benefits provided under cafeteria plans before the earlier of July 1, 1985 or the effective date of any plan modification to provide additional benefits after February 10, 1984.[103]

Comment: The inclusion of the "continued to fail thereafter" language raises several questions. If a plan, which was terminated after February 10, 1984 because the employer was not able to comply with the proposed regulations, was reactivated, would the plan have to comply with the TRA rules or would it qualify under the transitional rule? Tax Management understands that this situation is colloquially referred to as "the dead ZEBRA phenomenon" and that it is clear that any resurrection of the plan would have to comply with the TRA rules and would not be covered by the transitional rules. A second question is whether the more common situation in which an employer suspended the plan following February 10, 1984 will be considered a *de facto* termination? Tax Management understands that this is colloquially referred to as "the frozen ZEBRA phenomenon" and that it is likely that, if contributions to such plans resume, such plans will be covered by the transitional rules.

Essentially, this special transition provision provides relief with respect to the forfeiture ("use-it-or-lose-it") rules in the proposed regulations. If a plan was in existence on February 10, 1984, and the employee was required to fix the amount of the contributions to be made on his behalf before the beginning of the period, and cash is not available before the end of the year (or termination of employment, if earlier), the plan will be a cafeteria plan even though it fails to comply with the forfeiture restrictions in the proposed regulations. This transitional rule requires, however, that the plan be modified before January 1, 1985 to comply with these restrictions. The transitional relief expires for benefits provided after July 1, 1985 (or the effective date of any modification to provide additional benefits, if earlier).[104]

Query: What if a plan in existence on February 10, 1984 that did not comply with the forfeiture restrictions continues not to comply and then is terminated on January 1, 1985? Is this a "modification to comply" with the restrictions so as to qualify the 1984 operation of the plan for this special transitional relief?

In lieu of distributing taxable cash to a participant at the end of the applicable period of coverage, the Conference Report indicates that it would also be permissible for the unused amounts to be carried over to the succeeding year.[105] An arrangement could also permit a participant to terminate contributions during the period of coverage or to change the rate or amount of contributions during the period of coverage on account of certain changes in family status or a change in employment status from full-time to part-time, or vice versa. The conferees intended that this special transition relief would be available to arrangements that, on February 10, 1984 and thereafter, failed to satisfy the above restrictions if such arrangements were modified before January 1, 1985 to comply with the restrictions. The special relief under this rule is for benefits provided before the earlier of July 1, 1985, or the effective date of any modification of the arrangement to provide additional benefits if the modification becomes effective after February 10, 1984. Again, the conference agreement does not prevent the application of the proposed regulations after the earlier of the applicable dates.[106]

Comment: The heart of the controversy concerning ZEBRA arrangements is the amount of potential revenue loss. According to Treasury data, more than $130 billion in after-tax dollars is spent on nondeductible medical expenses alone by employees covered by employer health plans. If all these employers sponsored ZEBRAs with medical benefits, the $130 billion would be deductible. This statistic should be compared with the 1978 revenue cost estimate for cafeteria plans which was "less than $5 billion."

Note: From April to July 1984 there was correspondence between personnel at the Department of Treasury, the Department of Health and Human Services, the IRS, and Cong. Conable and Sen. Packwood on cafeteria plan issues that demonstrate the concerns and reasoning of those involved in developing cafeteria plan policy.[107]

4. Transition Rules Apply to Substantially Implemented Plans

Where a plan was not in existence on February 10, 1984 and therefore would not come within the transitional

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rules described *supra*, but the employer has incurred substantial implementation costs before February 10, 1984, the Act allows such cafeteria plans to be treated as though they existed on February 10, 1984.[108]

Although a definition of substantial implementation costs was not included in the statute, the Conference Report provides some guidance. If an employer has incurred, as of February 10, 1984, either more than $15,000 of implementation costs or more than half the total costs of implementing the cafeteria plan, the transition rules are to be available. The conferees also indicated that total implementation costs are the costs of designing and installing computer programs for operation of the plan and the costs of printing cafeteria plan brochures for employees.[109]

Comment: Tax Management understands that the Service will take a restrictive position on what will satisfy the substantial implementation rules. Thus, for example, it is unclear whether the payment of $15,000 for an opinion of outside legal counsel and a draft of a plan will be considered substantial implementation costs because legal fees are neither computer program nor printing costs. The issue should be resolved in regulations.

Note: Costs associated with more than one plan of the same employer are to be allocated among the plans on the basis of the number of participants in the plans.[110]

5. Reporting Requirements

The Act imposes reporting requirements on employers maintaining cafeteria plans during any taxable year that begins after 1984. Such employers are required to file a return (in a time and manner prescribed by the Secretary of the Treasury in regulations) including the following information for each plan year:

(1) The number of employees of the employer.

(2) The number of employees participating under the plan.

(3) The total cost of the plan during the taxable year.

(4) The name, address and taxpayer identification number of the employer and the type of business in which the employer is engaged.[111]

Note: Tax Management understands that a statistically significant number of employers (from .5 to 1 percent) will be selected based on a sampling from the first set of returns and will be required to file more complicated returns. The additional returns are likely to require information on the types of benefits provided under the plan and a breakdown of benefits by amount and type, according to various wage brackets of active employees. The data will show both whether the plan tends to discriminate in operation and how widespread is the use of these statutory fringe benefits under the plan across different income brackets.

Employers are also required to maintain records necessary to demonstrate whether the requirements of Act §531(b) are met.[112]

Further, the Act imposes a $25 per day penalty (up to $15,000) for failure to file the required information returns if the failure is not due to reasonable cause.[113]

6. Study of Effects of Cafeteria Plans on Health Care Costs

Act §531(b)(6) requires the Secretaries of Health and Human Services and the Treasury to jointly conduct a study of the effects of cafeteria plans on containing health care costs. That report is to be submitted to the House Committee on Ways on Means and the Senate Committee on Finance no later than April 1, 1985.[114]

The Conference Report directs that the study examine the impact which the use of cafeteria plans (including flexible spending arrangements) has on the containment of health care costs and that it recommend what modifications might be desirable with respect to the cafeteria plan rules to optimize their potential to reduce medical costs (balanced against the fulfillment of other health care policy goals).[115] The conferees also requested an analysis of the advisability of establishing federal guidelines relative to the type of medical plans that can qualify for cafeteria plan treatment in a manner similar to that applicable to qualified pension plans and of the advisability of adding additional benefits to cafeteria plans.[116] The conferees further required that the operation of the nondiscrimination rules and the forfeitability requirements under cafeteria plans, and the effects of such provisions on the federal tax base and on health care cost containment, be studied.[117]

III. Changes Relating to Group Term Life Insurance

A. Introduction

Employees may exclude from gross income amounts paid by their employer in their behalf to purchase up to $50,000 of §79 group-term life insurance.[118] If the employer provides more than $50,000 in coverage, the employee must include the cost of the excess, less any contributions that the employee made to the purchase, in gross income.[119] The cost of the amount that must be included in income is based on a table prepared by the IRS.[120] The table contains uniform premium costs that are substantially less than actual cost especially for those who have reached age 64.

The §79 rules also contain a nondiscrimination requirement which, essentially, denies the favorable tax treatment to key employees in a discriminatory plan. Under pre-TRA (post-TEFRA) law, if the plan was discriminatory, key employees had to include in income the full cost of group-term life insurance purchased on their behalf based on the amounts in the IRS uniform premium cost table. Under pre-TRA law, the rules of §79 did not cover disabled or retired employees and, therefore, the entire cost for providing life insurance in any amount to such employees was excludible from their gross income. In addition, the nondiscrimination requirements did not apply to the disabled or to retirees.

Apparently believing that the application of §79 to retired employees was too generous, Congress amended the provision to cut back benefits to retirees and to include retirees in testing for discrimination.

B. Overview of the TRA Rules

1. Provisions

The Act generally makes three changes to the pre-TRA treatment of group-term life insurance. First, after the

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TRA, retirees, as well as active employees, will not be permitted to exclude more than the cost of $50,000 of group-term life insurance from gross income. Second, the nondiscrimination rules will be applied to plans covering retired employees as well as active employees. Third, if a plan discriminates, key employees and retirees will have to include in income the actual cost of the insurance benefit rather than the uniform premium cost prescribed by the Treasury.[121]

2. Effective Date

In general, TRA §223 applies to taxable years beginning after December 31, 1983. The Act, however, contains a grandfather provision that provides relief for some participants in existing plans. The post-TRA group-term life insurance rules do not apply to any plan in existence before January 1, 1984, with respect to any employee who was employed before January 1, 1984 and who retires under the plan if the employee reached age 55 by January 1, 1984. This grandfather provision does not apply, however, to any individual retiring after December 31, 1986 if the plan discriminates after that date.

C. Detailed Analysis

1. General Provisions

a. Section 79 Extended to Former Employees

Section 79(a) excludes from the gross income of an employee for any taxable year the cost of up to $50,000 of group-term life insurance if the insurance is carried directly or indirectly by the employer.[122] (Any amount paid by the employee toward the purchase of such insurance increases the excludible amount.)[123]

Section 79(b) permits retired and disabled employees to exclude the total amount of premiums paid by a former employer on any amount of group-term life insurance even if it exceeds $50,000.

For determining cost for insurance in excess of $50,000, the Treasury has issued a uniform premium cost table, Table I. This table establishes premium costs on the basis of five-year age brackets.[124] If an employee has attained age 64, the cost of his group-term life insurance is computed under Table I as if he were age 63.[125]

The Act provides that retired employees will be treated as employees for purposes of §79 and, therefore, retired employees may not exclude more than the cost of $50,000 of employer-provided group-term life insurance.[126]

Thus, the $50,000 limit on the amount of group-term life insurance that may be provided tax-free to employees also applies, after the TRA, to retired employees. The provision, however, does not apply to those who have terminated employment because of disability. Disabled employees may continue to exclude the cost of providing group-term life insurance in any amount.[127]

The Act's amendment to §79 does not alter Table I. Therefore, if an employer carries life insurance in excess of $50,000 for a retired employee, the amount that will be included in the retired employee's gross income for that year will be computed under Table I. In addition, because Table I "tops-off" at age 63, the benefit will be computed at the age 63 cost.

2. Amount of Inclusion Where Plan is Discriminatory

TEFRA (P.L. 97-248) amended §79 to include nondiscrimination requirements for taxable years beginning after December 31, 1983.[128] The nondiscrimination rules require that where a plan is discriminatory, key employee (defined by reference to §416(i)) participants must include the full Table I cost of the employer-provided benefit in gross income.[129]

The TRA amended the TEFRA nondiscrimination provisions by requiring that a key employee in a discriminatory plan include the actual cost of the employer-provided group-term life insurance rather than the cost computed under Table I.[130] Thus, if the nondiscrimination standard is not met and the retired employee is a key employee, the actual cost of the coverage (without the $50,000 exclusion) will be included in his gross income. The consequences of prohibiting the use of the Table I where a plan is discriminatory is that the actual cost which must be included is likely to be greater than the Table I amount. The Senate Report provides an example of the cost differential. It indicates that at age 65, the premium cost in Table I was, at the time of that report, $1.17 per $1,000 of insurance. A retiree, age 65, who receives $100,000 of group-term would recognize $702 of income which would produce, under the tax tables in effect in 1984, a maximum of $351 in additional income tax. By contrast, the rate schedules of one major company set the premium for $100,000 of individual term coverage for a 65-year-old male in excess of $3,000 per year.[131]

3. Testing for Discrimination

Neither the statute nor the Conference Report provides guidance concerning how, for purposes of determining if a plan is discriminatory, insurance coverage for retired employees should be tested with respect to coverage for active employees.

The Senate Finance Committee Report indicates that, for purposes of determining whether a plan is discriminatory, insurance coverage for retired employees should be tested separately from insurance for active employees because employers often provide lower group-term benefits to retired employees and this reduction of benefits under a plan generally reflects a retired employee's reduced need for insurance coverage to replace his earning potential.[132] At one point in the legislative process, it was generally believed that the failure to include in the Senate Bill language implementing a separate testing procedure was an inadvertent omission which would be corrected in Conference. The language that emerged from Conference, however, also did not specifically implement this separate testing requirement. Further, although the Conference Report stated that it generally follows the Senate amendment, it made no specific reference to the separate testing discussion in the Senate Report nor did it set out any special guidance concerning whether retiree plans should be tested separately.

Query: Whether for purposes of determining whether a plan is discriminatory, insurance coverage for retired employees should be tested separately from insurance for active employees.

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4. Cost of Group Term Life Insurance Coverage Included in Income of Retiree for Year in Which Coverage is Received

The TRA amended §83(e) (relating to the application of §83) by indicating that the §83 rules concerning when to include in income property transferred in connection with the performance of services, do not apply to the cost of group-term life insurance to which §79 applies.[133] The effect of the amendment to §83 is that the cost of group-term life insurance coverage will be included in the income of the retiree for the year in which the coverage is received, whether or not the benefit of retirement coverage vests upon retirement.

Comment: The Conference Report indicates that, by adopting the Senate amendment, including the clarification of when the group-term life insurance benefit for a retired employee is included in income, the Conferees did not intend to affect in any way the determination of whether the form of the benefit received by an employee upon retirement constitutes group term life insurance for purposes of §79.[134]

5. Effective Date

The amendments made by the 1984 TRA to §§79 and 83 generally apply to taxable years that begin after 1983.

6. Nonapplicability Provisions for Existing Plans

There are certain nonapplicability or grandfathering provisions for existing plans. Essentially, the amendments made to §§79 and 83 do not apply to any pre-January 1, 1984 plan with respect to any pre-January 1, 1984 employee who retires under such plan, if the employee had reached age 55 by January 1, 1984. The provisions also do not apply to any employees who retired before January 1, 1984. The grandfather protection is not available, however, for any individual retiring after 1986, if the plan is discriminatory after that date.

Comment: Not only is the grandfather rule applicable to any group-term life insurance plan of the employer, but the statute clarifies that a successor plan of a successor employer is also covered by the grandfather rules.[135]

The Senate Report indicates that the term "employer" may be interpreted broadly to allow employee transfers between comparable plans by an affiliated group.[136] Also, for these purposes, a successor employer refers to a situation in which an employer assumes the group term insurance obligations of another employer because of a business merger or acquisition, but does not refer to a new employer when an individual covered by a plan changes jobs and becomes covered by the new employer's group-term life insurance plan.[137] There is no statutory language to this affect, and the Conference Report does not specifically pick up this language from the Senate Report. Therefore, it is unclear whether the statute permits transfers between comparable plans offered by an affiliated group and also whether a successor employer refers to a situation in which an employer assumes the group-term insurance obligations of another employer because of a business merger or acquisition.

The Act indicates that the coverage provided to employees who retired on or before December 31, 1986, will not be taken into account for purposes of determining whether the plan is discriminatory after December 31, 1986.[138]

IV. Changes Affecting Incentive Stock Options

A. Introduction

In 1981, as part of ERTA (P.L. 97-34)Congress added §422A to the Code establishing a new type of tax-favored stock options—incentive stock options (ISOs). Basically, under §422A, an employee realizes no income upon receiving or exercising an incentive option, and his gain upon the ultimate sale of stock acquired with the option is subject to tax at capital gain rates, provided that the employee does not transfer the stock within two years after the option is granted and within one year after the date of exercise.[139] The "bargain" element realized by an optionee upon exercise of an ISO (*i.e.*, the difference between the option price and the fair market value of the stock on the exercise date) is a preference item for purposes of the alternative minimum tax. A controversy has existed, however, as to the effect of restrictions on the fair market value of qualified stock and the corresponding amount of tax preference. Although the minimum tax regulations provide that, in calculating the amount of the tax preference, only nonlapse restrictions reduce the fair market value of qualified stock, the Tax Court rejected this position in *Gresham v. Comr.*, 79 T.C. 322 (1982).

To qualify for the favorable tax treatment described above, an incentive option and the plan under which it is granted must satisfy a number of criteria specified in §422A. One of the specific requirements imposed by the statute is that the option price of an incentive option must equal or exceed the fair market value of the stock at the time the option is granted. The statute also provides that the fair market value requirement will be satisfied when the parties make a good faith effort to value the stock subject to the option.

Because it apparently believed that §83 principles should generally govern the determination of the fair market value of stock subject to incentive options, the Senate proposed that the incentive stock option and alternative minimum tax rules be amended to provide that the fair market value of stock be determined without regard to any restrictions other than restrictions which, by their terms, will never lapse. The Senate also proposed a technical change in the rules governing modifications of incentive options. Although the House version of the Act did not contain parallel provisions, the Conference Committee adopted the Senate measures in the final bill.

B. Overview

The 1984 Act added a new paragraph to §422A(c) which provides that, for purposes of determining whether the fair market value of stock equals the option price, stock shall be valued without regard to any restriction other than a restriction which, by its terms, will never lapse.[140] The statute also added a parallel provision to §57(a)(10) to provide that, under the alternative minimum tax, the item of tax preference arising from the exercise of an incentive

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stock option will be calculated by determining the value of the stock without regard to restrictions that will lapse in the future.[141]

The Act also amended §425(h)(3) by removing the exclusion from the definition of the term "modification" which previously had existed for an amendment to an option to impose the transferability restrictions of §422A(b)(5). In light of this amendment, when an option is amended to include the requisite transferability restrictions, the option must be repriced to the current fair market value of the stock to qualify as an incentive option.

The amendment to §422A(c) applies to options granted after March 20, 1984, except that the amendment does not apply to an incentive stock option granted before September 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984. The amendment to the alternative minimum tax apparently generally applies to options exercised after March 20, 1984; however,in the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the amendment shall apply only to options exercised after December 31, 1984. Finally, the amendment regarding the definition of "modification" in §425(h)(3) presumably applies to modifications of options occurring after March 20, 1984.

Note: The effective dates of the latter two provisions are ambiguous inasmuch as the effective date provisions make erroneous references to the operative subsections of §555.

C. *Detailed Analysis*

1. *Effect of Restrictions on the Valuation of Stock Subject to Incentive Stock Options*

Section 422A(b)(4) provides that the option price of an incentive stock option must equal or exceed the fair market value of the stock on the date the option is granted. This fair market value rule will be deemed to be satisfied where the parties make a good faith effort to calculate the fair market value of the stock.[142]

New §422A(c)(10) provides that the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse. The legislative history suggests that Congress believed that restrictions might be added to incentive stock to circumvent the fair market value rule of §422A(b)(4).[143]

In drafting the amendment to §422A(c), Congress drew upon the statutory language and valuation principles of §83(a). That section provides that, in determining the amount of income realized by a person who receives property in exchange for performing services, the fair market value of such property is determined without regard to any restriction other than a restriction which, by its terms, will never lapse. Section 83(a) taxes the difference between the value of the property and the amount paid for the property.[144] Thus, in drafting §83, Congress recognized that restrictions which are permanently attached to property (commonly known as "nonlapse restrictions") can affect its value and should be taken into account when calculating the amount of income taxed under §83.

Although the statutory language of §83(a) appears broad enough to include most permanent restrictions which encumber property received by an employee, the Service has defined the term "nonlapse restriction" in a relatively narrow manner. The regulations under §83 provide that a nonlapse restriction is a:

> "permanent limitation on the transferability of property (i) which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and (ii) which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor)." [145]

Comment: For a detailed analysis of the regulation quoted above and its underlying legislative history, see 384 T.M., *Restricted Property—Section 83.* As noted in 384 T.M., it can be argued that the definition in the regulation is unduly restrictive in light of the committee reports explaining §83.

The Service presumably will adopt the principles in the §83 regulations in interpreting new §422(c)(10). Further, if the Service were to promulgate regulations adopting the standards in the §83 regulations as governing for purposes of §422A, a taxpayer who ignored those regulations presumably could have difficulty in demonstrating that he met the good faith exception to the fair market value requirement of §422A(b)(4).

2. *Alternative Minimum Tax*

Under the alternative minimum tax, the "bargain" element realized by an optionee upon his exercise of an incentive stock option is an item of tax preference.[146] Thus, if an optionee exercises an incentive option with an option price of $10 per share when the fair market value of the stock is $15, he will include in his items of tax preference $5 for each share of stock acquired.

Note: When Congress created incentive options by adding §422A to the Code it determined that the difference between the option price of an incentive option and the fair market value of the stock at the date of exercise should not be treated as an item of tax preference. *See* H.R. Rep. No. 215, 97th Cong., 1st Sess. 234 (1981). The revised alternative minimum tax enacted by TEFRA, however, included as an item of tax preference the amount by which the fair market value of stock acquired by an ISO optionee exceeds the option price. The Code treats this amount as a tax preference item for the year in which an incentive option is exercised.

Regs. §1.57-1(f)(3) provides that, in determining the fair market value of stock acquired pursuant to the exercise of a qualified stock option, restrictions other than nonlapse restrictions have no effect on value. The Tax Court held in *Gresham v. Comr.*[147] that this regulation was invalid because it exceeded the scope of the underlying statute. Specifically, the court reasoned that the former §57(a)(6),[148] which simply measured tax preference as the difference between the option price and the "fair market value" of stock, could not be read to support the position that restrictions other than nonlapse restrictions could be ignored when valuing stock. The court also contrasted §83(a) which, of course, expressly includes the valuation rules which the Service attempted to impose through its

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regulations adopted under §57. Although *Gresham* considered only the application of the minimum tax to qualified options, the rationale of the decision was equally applicable to incentive options and §57(a)(10).

The 1984 Act amended §57 to overrule the Tax Court's decision in *Gresham* and impose valuation rules identical to those added to §422A. Thus, §57(a)(10) now provides that, for purposes of determining the amount of an optionee's tax preferences, the fair market value of stock acquired pursuant to the exercise of an incentive option shall be determined without regard to any restriction other than a nonlapse restriction.[149] This amendment ensures that common principles will govern the valuation of stock under both the alternative minimum tax and the general incentive stock option rules.

3. Modification of Incentive Stock Options

Under §425(h)(1), the modification, extension, or renewal of an incentive option is treated as the granting of a new option. The term "modification" generally includes "any change in the terms of the option which gives the employee additional benefits under the option."[150] Inasmuch as a modification is treated as the grant of a new option, the "new option" must meet, at the time of the modification, all the statutory requirements applicable to incentive options. Thus, if an incentive option is modified within the meaning of §425(h) and the stock subject to the option has appreciated since the date of original grant, the option price must be reset to the fair market value of the stock on the date of the modification in order for the option to qualify as an incentive option.

Prior to the enactment of the 1984 Act,§425(h)(3) excluded from the definition of "modification" a change in the terms of an option to impose the transferability restriction of §422A(b)(5). This latter section provides that an incentive option may not be transferable by the optionee other than by will or the laws of descent and distribution, and must be exercisable only by the employee during his lifetime. The Act amended §425(h)(3) to delete this exclusion from the definition of the term modification.[151] Thus, if an option is amended to conform to the nontransferability requirement of §422A, the amendment will be treated as the grant of a new option, which must satisfy all of the applicable incentive option rules as of the date of the modification (*e.g.*, the option price must equal the fair market value of the stock on that date, etc.).

Comment: The Act's legislative history does not reveal Congress' purpose for the amendment to the modification rules. The amendment is somewhat curious in light of the fact that §425(h) allowed qualified and restricted options (the predecessors of incentive options) to be amended to include similar transferability restrictions without the amendments creating a modification.

V. Changes Affecting Restricted Property Elections

A. Introduction

In 1969, Congress enacted §83 of the Internal Revenue Code in response to the disparity in the tax treatment of restricted stock plans and other types of deferred compensation arrangements.[152] Although Congress was concerned primarily with the favorable tax treatment afforded restricted stock plans, the statute was drafted with broader application. It provides that whenever any kind of property is transferred to an employee in connection with the performance of services it is includable in income (to the extent the value of the property exceeds the amount paid) in the first taxable year the property is transferrable and not subject to a substantial risk of forfeiture.

Section 83 permits a taxpayer to elect to include in gross income at the time the property is initially transferred the excess of the property's value (determined without regard to restrictions) over the amount paid.[153] This election must be made within 30 days of the transfer of property.[154]

Section 83 has been subject to several legal attacks on its broad application.[155] In one such case, *Alves v. Comr.*,[156] a taxpayer challenged the applicability of §83 to his purchase of his employer's stock at fair market value. Until *Alves*, it was widely believed that non-discount or non-bargain purchases of employer stock by employees were not covered by §83(a). The Tax Court, affirmed by the 9th Circuit, held that the stock, although initially transferred for fair market value, was transferred in connection with the performance of services and therefore was subject to §83(a). The court said that Mr. Alves could have made a §83(b) election at the time of initial transfer thereby avoiding tax on the subsequent appreciation in value, but because Mr. Alves had not made the election, he was subject to taxation on the appreciated value at the time the property became transferrable and not subject to a substantial risk of forfeiture.[157]

B. Overview of TRA Provision

The Court's holding caught many in the business community by surprise and left many taxpayers who were instrumental in starting successful firms in the 1970s and 1980s and who had not made §83(b) elections in a large potential tax liability situation. In response, Congress amended the election provisions of §83(b) to provide a one-time extension of time to make the election to those who acquired restricted stock during the specified time period.[158]

Section 556 of the 1984 TRA permits those who bought stock at fair market value (in connection with the performance of services) after June 30, 1976 and before November 18, 1982, the date of the Tax Court decision in *Alves*, to make a §83(b) election for the stock without regard to the 30 day limit, provided the employer consents to the election.[159]

C. Detailed Analysis

Section 556 of the Act permits a person to whom property was transferred in connection with the performance of services after June 30, 1976 and before November 18, 1982, the date of the *Alves* Tax Court opinion, to make a §83(b) election on his income tax return for the first taxable year ending after July 18, 1984. For individuals using a calendar tax year, the election should be made on their 1984 tax return. This remedial election is only permitted if the taxpayer paid fair market value for the property (regardless of any restrictions on the property other than a restriction which, by its terms, will never lapse) and the election must be consented to by the person who transferred the property, typically the employer.[160]

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The provision requires that the election contain information currently required by the Secretary of Treasury for making §83(b) elections. The period for assessing any tax attributable to the transfer of property which is the subject of the election is held open for three years from the date of election.

Comment: Although Congress has determined that it will provide remedial relief to certain taxpayers who paid fair market value for property received in connection with the performance of services and who neglected to make a §83(b) election within the 30 day period prescribed by §83(b), the relief provided did not assist Mr. Alves because the transfer of property in his case took place before June 30, 1976. The June 30, 1976 date was adopted in response to a specific request by the special interest group (not connected with Mr. Alves) that promoted the relief provision.

Although it, too, would not have provided relief to *Alves,* the Senate floor amendment contained a larger window within which transfers could be the subject of an election. In the Senate amendment, the election would have applied with respect to transfers of property made after June 30, 1976 and before the date of enactment of the 1984 TRA. In Conference, however, the window period was cut to the time between June 30, 1976 and the date the Tax Court reached its decision in *Alves.* This presumably reflects the conferees' belief that those receiving transfers after the date of the *Alves* decision had due notice that the transfer would be subject to §83(a) and that, to avoid adverse consequences, a §83(b) election should be made.

Comment: This result appears to be a bit harsh, even for those represented by counsel, because of the time it takes to disseminate a new opinion and to restructure arrangements to satisfy its requirements.

While Act §556, extending the time for making §83(b) elections, provides some relief to those who received property within the specified time period and who choose during the period provided to make the election, the amendment has no effect on the future application of §83.[161] Further, the amendment in no way alters the conclusions of the Tax Court and the 9th Circuit concerning the fact that stock transferred to an employee at fair market value in a factual situation similar to Mr. Alves' is the "transfer of property in connection with the performance of services." Thus, with the adoption of TRA §556, Congress has not signalled an intent to limit the scope of the applicability of §83, an issue which has been the subject of much recent litigation.

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[1] All section references herein are to the 1954 Internal Revenue Code as amended and the regulations promulgated thereunder unless otherwise specified.
[2] *Comr. v. Smith,* 324 U.S. 177, 181 (1945).
[3] §§3121(a), 3306(b), and 3401(a). The Railroad Retirement Tax also applies to any form of money remuneration (§3231(e)).
[4] *See,* for example, Regs. §31.3121(a)-1(e).
[5] Educational benefits provided under a nondiscriminatory plan were among the excludable benefits until the provision, §127, expired on December 31, 1983.
[6] P.L. 95-427; P.L. 96-167; and P.L. 97-34.
[7] Treasury Department News Release R-2461, December 20, 1983, 1984-4 I.R.B. 31.
[8] Of particular note was H.R. 3525, "The Permanent Tax Treatment of Fringe Benefits Act of 1983," introduced by Congressmen Stark and Conable in the 98th Congress, 1st Session, and S. 1817, "The Fringe Benefits Tax Act of 1983," introduced by Senator Symms in that same session of Congress. H.R. 3525 was not favorably received by many members of the business community because of its limitations on existing practices. Nevertheless, it provided the basis for much of the language adopted in the Act.
[9] For example, in a retail clothing business where an employer wishes its salespersons to wear the clothes they are selling to the public, such practices serve a business purpose as well as benefiting the employee. H. R. Rep. No. 232 (Part II), 98th Cong., 2d Sess. 1591 (1984) (hereinafter "House Report" or "H. Rep.").
[10] H. Rep., p. 1592.
[11] 1984 Tax Reform Act (hereinafter "the Act") §531(a) adding new Code §132(a) and, for the qualified tuition reduction, Act §532 amending Code §117 (scholarships and fellowship grants) by adding a new subsection (d).
[12] Act §531(d) making conforming amendments to employment taxes and benefit base.
[13] Act §531(d)(2).
[14] Act §531(c).
[15] H. Rep., p. 1593 and Conf. Rep., p. 1169.
[16] Act §531(a) adding a new Code §132(j).
[17] Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1169 (1984) (hereinafter "Conference Report" or "Conf. Rep.").
[18] Act §531(d)(5).
[19] Conf. Rep., p. 1170.
[20] Act §531(a) adding a new Code §132(a)(1).
[21] Act §531(a) adding a new Code §132(b).
[22] Act §531(a) adding a new Code §132(f)(1).
[23] A dependent is defined as any child (within the meaning of §151(e)(3)) of the employee who is a dependent of the employee or both of whose parents are deceased. For purposes of the preceding sentence, any child to whom §152(e) applies shall be treated as a dependent of both parents. Act §531(a) adding a new Code §132(f)(2).
[24] H. Rep., p. 1594.
[25] H. Rep., pp. 1594-1595.
[26] H. Rep., p. 1595. Similar rules apply to payroll department employees or other "headquarters" personnel.
[27] Act §531(a) adding a new Code §132(g)(1).
[28] Act §531(a) adding a new code §132(g)(2).
[29] Act §531(a) adding a new Code §132(h)(1).
[30] The employee, however, would be able to exclude the cost of airline services provided by another company in a controlled group conglomerate.
[31] H. Rep., p. 1597.
[32] Act §531(a) adding new Code §132(c).
[33] H. Rep., p. 1597.
[34] Act §531(a) adding a new Code §132(c)(3).
[35] Act §531(a) adding a new Code §132(c)(4).
[36] *Id.*
[37] H. Rep., p. 1597.
[38] H. Rep., p. 1597.
[39] H. Rep., p. 1597.
[40] Act §531(a) adding a new Code §132(c)(1)(B).
[41] Act §531(a) adding a new Code §132(c)(1)(A).
[42] Act §531(a) adding a new Code §132(c)(2)(A).
[43] Act §531(a) adding a new Code §132(c)(2)(B).
[44] Act §531(a) adding a new §132(g)(2).
[45] Act §531(f).
[46] Act §531(a) adding a new Code §132(h).
[47] Act §531(a) adding a new Code §132(f).
[48] Act §531(a) adding a new Code §132(h)(2)(B).
[49] Act §531(a) adding a new Code §132(h)(2)(A).
[50] Act §531(a) adding a new Code §132(d).
[51] H. Rep., p. 1601.
[52] In this case, the fair market value of the subscription is an excluded working condition fringe because the expense would have been deducted as a business expense if the employee had directly paid for the subscription. H. Rep., p. 1601.
[53] H. Rep., p. 1602.
[54] H. Rep., p. 1602.
[55] H. Rep., p. 1602.
[56] H. Rep., p. 1602.
[57] H. Rep., pp. 1602-1603.

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[58] Conf. Rep., p. 1171.
[59] Act §531(a) adding new Code §132(h)(3).
[60] Act §531(a) adding new code §132(h)(3)(B).
[61] Conf. Rep., p. 1171.
[62] Act §531(a) adding a new Code §132(h)(4).
[63] The nondiscrimination requirement in the House bill was not carried into the Act but a new requirement, that the parking be an ordinary and necessary business expense deductible under §162, was added to the final version. This limitation minimizes the need for a nondiscrimination requirement.
[64] Act §531(a) adding new Code §132(e).
[65] Act §531(a) adding new Code §132(e)(1).
[66] H. Rep., pp. 1603-4.
[67] Conf. Rep., p. 1172.
[68] Act §531(a) adding new Code §132(e)(2).
[69] Act §531(a) adding new Code §132(e).
[70] H. Rep., p. 1604.
[71] H. Rep., p. 1604.
[72] Act §532(a) amending §117 of the Code (relating to scholarships and fellowship grants) by adding a new subsection (d).
[73] A §170(b)(1)(A)(ii) educational institution normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are generally carried on.
[74] Section 532(a) of the Act adding a new subsection (d)(3) to §117.
[75] Act §532(b).
[76] Conf. Rep., p. 1173.
[77] Act §531(a) adding a new Code §132(h)(5).
[78] Act §531(g).
[79] Act §531(g)(2).
[80] Conf. Rep., p. 1172.
[81] Act §531(h).
[82] Act §532(b)
[83] Act §531(g).
[84] H. Rep., p. 1608-9. The House bill provision was included at the request of the Administration and, in fact, was an item in the 1983-84 Budget.
[85] Prop. Regs. §1.61-16 would have required that the choice between taxable and non-taxable benefits not only be made before the amounts become payable to the employee (as required by some courts that had reviewed the constructive receipt issue), but also that such choice be made a sufficient length of time before the amounts are payable to avoid the application of the constructive receipt doctrine. The proposed §61 regulations implied that the deferral election had to be made before the services were performed which gave rise to the compensation to avoid the application of principles of constructive receipt.
[86] The passage of §125 can be viewed as a reaction to Prop. Regs. §1.61.16. In effect, §125 protects employees that make their election (to chose either taxable or non-taxable benefits) before performing their services.
[87] At the IRS hearings on the proposed regulations held July 26, 1984, Service personnel expressed their intent to re-propose regulations by the end of August, 1984.
[88] Pre-TRA §125(d).
[89] Act §531(b)(1) amending §125(d). The Act also amends §125(c) by deleting the reference to "other taxable benefits" and by substituting "statutory nontaxable benefits." Act §531(b)(2)(B).
[90] Act §531(b)(2) amending §125(f). Section 127 expired in 1983. The Senate bill contained an extension of §127 which it was assumed would be adopted in conference. In conference, however, the Senate agreed to the deletion of the §127 extension but the drafters neglected, presumably inadvertently, to delete the reference to §127 from Act §531(b)(2).
[91] Act §531(b)(2) amending §125(f).
[92] H. Rep., p. 1608.
[93] Regs. §1.62-2(d)(2)(ii)(b).
[94] Code §125(b)(1) and §125(c).
[95] Act §531(b)(3) amending §125(b).
[96] Conf. Rep., p. 1175.
[97] Note that Act [713(f) amends [416(i) to exclude from the definition of key employee any officer whose annual compensation is no more than 150 percent of the §415(c)(1)(A) dollar limit (i.e., $45,000 for 1984).
[98] Act §713(f)(1) amending §416(i)(1)(A).
[99] Act §531(b)(3) amending §125(b).
[100] Act §531(b)(3) amending §125(b). (Post-TRA §125(b)(3).)
[101] Act §531(b)(5)(A).
[102] Conf. Rep., p. 1175. Note that the conference agreement does not prevent the application of the proposed regulations after the earlier of the two transition dates discussed *infra*. (Conf. Rep., p. 1175.).
[103] Act §531(b)(5)(B).
[104] Note that the Conference Agreement does not prevent the application of the proposed regulations after the earlier of such dates. (Conf. Rep., p. 1175.)
[105] Conf. Rep., p. 1176.
[106] Conf. Rep., p. 1176.
[107] *See* the complete text of these letters in the following issues of *Tax Notes:* April 16, 1984, p. 308 (letter from John E. Chapoton, Assistant Treasury Secretary for Tax Policy, to Robert J. Rubin, M.D., Assistant Secretary of HHS for Planning and Evaluation); April 30, 1984, p. 547 (from Robert J. Rubin, M.D. to John E. Chapoton); May 21, 1984, p. 889 (letter from several Finance Committee members to Treasury Secretary Donald T. Regan); June 4, 1984, p. 1107 (letter from Rep. Barber Conable to John E. Chapoton); June 25, 1984, p. 1358 (letter from Roscoe L. Egger, Jr., IRS Commissioner, to Mr. Conable).
[108] Act §531(b)(5)(C).
[109] Conf. Rep., p. 1177.
[110] Conf. Rep., p. 1177.
[111] Act §531(b)(4) redesignating §125(h) as §125(i) and inserting after §125(g) a new subsection (h).
[112] Act §531(b)(4) adding a new §125(h)(2).
[113] The Act amends §6652(h) (concerning the failure to file certain information returns in connection with plans of deferred compensation) to indicate that the failure to follow the TRA's cafeteria plan reporting requirements will trigger the §6652 penalty. Also, the term "etc.," is added at the end of the term deferred compensation in the heading of §6652(h) to indicate that the subsection covers more than deferred compensation. (Act §531(b)(4)(B).)
[114] Act §531(b)(6).
[115] Conf. Rep., p. 1177.
[116] *Id.*
[117] *Id.*
[118] §79(a).
[119] §79(a).
[120] Regs. 1.79-3(d)(2).
[121] The provision passed by the Senate was substantially identical to the House version concerning the changes to §79. However, the Senate Finance Committee made some important changes in the effective date provision which provided for more restrictive effective date and grandfathering rules than were contained in the House version. The conferees essentially adopted the Senate effective date provisions but further tightened their application.
[122] §79(a)(1).
[123] §79(a)(2).
[124] Regs. §1.79-3(d).
[125] §79(c).
[126] Act §223(a) amending §79 by adding a new subsection (e) and amending §79(b), an exception to the cost limitation of the general rule of §79 for retired and disabled employees, to indicate that the exception only applies to *disabled* former employees and not to retired former employees.
[127] I.e., disregarding the $50,000 limitation.
[128] §79(d).
[129] §79(d)(1).
[130] Act §223 amending §79(d)(1).
[131] S. Rep. No. 98-169, 98th Cong., 2d Sess. 583 (1984), (Senate Report).
[132] *Id.* at 582.
[133] Act §223(c) amending §83(e) by adding a new paragraph (s).
[134] H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1080 (1984) (Conference Report).
[135] Act §223(d)(2)(A)(ii).
[136] Senate Report at 583.
[137] *Id.*
[138] Act §223(b)(2)(C).
[139] Even though TRA reduced the long term capital gain holding period from one year to six months, §422A(a)(1) still requires incentive stock to be held for one year after purchase to qualify for long term capital gain treatment.
[140] P.L. 98-369, §555(a)(1), *adding* §422A(c)(10).
[141] P.L. 98-369, §555(a)(2), *amending* §57(a)(10).
[142] §422(c)(1).
[143] *See* S. Rept. No. 169 (Vol.1) 98th Cong., 2d Sess. 767 (1984).
[144] Section 83(a) also provides rules for determining the taxable year in which the fair market value of the property is calculated and taxed to the employee. Basically, these events occur in the first taxable year in which the employee's rights in the property are either transferable or not subject to a substantial risk of forfeiture.
[145] Regs. §1.83-3(h).

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[146] §57(a)(10).
[147] 79 T.C. 322 (1982) (court reviewed).
[148] Section 57(a)(6) applied to stock acquired by the exercise of qualified or restricted options (the historical tax-favored antecedents of incentive stock options). Section 57(a)(10) applies an identical rule to incentive options.
[149] *See* P.L. 98-369, §555(a)(2), *amending* §57(a)(10).
[150] §425(h)(3).
[151] P.L. 98-369, 555(b), *amending* §425(h)(3).
[152] S. Rep. No. 552, 91st Cong., 1st Sess. 120-21.
[153] §83(b).
[154] §83(b).
[155] *See* for example, *Pledger v. Comr.*, 641 F. 2d 287 (5th Cir.), cert. denied, 454 U.S. 964, 102 S. Ct. 504; *Sakol v. Comr.*, 574 F. 2d 694 (2nd Cir.), cert. denied, 439 U.S. 859, 99 S. Ct. 177, (1978); *Cohn v. Comr.*, 73 T.C. 443 (1979); *Cassetta v. Comr.*, 39 T.C.M. (CPH) 188 (1979).
[156] 79 T.C. 864 (1982), aff'd., 734 F. 2d 478 (9th Cir. 1984)
[157] 79 T.C. at 879.
[158] *See* Senator Tsongas' statement in which he introduced the amendment to §83(b). Cong. Rec., p. S4509 (4/12/84).
[159] The provision was introduced for the first time on the Senate floor on April 12, 1984 by Senator Tsongas of Massachusetts. In his floor statement, Mr. Tsongas said that the purpose of his amendment was to prevent an unintended tax result where restricted stock is sold by a start-up company to its founders for full fair-market value. He pointed to the *Alves* case and said that it appears that §83 might make such a sale a taxable event to the employee, entitling the company to a tax deduction, unless the employee files an election to include a zero amount in his taxable income within 30 days after his stock purchase. Mr. Tsongas said, "This is a questionable tax policy result and its main impact will fall on founders of new successful high technology and other enterprises who have no warning that such a tax trap could be involved in a routine corporate formation." (Cong. Rec., p. S4509-S4510 (4/12/84).) Sen. Tsongas emphasized that it was the intention of the amendment to provide a cure procedure for those who had failed in the past to make elections in the typical start-up situation. In essence, "[t]he Act provides a one-time opportunity for taxpayers to make an election to include zero in gross income with respect to property acquired before a specific date. The amendment will have no affect on the future application of §83." (Cong. Rec., p. S4510 (4/12/84)).
[160] Act §556.
[161] *See* Sen. Tsongas' statement quoted in footnote 159, *supra*.

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Chapter 47

NEW RULES FOR WELFARE BENEFIT PLANS

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I. Introduction

A. *Overview*

In enacting §§511 through 513 of the Tax Reform Act of 1984 (the Act) Congress sought to correct certain perceived abuses and inequities involving employer-provided welfare and deferred compensation benefits. Some of the specific perceived abuses are the use of retired lives reserve accounts (RLRs) and stabilization funds maintained by insurance companies to accumulate funds to pay life insurance and health and disability insurance benefits to executives after retirement, excessively funded severance pay plans, the use of voluntary employee beneficiary associations (VEBAs) to purchase facilities such as ski chalets and obtain full current deductions, and the reversion of accumulated VEBA assets to employers or key employees.[1]

Under prior law, an employer's entire contribution to a welfare benefit fund (WBF) was deductible in the year it was made rather than at the time the benefit was provided. Such treatment differed from deductions for employer contributions to nonqualified deferred compensation plans, for example, in that generally contributions to the latter are not allowed until an amount is includable in the gross income of the employee under §83. Congress has concluded that such favorable tax treatment for welfare benefit funds is inappropriate in view of the favorable tax treatment already provided to employees in the form of the exclusion of many of the benefits provided by WBFs from adjusted gross income.[2] Congress has also determined that the prior rules under which employers could take deductions for plan contributions well in advance of when the benefits were paid were not desirable because they allowed tax-free accumulation of funds. Such an accumulation, especially in a fund that is also tax-exempt, as in the case of a VEBA, gave WBFs tax-shelter potential.[3]

Congress was also concerned about the lack of clarity in the distinction between welfare benefits and unfunded benefits that are deferred compensation. This lack of clarity has generated litigation and, in one case, a court has held that a benefit treated by the Service as deferred compensation was, in fact, a welfare benefit.[4]

B. *Outline of New Provisions*

The Act imposes limitations on the amount of contributions to WBFs that are permitted as deductions,[5] it revises the unrelated business income rules to prohibit the accumulation of unlimited surpluses in VEBAs and qualified group legal service plans (GLSOs),[6] provides the new nondiscrimination requirements for WBFs,[7] imposes a new excise tax on certain disqualified benefits,[8] imposes additional reporting requirements on VEBAs and GLSOs seeking non-profit organization status,[9] and clarifies the distinction between welfare benefits and unfunded deferred compensation.[10]

The overall impact of these provisions will be to require accrual basis employers to account for deductions for contributions to WBFs as though they were on a cash basis, reduce the employer deduction benefits of maintaining WBFs, limit the accumulation of assets in such plans generally, and particularly with regard to retirement, health and insurance benefits for key employees, and to make WBFs far more expensive to administer by necessitating an actuary's certification in order to obtain the higher deduction limits. As a result of these changes, the greatest impact will be felt by smaller employers that will essentially have to comply with the safe harbor limits for deductions because they cannot afford, or do not choose to obtain, actuarial certification.

C. *Effective Date*

Although there are several exceptions, the general effective date for the Act §511 provisions setting limits on deductions to WBPs, amending the unrelated business income provisions, and imposing new excise taxes with respect to WBPs is for contributions paid or accrued on or after January 1, 1986. The general effective date for the Act §512 rules concerning unfunded deferred benefits is for amounts paid or incurred on or after July 18, 1984 (the Act's enactment date) and the effective date for the Act §513 nondiscrimination requirements with regard to VEBAs and GLSOs is for "years" beginning after 1984.

II. Detailed Analysis

A. *Funded Welfare Benefit Plans*

1. *Coverage*

While the major impact of the WBF provisions will be on VEBAs, the provisions apply more broadly. Act §511(a) added Code §419(e)(1), which defines "welfare benefit fund" as any fund that is part of a plan of an employer through which the employer provides welfare benefits to its employees and beneficiaries.[11] Welfare benefits are defined in new §419(e)(2) as all benefits except those (a) provided under a qualified retirement-type plan to which §404 or §404A (relating to certain foreign deferred compensation plans) applies, (b) involving a transfer of property in connection with the performance of services that is deductible by an employer under §83(h), or (c) involving a vacation pay accrual election under Code §463.[12] In addition to tax-exempt social clubs, VEBAs, supplemental unemployment benefit trusts (SUBs), and GLSOs, the term

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"fund" includes retired lives reserve accounts (RLRs) and stabilization accounts typically held for employers (or VEBAs) by insurance companies.[13] Any trust, corporation or other organization not exempt from income tax is also considered a welfare benefit fund.[14] Even when there is no plan, but the arrangement of employer contributions or benefits has the effect of a plan, the Act treats the arrangement as a WBF.[15] Plans for independent contractors, if such plans would be WBFs but for a lack of the employee-employer relationship, also are treated as WBFs.[16]

2. Deduction Limits

The Act provides rules for determining the timing and the amount of an employer's deduction for a contribution to a WBF. It contains an exception from these rules for plans to which 10 or more employers contribute and no one employer contributes more than 10 percent of the total contributions.[17]

Under the Act, a contribution which is otherwise deductible under the Code will be deductible under new Code §419 in the taxable year in which paid only to the extent that it does not exceed the qualified cost of the plan for the taxable year.[18] Qualified costs are the direct costs for the taxable year plus certain additions to "qualified asset accounts" for the taxable year within the limits imposed by new §419A(b), *i.e.*, reserves.

a. Qualified Direct Cost

A qualified direct cost for any taxable year of the employer is the aggregate amount (including administrative expenses) which would have been allowed as a deduction to a cash method taxpayer with respect to benefits provided during the taxable year if the taxpayer had provided the benefits directly on a current basis.[19] For example, in the case of a self-insured medical reimbursement plan, the qualified direct cost equals the actual benefit payment made to employees for the taxable year, plus an allocable share of the administrative costs of providing such benefits.[20]

For purposes of determining the qualified direct cost, a benefit is treated as provided when the benefit would be includable in the gross income of the employee (or would be includable in the employee's gross income but for a provision of the Code).[21]

Whereas, generally, the Act reflects a Congressional desire to limit perceived abuses involving the contribution of facilities to WBFs, the Act carves out special favorable treatment for child care facilities. In determining qualified direct cost, the adjusted basis of the facility is deductible over a period of 60 months. To obtain this special treatment, the child care facility must be tangible property of a character subject to depreciation and located in the United States. Further, it must be used primarily for the children of the employees of the employer.[22]

b. Qualified Asset Account

(1) General Limitation

Additions to a qualified asset account are only permitted where a WBF self-funds a reserve set aside to pay insurance-type benefits such as disability benefits, medical benefits, supplemental unemployment or severance pay benefits, and life insurance benefits.[23] A primary thrust of the new WBF provisions is to limit accelerated additions to such an account.[24]

In the past, acceleration resulted from basing the deduction on an obligation to fund a plan in the aggregate rather than on an obligation to pay specific benefits. The new limitations were imposed to assure that no more than the amount estimated to be necessary under actuarial assumptions (such assumptions must be reasonable in the aggregate) are used to fund the liabilities of the plan for the amount of claims incurred but unpaid (as of the close of the taxable year) for benefits permitted under the plan, and for the administrative costs of providing such benefits.[25] The Conference Report states that claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death, actually occurs.

The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid.[26] An example of an incurred but unpaid claim is the occurrence of the death of an employee during the year under a plan that provides for payment to a survivor of the employee for the survivor's remaining life. The qualified asset account may include the estimated present value of the future stream of benefits payable to the survivor, using reasonable assumptions as to earnings of the fund and mortality experience.[27]

Essentially, the Act permits reserves up to specified safe harbor limits and permits higher reserves in certain instances provided the employer does not exceed the statutory limits and obtains actuarial certification.[28]

(2) Special Limitations Applying to Specific Types of Benefits

In addition to the general rule for permissible reserve accounts, the Act provides special rules for specific types of benefits.

(i) Additional Reserve for Post-Retirement Medical and Life Insurance Benefits

The asset account rules expressly permit an additional reserve for post-retirement medical and life insurance benefits provided certain limitation and nondiscrimination requirements are met. *See* new §419A(e).

This type of retirement benefit reserve must be funded over the working lives of covered employees and must be actuarially determined (using assumptions that are reasonable in the aggregate) on a level basis as necessary for either post-retirement medical benefits (determined on the basis of current medical costs), or post-retirement life insurance benefits.[29] The account is limited to the amount of life insurance that would be tax-free to the employee under §79 (employer-provided group-term life insurance) or §101(b) (employee death benefits). The §101(b) amount is determined by substituting $50,000 for $5,000. Under the new §79 rules, the maximum available life insurance for a retiree is $50,000 and this exclusion is only available if the plan is nondiscriminatory under the new §79 rules.[30] In addition, in order for post-retirement medical and life insurance benefits to be included in the account, they must be nondiscriminatory as defined under new Code §505.[31]

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(ii) SUB or Severance Pay Benefits

If the WBF provides SUB or severance pay benefits, the account limit is 75 percent of the average annual qualified direct costs of such benefits for any two of the immediately preceding seven taxable years plus the average annual administrative costs for the relevant two years allocable to SUB or severance pay benefits.[32] The SUB or severance pay benefit payable to any individual that may be taken into account for this purpose may not exceed an amount that is payable at an annual rate of 150 percent of the limit in effect under §415(c)(1)(A) (the limit on annual additions to §401(a) defined contribution plans). For 1984, the account limit would be $45,000.[33]

(iii) Disability Benefits

The Act provides that disability benefits payable to individuals may not be credited to the qualified asset account to the extent that the benefits are payable at an annual rate that exceeds either the 75 percent of the individual's average compensation for his high three years (within the meaning of §415(b)(3)) or the limitation in effect under §415(b)(1)(A)) (the limit on annual benefit accruals for §401(a) defined benefit plans), whichever is lower.[34] For 1984, the latter limitation would be $90,000.

c. Safe Harbor Limits

The Act provides that unless there is an actuarial certification of the account limit for any taxable year, the account limit for the year may not be more than the sum of the various safe harbor limits for the different types of benefits in any such year.[35] The safe harbor for short-term disability benefits for any taxable year is 17.5 percent of the qualified direct costs for the immediately preceding taxable year. The safe harbor for medical benefits is 35 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year.[36] For SUB or severance pay benefits, the safe harbor is the same as the amount otherwise permitted to be taken into account. (That is, the average annual qualified direct costs for such benefits for any two of the immediately preceding seven taxable years.) The Act does not prescribe a safe harbor for long-term disability or life insurance benefits. Rather, the establishment of such limits will be prescribed by regulation.[37]

Comment: These safe harbor limits may not provide a complete safety net. The Conference Report states that, even if the safe harbor limits are satisfied, the taxpayer must show that the reserves are reasonable under the facts of the particular case. Actuarial input may also be required.[38]

d. Separate Accounts for Key Employees

Although the Conference did not adopt a Senate proposal to define and limit top-heavy VEBA benefits paid to key employees, the Act does contain certain provisions requiring special separate account treatment for contributions to fund certain benefits for key employees.

Contributions to fund post-retirement medical and life insurance benefits provided with respect to a key employee must be made to a separate account for each key employee and benefits provided with respect to the key employee must be paid from this account.[39] Presumably, this provision was an accommodation to the Senate's concern that, because there are no vesting requirements for VEBAs, amounts contributed for those who are no longer employees could be used for the benefit of key employees upon termination of the plan. The Act also provides that any amount attributable to medical benefits allocated to a key employee account must be treated as an annual addition to a defined contribution plan for purposes of applying the §415(c) limits on annual additions to defined contribution plans.[40] For these purposes, the Act defines key employee as the term is defined in §416(i). Thus, the definition includes 5-percent owners and certain officers and highly paid employees.[41]

e. Collectively Bargained Plans

The Act requires that the Treasury Department publish final regulations by July 1, 1985, establishing special (higher) reserve limit principles for qualified asset accounts maintained under welfare benefit funds maintained pursuant to collectively bargained plans.[42] The Conference Report indicates that in establishing these limits, the Treasury is directed to presume that reserves in collectively bargained welfare benefit funds are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process.[43]

f. Elective Aggregation

The Act permits an employer to elect to aggregate two or more WBFs to treat them as one fund for purposes of determining the deduction limit.[44]

Comment: Although there is no explicit tie-in between new §419A (account limits rules) and §505 (nondiscrimination rules), the Conference Report indicates that the election to aggregate must be consistent for deduction and discrimination purposes. For example, if an employer elects to aggregate two plans for deduction purposes, those plans must be aggregated when testing for discrimination.[45]

g. Transitional Rule

The Conference Agreement provides for a transition period during which fund reserves that exceed the new limits may be reduced without adverse consequences. The transition rule applies to WBFs that were in existence on June 22, 1984. Essentially, the rule requires no more than a 20 percent reduction in the reserve per year over a four-year period. This is accomplished by permitting a larger reserve for the first four years following the effective date than is otherwise permitted under the account limit rules. Specifically, for the first year, the account limit for the year may be increased to the sum of the new limit (determined without regard to the transitional rule) and 80 percent of the excess reserve amount. The Act defines the excess reserve amount for any year as the excess of the reserve as of the end of the first plan year ending after July 18, 1984 over the limit determined without regard to the transitional rule. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively, of the excess reserve amount for such years is to be added to the limit determined under the rules. Thus, plans are permitted to retain up to 80 percent of their excess in the first year but only 60 percent and so on in the succeeding years.[46]

h. After-Tax Income

The new deduction limits require that the qualified cost of a WBF for any taxable year must be reduced by the

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after tax income of the WBF for the taxable year. The Act provides that in determining the gross income of a WBF, contributions and other amounts received from employees will be taken into account.[47]

i. Carryover of Excess Contributions

The Act provides that amounts that exceed the fund's qualified cost for the taxable year will be treated as an amount paid by the employer to the WBF during a succeeding taxable year.[48] Thus, there is automatic attribution of any excess to a succeeding year.

3. Unrelated Business Income

The Act extends certain unrelated business income rules that previously only applied to tax-exempt recreational clubs and VEBAs to SUBs and GLSOs.[49] In addition, it places a limit, not previously imposed, on the size of the reserve that a VEBA (SUB or GLSO) is permitted to accumulate. Reserves in excess of the permitted amount are treated as unrelated business income.

Specifically, the Act amends §512(a)(3) which previously permitted a VEBA to set aside earnings on plan assets without being subject to the unrelated business income tax, provided the excess was used to provide benefits under the plan.[50] The Act limits the amount of this set-aside by providing that earnings on VEBA, SUB and GLSO assets will be tax-free only to the extent that the amount of the reserve set aside under §512(a)(3)(B) does not exceed the limits established under the new account limit provisions.[51]

In computing the permissible set-aside, several special rules must be considered. First, any reserves for post-retirement medical benefits that have been considered in establishing the §419A(c)(2) asset account limit must be subtracted.[52] Second, the set-aside may not include the value of a facility used to provide recreational and other benefits.[53] Third, and perhaps most significant, the Act provides grandfathering relief for retirement medical and life insurance benefits including RLR arrangements.[54] There is no limit on the permissible set-aside attributable to an existing reserve for post-retirement medical or life insurance benefits. The term "existing reserve" for post-retirement medical or life insurance benefits is defined as the amount of assets set aside at the close of the last plan year ending before July 18, 1984.[55]

Comment: This transition relief applies to an existing reserve only to the extent that the accumulated amount does not exceed the amounts permitted under the principles of prior RLR rulings. (*e.g.*, Rev. Ruls. 69-382, 1969-2 C.B. 28, and 73-599, 1973-2 C.B. 40.) [56]

The Act also provides that all future payments of medical or life insurance benefits to retirees under all plans of the employer are to be charged against the reserve to which the transition rule applies.[57]

There is a general exception to the restrictions imposed on the amount of permissible set-aside where substantially all of the contributions to the VEBA, SUB or GLSO are made by employers who are tax-exempt throughout the five-taxable year period ending with the taxable year in which the contributions are made.[58] Thus, for example, if a VEBA was established for teachers, and substantially all contributions to the VEBA are made by tax-exempt school districts employing the teachers, the Act's unrelated business income amendments would not apply to the VEBA and there would be no restriction on the amount of the set-aside other than the requirement that the set-aside be used to provide permissible benefits. The limit on the set-aside, however, does apply to more-than-10-employer VEBAs, SUBs and GLSOs that are otherwise exempt from the deduction limitations.

4. Excise Taxes

The Act adds a new 100 percent excise tax on an employer that provides disqualified benefits through a WBF.[59] A disqualified benefit is defined as: (1) any medical or life insurance benefit with respect to a key employee if it is not paid from a separate account as provided under §419A(d); (2) any post-retirement medical or life insurance benefit provided with respect to a retired employee if the plan is discriminatory (under the rules of new §505(b)(1)) [60]; and (3) any portion of a WBF reverting to the benefit of the employer.[61]

Comment: The Act potentially subjects VEBAs to a double tax. One is an unrelated business tax for amounts not set aside in accordance with the reserve rules of Code §419A and the other is the excise tax on certain disqualified benefits. It is possible for both taxes to apply so that not only would the trust pay the unrelated business taxes on the excess reserve, but the 100 percent excise tax could also apply on the same amounts so that the next tax paid would, in effect, exceed 100 percent.[62]

5. Effective Date

The new rules with regard to deduction limits, unrelated business income set-asides and the excise tax apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date.[63] There is a special rule for plans maintained pursuant to collective bargaining agreements and for contributions of facilities. With respect to collectively bargained plans in effect on July 1, 1985 (or ratified on or before that date), the provisions of Act §511 do not apply to years beginning before the date on which the last of the collective bargaining agreements relating to the plan terminates.[64]

There is also a special effective date rule for contributions of facilities.[65] The new provisions will apply to the contribution of a facility (or assets to purchase a facility) to a WBF after June 22, 1984 unless the facility is placed in service before January 1, 1987 and the facility is either acquired or improved by the fund pursuant to a binding contract in effect on June 22, 1984 or the construction of the facility began before that date.[66]

6. Impact of New Premature Accrual Rules

Of particular interest is the impact of the new accounting rules (restricting premature accruals) on WBF contributions until such time as the new WBF rules become effective. Under new §461(h)(5)(D) of the Code, the premature accrual rules do not apply if another Code provision specifically provides for a deduction for a reserve for estimated expenses. However, since the WBF rules in new Code §§419 and 419A are not effective until 1986, the Service may take the position that the premature accrual rules will apply until the WBF rules become effective.

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Comment: The net effect of these premature accrual rules may be to eliminate any deduction for accrued but unpaid WBF contributions and to prohibit any deduction until the employee has performed such services as are required to be entitled to the benefit provided by the WBF. Such an interpretation could result in a substantial delay in the deduction for the WBF contribution.

B. New Nondiscrimination and Reporting Requirements

1. Nondiscrimination Requirements

The Act establishes new nondiscrimination standards for VEBAs and GLSOs. The standards are the traditional nondiscrimination rules applied to other employee benefits such as those for medical reimbursement plans under §105(h). No VEBA or GLSO, with the exception of plans maintained pursuant to a collectively bargained agreement, will be exempt from tax under §501(a) unless these nondiscrimination requirements are met.[67] The new standards are intended to be a codification of existing regulatory provisions.

Under the Act, the coverage of a VEBA or a GLSO must be nondiscriminatory and benefits must be provided on a nondiscriminatory basis. The new standards specifically require that each class of benefits be made available to a classification of employees that does not favor the highly compensated. The classification must be described in the plan and the Treasury must determine that it is not discriminatory. In addition, each class of benefits must not be provided in a manner that discriminates in favor of highly compensated employees.[68]

In testing whether the benefits are available to a nondiscriminatory classification of employees, employees who decline to make required contributions must be considered.[69] On the other hand, in testing for discrimination, certain employees who are not covered by a plan may be excluded from consideration. These employees are those who have not attained the age of 21, who have not completed three years of service with the employer, work less than half-time, are included in the collective bargaining unit (if the benefits involved have been the subject of good faith bargaining), or are nonresident aliens.[70]

The Act specially provides that life insurance, disability, severance pay, or supplemental unemployment compensation benefits will not be considered to fail to meet the nondiscrimination requirements merely because the benefits bear a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees covered by the plan.[71]

The nondiscrimination rules define highly compensated individuals in the same manner that that term is defined in §105(h)(5) for purposes of uninsured medical reimbursement plans with the exception, however, that "10 percent" is substituted for "25 percent."[72] A highly compensated employee, therefore, is one of the five highest paid officers, a shareholder owning more than 10 percent of the employer, or an employee who is among the highest paid 10 percent of all employees.

The Act provides that, in testing a VEBA or GLSO for discrimination, employer aggregation rules similar to the rules of §414(b), (c), (m), and (n) apply. (Section 414(n) is applied without regard to paragraph (5).)[73] Also, as noted *infra*,[74] the Conference Report, at page 1159, provides that if plan aggregation for discrimination purposes is elected, it also must be utilized when calculating the new deduction limits.

Where the Code contains specific nondiscrimination rules for a particular benefit provided under a §501(c)(9) or §501(c)(20) trust, the new general nondiscrimination requirements in the Act will be met only if the specific nondiscrimination requirements for the benefit are satisfied.

Although the Act does not specifically address the issue of the integration of benefits with Social Security, the Conference Report clarifies that, in determining Social Security integration, generally, a VEBA cannot take into account disability benefits under Social Security, if those benefits are also taken into account under a qualified retirement plan of the employer covering the same employees.[75] Thus, the intention is to prohibit double integration although there is no statutory provision to this effect.

Comment: The conferees' limits on integration apply only to VEBAs[76] and would not apply to insurance accounts. If a disability benefit were provided through an insurance arrangement it might be integrated with Social Security even though the employer's retirement plan fully utilized Social Security benefits in integrating the retirement plan. As a result, employers may seek to provide long-term disability benefits outside VEBAs.

The nondiscrimination requirements are effective for years beginning after December 31, 1984.[77] However, the Act indicates that, for any benefits in pay status as of January 1, 1985, an employer may elect to exclude from consideration all disability or severance payments.[78] This provision, however, will not apply to any payment if a plan amendment to increase benefits is adopted after June 22, 1984.[79]

2. Additional Reporting Requirements

In order to be treated as a tax-exempt organization under §501(c)(9) and (20), the organization must give notice to the Secretary of the Treasury that it is applying for exempt status. (The Secretary will indicate in regulations how that notice shall be given.) Organizations in existence on July 18, 1984 that have not applied for exempt status must apply within one year from that date.[80]

3. Effective Date

The new nondiscrimination and reporting requirements apply to years beginning after December 31, 1984.[81]

C. Unfunded Deferred Benefits

1. Background

Under prior law, neither the Code nor Treasury regulations provided a definition that clearly distinguished welfare benefits from deferred benefits. Section 512 of the Act is designed to provide the distinction by establishing the presumption that benefits are deferred unless provided through a welfare benefit fund as that term is defined in Act §419(e)[82] or is vacation pay regarding which an accrual basis taxpayer has made a §463 election.[83] The Act also clarifies that, where a benefit method or arrangement has the effect of deferring compensation, it will be treated as a deferred compensation plan even though there is no plan.[84]

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The distinction between unfunded deferred compensation and welfare benefits is significant because the special deduction timing rules and rules for measuring deductions that apply to amounts paid under a plan of deferred compensation do not apply to deductions for welfare benefits.[85] A deduction is allowed to an employer for a contribution paid under a nonqualified plan of deferred compensation only in the employer's taxable year that ends in the year the contribution is includible in the employee's gross income if separate accounts are maintained.[86] Apparently, in enacting §512, Congress wished to indicate its disapproval of the decision in *Greensboro Pathology Associates, P.A. v. U.S.*,[87] in which the Court of Appeals for the Federal Circuit held that a plan providing educational benefits to the children of employees was a welfare plan rather than a plan of deferred compensation. As a result, the employer was allowed a current deduction for contributions to the plan.[88]

2. Description Of Provision

Act §512 amends Code §404(b) (relating to method of contributions having the effect of a plan) to clarify that, where there is no plan, if the arrangement of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, annuity plan or any other plan, including an unfunded plan, that defers receipt of compensation, the rules of Code §404(a) rather than §162 or §212 will apply.[89] The rules of Code §404(a) require generally that an employer may take a deduction for a contribution to a non-qualified plan only in the taxable year during which the contribution is includable in the gross income of the employee.[90] In addition, Act §512 clarifies that any plan providing deferred benefits (other than compensation) will be treated as a deferred compensation plan.[91] Further, it provides that the determination of when an amount is includible in gross income must be made without regard to any of the tax provisions that exclude such benefits from gross income.[92] For example, if an employer maintains a qualified plan providing legal services to employees pursuant to Code §120, the employee may exclude the employer's contribution from gross income. The employer, on the other hand, may deduct the contribution only in the year the amount would have been includable in the employee's gross income but for Code §120.

The provision contains an exception from treatment as an unfunded deferred compensation plan for certain vacation pay arrangements. Specifically excepted are benefits for which an accrual basis taxpayer has made an election under Code §463 [93] and extended vacation pay plans maintained pursuant to a collective bargaining agreement in effect on June 22, 1984.[94] With respect to such collectively bargained benefits, Act §512 will apply only after the agreement terminates. (The Act clarifies that any plan amendment made solely to conform to the requirements added by Act §512 will not be treated as a termination of the collective bargaining agreement.)

Of particular importance is language in the Conference Report that limits the scope of the new provision to exclude the payment of bonuses or other amounts shortly after the close of the taxable year in which significant services have been performed. The Report indicates that Congress does not intend such benefits to be considered as deferred compensation or as a deferred benefit plan if amounts are paid within 2½ months after the close of the taxable year in which the services were performed.[95]

Act §512 is effective on July 18, 1984 for amounts paid or incurred after that date in taxable years ending after that date.[96]

III. Implications

In general, the new rules will not have an effect on a cash basis employer's deductions for payments in connection with unfunded benefits but will affect accrual basis employers because it will treat them as though they were on the cash basis with respect to unfunded benefits. The new rules will have the greatest impact on funded plans. They clearly limit deductions for contributions to WBFs, and such limitations are likely to be felt more by small plans than larger plans to the extent that small plans, due to cost considerations, choose to conform to the safe harbor limits that, as a rule, will permit lower deductions than under assumptions that are actuarially certified.[97] In addition, set-asides of income earned by SUBs, VEBAs, and GLSOs, to the extent they exceed the deduction limits, with some modifications, will be treated as unrelated business income. Although this will not affect existing reserves for post-retirement medical and life insurance benefits (whether held by the VEBA or in an RLR), future reserves for such benefits will be severely restricted. The new excise tax on discriminatory post-retirement medical or life insurance benefits may lead to the revision or curtailing of this type of plan since many such plans would be discriminatory within the meaning of the new rules. Last, the new rules effectively eliminate any reversion of assets to the benefit of the employer by imposing 100 percent excise tax on such a reversion. In addition, the requirement that post-retirement medical and life insurance benefits for key employees be paid only from a separately established account will prevent using plan assets attributable to contributions for non-key employees to provide additional benefits to key employees at plan termination.

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[1] Conference Report, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1275-76 (1984) (hereinafter "Conference Report" or "Conf. Rep.").
[2] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1275 (1984), (hereinafter "House Report" or "H. Rep").
[3] H. Rep., p. 1275.
[4] Conf. Rep., p. 1274.
[5] Act §511(a) adding new Code §§419 and 419A.
[6] Act §511(b) amending Code §512(a)(3).
[7] Act §513(a) adding new Code §505(a).
[8] Act §511(c) adding new Code §4976.
[9] Act §513(a) adding new Code §505(c).
[10] Act §512(a) amending Code §404(b).
[11] Act §511(a) adding new Code §419(e).
[12] Act §511(a) adding new Code §419(e)(2). Note that, for purposes of

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(a), above §404 is applied without reference to new §404(b)(2) (relating to unfunded deferred benefits) as added by Act §512(a).

[13] Act §511(a) adding new Code §419(e)(3). Although the section does not specifically refer to RLRs, it does apply to "any account held for an employer by any person."

[14] Act §511(a) adding new Code §419(e)(3)(B).

[15] Act §511(a) adding new Code §419(f).

[16] Act §511(a) adding new Code §419(g).

[17] Act §511(a) adding new Code §419A(f)(6). Notwithstanding compliance with the ten percent rule, a plan is not exempt from the deduction limits if the liability of individual employers who maintain the plan is determined on the basis of experience rating. Conf. Rep., p. 1159.

[18] Act §511(a) adding new Code §419(b).

[19] New Code §419(c)(3).

[20] H. Rep., p. 1277. The House Report provides several examples of how the qualified direct cost rules pick up other rules in the Code that generally limit deductions with respect to WBF contributions. For example, if an employer contributes amounts that the WBF uses to purchase land used for an employee recreational facility, no deduction is allowed for this contribution because §263 of the Code would not have allowed the deduction if the employer had purchased the land directly. Similarly, other expenses of a WBF (such as maintenance expenses) with respect to such a facility would be a qualified direct cost giving rise to employer deductions only if the requirements of §274 are satisfied. WBF expenditures for insurance that would not have been deductible under §264 if made directly by the employer are not qualified direct costs and thus, no deductions are available to the employer with respect to such expenditures. H. Rep., pp. 1277-1278.

[21] The House Report provides the following example: "[i]f an employer contributes to a fund to pay premiums or considerations for insurance under a plan, then the qualified direct cost for the year would be determined on the basis of the cost of the insurance for the period for which the coverage is provided, without regard to whether any part of that cost is excludable from the gross income of an employee. On the other hand, to the extent the liability is self-insured, the time at which benefits would be includable would be based on the time at which benefits are paid, rather than the time of current insurance coverage, because this is the time when benefits would be included if the self-insured benefits were provided directly by the employer on an unfunded basis." H. Rep., p. 1278, footnote 13.

[22] Act §511(a) adding new Code §419(c)(3)(C).

[23] Act §511(a) adding new Code §419A(a).

[24] *See* Act §511(a) adding new Code §419A(b).

[25] Act §511(a) adding new Code §419A(c), defining "account limit."

[26] Conf. Rep., p. 1156.

[27] Conf. Rep., p. 1156.

[28] Act §511(a) adding new Code §419A(c)(5).

[29] Act §511(a) adding new Code §419A(c)(2).

[30] Act §513(a). *See* discussion in II, B, *infra.*

[31] Act §223(a) amends Code §79. The $50,000 limit with respect to §79 may not apply in the case of certain grandfathered employees as defined in the amendment to §79. Act §223(d).

[32] Act §511(a) adding new Code §419A(c)(3).

[33] Act §511(a) adding new Code §419A(c)(4)(B).

[34] Act §511(a) adding new Code §419A(c)(4)(A).

[35] Act §511(a) adding new Code §419A(c)(5).

[36] Act §511(a) adding new Code §419A(c)(5)(B)(i) and (ii). The Conference Report indicates that for any safe harbor limitation based on prior plan costs, insurance premiums may not be taken into account, because the conferees did not intend that a WBF was to be used as a vehicle for prepayment of insurance premiums for current benefits. Conf. Rep., p. 1158.

[37] Act §511(a) adding new Code §419A(c)(5)(B)(iv).

[38] Conf. Rep., p. 1158.

[39] Act §511(a) adding new Code §419(d).

[40] Act §511(a) adding new Code §419A(d)(2). This conforms to Act §528 amending Code §415 to provide that contributions to a defined benefit plan allocated for medical benefits will be treated as annual additions to a defined contribution plan for purposes of Code §415(c).

[41] Act §511(a) adding new Code §419A(d)(3). It is interesting to note that for purposes of the Act's amendment to §401(h) concerning post-retirement medical benefits, the §416 definition of key employee, is not used, but rather, the limits are imposed only for 5-percent owners. Act §528(b).

[42] Act §511(a) adding new Code §419A(f)(5).

[43] Conf. Rep., p. 1158.

[44] Act §511(a) adding new Code §419A(h).

[45] Conf. Rep., p. 1159.

[46] Act §511(a) adding new Code §419A(e)(7).

[47] Act §511(a) adding new Code §419(c)(4).

[48] Act §511(a) adding new Code §419(d).

[49] Act §511(b) amending §512(a)(3). Note that employers that sponsor WBFs that are not tax-exempt under §501(c)(7),(9),(17) or (20) will be subject, nevertheless, to the unrelated business income rules of §512(a)(3) by virtue of their excess being deemed unrelated business income. Act §511 adding new Code §419A(g).

[50] Section 512(a)(3)(B).

[51] *I.e.*, new Code §419(b). For a discussion of the new account limits, *see* II, A, 2, *infra.*

[52] Act §511(b) adding new paragraph (E)(i) to §512(a)(3).

[53] Act §511(b) adding new paragraph (E)(ii) to §512(a)(3).

[54] Act §511(b) adding new paragraph (E)(iii) to §512(a)(3).

[55] Act §511(b) adding new paragraph (E)(iii)(II) to §512(a)(3).

[56] Conf. Rep., p. 1163.

[57] Act §511(b) adding new paragraph (E)(iii)(III) to §512(a)(3).

[58] Act §511(b) adding new paragraph (E)(iv) to §512(a)(3).

[59] Act §511(c) adding new Code §4976.

[60] *See* discussion in II, B, *infra.*

[61] Act §511(c) adding new Code §4976(b).

[62] The excise tax is imposed on the employer while the unrelated business income tax is paid by the trust.

[63] Act §511(e).

[64] Act §511(e) provides that any plan amendment made pursuant to a collective bargaining agreement that amends the plan solely to conform to a requirement added by §511 of the Act, is not treated as a termination of the collective bargaining agreement.

[65] Act §511(e)(4).

[66] Act §511(e)(2).

[67] Act §513 adding new Code §505(a)(1).

[68] Act §513(a) adding new Code §505(b)(1).

[69] House Report, p. 1290.

[70] Act §513 adding new Code §505(b)(2).

[71] Act §513(a) adding new Code §513(b)(1).

[72] Act §513(a) adding new Code §505(b)(5).

[73] Act §513(a) adding new Code §505(b)(4).

[74] *See* II, A, 2, f.

[75] Conf. Rep., p. 1164.

[76] Conf. Rep., p. 1164.

[77] Act §513(c).

[78] Act §513(c)(2). The Conference Report confirms that this provision does not affect the integration of long-term disability benefits for employees who are disabled before the effective date. Conf. Rep., p. 1165.

[79] Act §513(c)(2).

[80] Act §513(a) adding new Code §505(c).

[81] Act §513(c)(1).

[82] *See* discussion in II, A, 1, *infra.*

[83] Act §512(a)(2).

[84] Act §512(a)(1).

[85] Section 404 of the Code provides rules for the deduction of amounts paid under a plan of deferred compensation.

[86] Code §404(a)(5).

[87] 698 F.2d 1196 (Fed. Cir. 1982).

[88] As applied to education benefits, the case is no longer of concern since Code §127, concerning educational benefit plans, has expired.

[89] Act §512(a)(1).

[90] Section 404(a)(5).

[91] Act §512(a)(2).

[92] Act §512(a)(2).

[93] Act §512(a)(2)(B)(ii).

[94] Act §512(c)(2). All other extended vacation pay plans are considered to be deferred benefits.

[95] Conf. Rep., p. 1160.

[96] Act §512(e)(1).

[97] Presumably, there will be additional costs even under the safe harbor rules since the Conference Report requires that the employer demonstrate "under the general standards provided by the bill" that the reserves are reasonable. Conf. Rep., p. 1158. The general standards in new Code §419(A)(c), at least with regard to post-retirement medical and life insurance benefits, require that reserves be actuarially determined.

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CHAPTER 48

NEW PROVISIONS FOR ESOPs

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I. Introduction

A. Background

An employee stock ownership plan ("ESOP") is a qualified plan under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust. Dividends paid on stock held in trust for employees may be distributed to employees or may be held in the trust. Prior to the TRA, gain realized on the sale of employer securities to an ESOP was generally recognized and was taxed as capital gain.

An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. Under §44G(a)(2), the credit is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the credit is limited to one-half of 1 percent. Prior to the TRA, with respect to compensation paid or accrued in 1985-87, the limit was three-quarters of 1 percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

An ESOP that borrows to acquire employer stock is referred to as a "leveraged ESOP." Under a leveraged ESOP, the employer is allowed a deduction, within limits, for contributions to the plan which are applied by the plan to repay loan principal. Such limits apply notwithstanding the deduction limits applicable to other qualified plans sponsored by the employer. No deduction limit applies to an employer's ESOP contributions that are applied by the plan to pay interest on the loan.

Employer securities that have been allocated to participants' accounts under a tax credit ESOP may not be distributed for 84 months after the date of allocation. The 84-month holding period requirement does not apply in the case of (1) death, disability, or separation from service, (2) certain transfers of participants to acquiring employers, and (3) certain sales of subsidiaries.

B. Reasons for Change

Congress believed that, in light of the budget deficits, it was appropriate to freeze the maximum income tax credit for contributions to a tax credit ESOP at one-half of 1 percent of payroll. Congress also believed, however, that "alternative tax incentives, applicable with respect to both tax credit ESOPs and leveraged ESOPs, are important to encourage employee stock ownership."

II. Overview

Prior to the TRA, the limit on the tax credit for employer contributions to an ESOP was scheduled to increase from one-half of 1 percent of payroll in 1983 and 1984 to three-fourths of 1 percent in 1985. Act §14 freezes the limit at one-half of 1 percent through 1987. After 1987, the credit is scheduled (as under prior law) to expire.

The TRA contains a number of tax incentives designed to encourage employee stock ownership. First, the legislation permits a tax-free rollover of the proceeds from the sale of a business to an ESOP or to certain worker-owned cooperatives, provided (1) the proceeds are reinvested in the securities of another business and (2) immediately after the sale, the ESOP owns at least 30 percent of the value of employer securities. Second, a corporate deduction is allowed for dividends paid on ESOP stock, provided the dividends are paid out currently to employees. Third, a bank, insurance company, or other commercial lender is permitted to exclude from income 50 percent of the interest received on loans to ESOP sponsors, provided the loan proceeds are used to finance an ESOP's acquisition of employer stock. Fourth, liability for estate taxes may be assumed by an ESOP in return for a transfer from the estate of stock of an equal value, provided the company sponsoring the ESOP guarantees payment of the taxes.

The provisions are effective for tax years beginning after July 18, 1984.

III. Detailed Analysis

A. Tax-Free Rollover on Sale to Employees

Act §541 adds Code §1042. Section 1042 accords nonrecognition to gain from certain sales of employer stock to ESOPs or worker-owned cooperatives. For a sale to qualify for nonrecognition treatment, several requirements must be satisfied.

First, the seller must elect nonrecognition under §1042. The election must be filed not later than the due date (including extensions) for filing the seller's income tax return for the taxable year in which the sale occurs.

Second, if the sale is to an ESOP, the seller must file with the Service a written statement executed by the employer of the employees covered by the ESOP. In the statement, the employer must consent to the application of

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post-TRA §4978(a), which imposes an excise tax on certain dispositions of employer securities by an ESOP or a worker-owned cooperative. Alternatively, if the sale is to a worker-owned cooperative, the seller must file with the Service a written statement executed by an authorized officer of the cooperative. As with the other alternative, the written statement must consent to the application of §4978(a). The excise tax imposed by §4978 is discussed later in this chapter.

Third, the securities sold to the ESOP or worker-owned cooperative must be "qualified securities." Qualified securities are employer securities (as defined in §409A(l)) which (1) are issued by a domestic corporation that has no securities outstanding that are readily tradable on an established securities market, (2) have been held by the seller for more than one year at the time of the sale and (3) were not received by the seller in a distribution from a qualified plan or in a transfer pursuant to an option or other right to acquire stock to which §§83, 422, 422A, 423 or 424 applies.

Fourth, the sale must be to an ESOP as defined in §4975(e)(7) or to an "eligible" worker-owned cooperative. An eligible worker-owned cooperative is any organization (1) which is described in §1381, (2) a majority of the membership of which is composed of employees of the organization, (3) a majority of the voting stock of which is owned by members, (4) a majority of the board of directors of which is elected by the members on the basis of one person, one vote, and (5) a majority of the allocated earnings and losses of which are allocated to members on the basis of patronage, capital contributions, or some combination of patronage and capital contributions.

Fifth, the ESOP or worker-owned cooperative must own, immediately after the sale, at least 30 percent of the total value of the qualified securities of the employer outstanding at that time.

Sixth, no portion of the assets of the ESOP or cooperative attributable to qualified securities acquired by the ESOP or cooperative pursuant to the sale can accrue under the ESOP, or be allocated by the cooperative, for the benefit of the seller, any person who is a member of the family of the seller (within the meaning of §267(c)(4)), or any other person who owns (after application of §318(a)) more than 25 percent in value of any class of outstanding qualified securities.

Seventh, the seller must purchase "qualified replacement property" within the "replacement period." "Qualified replacement property" means any securities (as defined in §165(g)(2)) issued by a domestic corporation which does not, for the taxable year in which such securities are issued, have passive investment income (as defined in §1362(d)(3)(D)) that exceeds 25 percent of the gross receipts of the corporation for that taxable year. "Replacement period" means the period which begins three months before the date on which the sale of securities to the ESOP or worker-owned cooperative occurs and which ends 12 months after the date of the sale.

If all of these requirements are satisfied, any gain realized on the sale will be recognized only to the extent that the amount realized on the sale exceeds the cost to the seller of the qualified replacement property purchased by him. The seller's basis in the replacement property is equal to its purchase price reduced by the amount of gain not recognized on the sale to the ESOP or worker-owned cooperative. If more than one item of replacement property is purchased, the basis of each item shall be reduced by an amount determined by multiplying the total gain not recognized on the sale by a fraction. The numerator of that fraction is the cost of the item of replacement property in question. The denominator is the total cost of all such items of property.

The seller's holding period in qualified replacement property includes his holding period for the qualified securities which he sold to the ESOP or worker-owned cooperative.

The period of limitations for assessing any deficiency with respect to gain realized but not recognized on the sale does not expire before three years from the date on which the seller notifies the Service of (1) the seller's cost of acquiring replacement property, (2) the seller's intention not to acquire replacement property, or (3) the seller's failure to acquire replacement property within the replacement period.

No acquisition of securities by an underwriter in the ordinary course of his trade or business as an underwriter, whether or not guaranteed, is to be treated as a sale for purposes of §1042.

Section 1042 applies to sales of securities in taxable years beginning after July 18, 1984.

B. Tax on Certain Dispositions of Employer Securities

Act §545 adds Code §4978. Section 4978 imposes an excise tax on certain dispositions of employer securities by ESOPs or worker-owned cooperatives. The excise tax applies if, during the three-year period after the date the ESOP or cooperative acquired any qualified securities in a sale to which §1042 applied, the ESOP or cooperative disposes of any qualified securities and either (1) the total number of shares held by the ESOP or cooperative after the disposition is less than the total number of qualified securities held immediately after the earlier sale qualifying for nonrecognition or (2) the value of qualified securities held by the ESOP or cooperative after the disposition is less than 30 percent of the total value of all qualified securities as of the disposition.

If these conditions are satisfied, an excise tax is imposed on the disposition. The tax is generally equal to 10 percent of the amount realized on the disposition. In applying this formula, however, the amount realized that is taken into account is not to exceed that portion applicable to qualified securities acquired in the nonrecognition sale. This portion is to be determined as if the securities so allocable were disposed of before any other securities. Further, in applying the 10 percent formula, the amount realized on any distribution to an employee for less than fair market value is to be determined as if the qualified security had been sold to the employee at fair market value.

The tax imposed by §4978 must be paid by the person that made the written statement consenting to the application of the tax that was required under §1042. Thus, if the disposition of qualified securities is by an ESOP, the tax

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must be paid by the employer. If the disposition is by a cooperative, the tax must be paid by the cooperative.

For purposes of the tax, a distribution of qualified securities is generally treated as a disposition. However, the tax does not apply with respect to any distribution (or sale) which is made by reason of (1) the death of the employee, (2) the retirement of the employee after the employee has attained 59½ years of age, (3) the disability of the employee (within the meaning of §72(m)(5)), or (4) the separation of the employee from the employer's service for any period which results in a one-year break in service (within the meaning of §411(a)(6)(A)). Additionally, in the case of any exchange of qualified securities for stock of another corporation in a reorganization described in §368(a)(1), the exchange is not treated as a disposition for purposes of the tax.

Both tax credit and leveraged ESOPs are subject to the tax. For purposes of the tax, "qualified securities" has the same meaning it has in §1042. Similarly, "worker-owned cooperative" has the same meaning it has in §1042.

The tax is effective for taxable years beginning after July 18, 1984.

C. Deduction for Dividends Paid on ESOP Stock

Act §542 adds Code §404(k). Section 404(k) allows a corporate employer to deduct dividends paid on stock held by an ESOP provided certain conditions are satisfied. First, the dividend must be paid in cash. Second, it must be paid with respect to stock held on the record date for the dividend by a tax credit or leveraged ESOP which is maintained by the distributing corporation or by any other corporation that is a member of a controlled group that includes the distributing corporation. Third, the dividend must be paid, in accordance with the plan provisions, to the participants in the ESOP or, alternatively, the dividend must be paid to the plan and then distributed in cash to the participants not later than 90 days after the close of the plan year in which the dividend is paid.

If a dividend is deductible to the corporate employer under this provision, the recipient of the dividend will not be entitled to a dividend exclusion under §116. Act §542 amends §116 to make it inapplicable to deductible dividends paid on stock held by an ESOP. If §116 were not made inapplicable to such dividends, some or all of the earnings represented by the dividends would go untaxed. They would not be taxed at the corporate level since the corporation is entitled to a deduction. Further, up to a specified ceiling, they would not be taxed at the shareholder level since the shareholder would be entitled to an exclusion from gross income under §116.

No withholding is required with respect to deductible dividends paid on stock held by an ESOP. This result is achieved through Act §542's amendment of §3405(d)(1)(B).

Section 404(k) applies to taxable years beginning after July 18, 1984.

D. Partial Exclusion of Interest Earned on ESOP Loans

Act §543 adds Code §133. Section 133 permits banks, insurance companies and other corporate commercial lenders to exclude from gross income 50 percent of the interest received with respect to a "securities acquisition loan." A securities acquisition loan is any loan to a corporate employer or ESOP, the proceeds of which are used to acquire employer securities (within the meaning of §409A(1)) for the ESOP.

If the loan is made to the employer rather than the ESOP, the legislative history indicates that the employer must, in turn, lend the proceeds to the ESOP. Regardless of whether the loan to the ESOP is direct or made via the employer, the ESOP must use the loan proceeds to purchase employer securities.

It is not necessary, however, that the entire loan proceeds be used to purchase employer securities. Section 133 applies even if only a portion of the proceeds are used for this purpose. In such a case, however, the interest excluded from gross income is limited to the portion of the interest received that is allocable to the loan proceeds used to purchase the employer securities.

Section 133 does not apply to loans between members of a controlled group of corporations. The section refers to §409A(1)(4) for the definition of a controlled group. Further, §133 does not apply to interest on loans between an ESOP and the employer maintaining the ESOP or between an ESOP and any member of a controlled group of corporations that includes the employer.

For purposes of §133, "ESOP" has the same meaning it has in §4975(e)(7).

Section 133 applies to loans used to acquire employer securities after July 18, 1984.

E. Assumption of Estate Tax Liability by ESOP or Cooperative

Act §544 adds §2210 to the Code. Section 2210 permits, under certain circumstances, an ESOP or worker-owned cooperative to assume a decedent's estate tax liability in return for a transfer from the estate of employer securities having an equal value. The transfer of employer securities to the ESOP or cooperative may take one of three forms: (1) The securities may be "acquired from the decedent" by the ESOP or cooperative; (2) They may "pass" from the decedent to the ESOP or cooperative; or (3) They may be transferred by the executor to the ESOP or cooperative.

If a transfer as described occurs and if the executor elects the application of §2210 and files certain agreements with the Service, the executor is relieved of liability for payment of that portion of the estate tax which the ESOP or cooperative is required to pay under §2210(b). Under this subsection, the ESOP or cooperative must pay that portion of the decedent's estate tax which is equal to the lesser of (a) the value of the employer securities transferred to the ESOP or cooperative which is included in the decedent's gross estate, or (b) the estate tax imposed on the decedent's taxable estate reduced by the sum of the credits allowable against such tax.

Election of §2210 must be made before the due date (including extensions) for filing the estate tax return. Similarly, the written statements required to be filed by the executor in conjunction with the election must be filed before that date. The written statements required to be

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filed are: (1) a written agreement signed by the plan administrator of the ESOP, or by an authorized officer of the cooperative, consenting to the assumption of estate tax liability by the ESOP or cooperative; and (2) in the case of assumption of estate tax liability by an ESOP, a written agreement signed by the employer maintaining the ESOP in which the employer consents to the application of §2210(d).

Under §2210(d), an employer maintaining an ESOP that has agreed to assume estate tax liability under §2210 is required to guarantee (in such manner as the Treasury may prescribe) the payment of the estate tax liability assumed by the ESOP, including any interest payable under §6601 which is attributable to the assumed liability.

The ESOP or cooperative, if it qualifies, may elect under §6166 to defer payment of the estate tax liability assumed by it. An election to defer payment is allowed, however, only if the executor of the decedent's estate also elects §6166 treatment with respect to employer securities includible in the estate. If the ESOP or cooperative elects §6166, the election must be filed with the Service before the due date (including extensions) for filing the estate tax return.

For purposes of §2210, "employer securities" has the same meaning it has in §409A(1). "ESOP" has the meaning assigned to it in §4975(e)(7). "Worker-owned cooperative" has the same meaning it has in §1042. Finally, "plan administrator" has the meaning assigned it in §414(g).

In connection with the enactment of §2210, Act §544 adds Code §6018(c). Under §6018(c), in the case of an election under §2210, the executor is required to file an estate tax return with respect to the portion of the estate tax that is in excess of the tax assumed by the ESOP or cooperative. The plan administrator of the ESOP, or the cooperative, as the case may be, is required to file an estate tax return with respect to that portion of the tax that is assumed by the ESOP or cooperative.

Sections 2210 and 6018(c) apply to estates of decedents which are required to file returns on a date (including any extensions) after July 18, 1984.

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CHAPTER 49

REVISED DISTRIBUTION AND TAXATION RULES FOR QUALIFIED PLANS AND IRAs

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I. Required Distribution Rules for Qualified Plans and IRAs

A. Introduction

1. Qualified Plans

Section 401(a)(14) requires that a qualified plan provide for the payment of benefits to the participant, unless the participant otherwise elects, no later than the 60th day after the end of the plan year in which (i) the participant reaches the earlier of age 65 or the normal retirement age of the plan, (ii) the 10th year after the participant commences participation in the plan, or (iii) the participant terminates his service with the employer, whichever is the latest of these three events. Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), no additional mandatory distribution requirements existed except with respect to plans covering self-employed individuals (H.R. 10 Plans). In the case of H.R. 10 Plans, distributions were generally required to commence not later than the year in which the employee attained age 70½ or retired, whichever event was later.[1]

TEFRA [2] revised §401(a)(9) to extend the H.R. 10 Plan rules to all qualified plans, effective generally for plan years beginning after 1983.[3] Under §401(a)(9)(A), a plan is not qualified unless it provides that each employee's entire interest in the plan will be distributed, or will begin to be distributed, to the employee no later than the taxable year in which he reaches age 70½ or, if later, the year in which he retires. In the case of a key employee who is a participant in a top-heavy plan, distributions must begin in the year the employee attains age 70½, regardless of when he retires. If an employee's interest is not completely distributed in the first year that a distribution is required under §401(a)(9)(A), the interest must be distributed over one of the four following periods:

(a) The life of the employee;

(b) The joint lives of the employee and the employee's spouse;

(c) A period not extending beyond the life expectancy of the employee; or

(d) A period not extending beyond the joint life expectancy of the employee and the employee's spouse.

Regulations to implement the foregoing distribution rules are to be prescribed. Although at the time of enactment of the TRA regulations under §401(a)(9) had yet to be issued, the Service did provide interim guidelines in Notice 83-23.[4] The Service in this Notice has taken the position that generally the IRA distribution rules set forth in Regs. §1.408-2(b)(6) will apply to qualified plans in determining the minimum payment that must be made once distributions must commence. Under this regulation, the fixing of the minimum payment period, based on life expectancy, can be made only once at age 70½. This rule is more restrictive than the distribution rules that applied to H.R. 10 plans since the regulations for such plans permitted the periodic redetermination of life expectancy over which the minimum distributions must be made.[5] By periodically redetermining life expectancy, the minimum payment period is extended. Since §401(a)(9) was intended to be an extension of the H.R. 10 Plan rules, the Service position in Notice 83-23 is arguably incorrect.

Under §401(a)(9)(B), as amended by TEFRA, mandatory distributions of a participant's interest in a qualified plan are required after the participant's death. Generally, all qualified plans must provide for distribution of the employee's entire interest, or completion of distributions if payment has commenced, within 5 years after the employee's death. If the distribution has commenced to the employee's surviving spouse and the surviving spouse dies before receipt of the employee's full interest, the remaining portion of the employee's interest must be distributed within five years after the death of the surviving spouse. This five-year rule does not apply, however, if the distribution of the employee's interest has commenced and such distribution is for a period of years not exceeding the life expectancy of the employee or the joint life expectancy of the employee and spouse.

The §401(a)(9) required distribution rules, as added by TEFRA, were generally effective for plan years beginning after December 31, 1983.[6]

2. IRAs

Sections 408(a)(6) and (7) and 408(b)(3) and (4) set forth mandatory distribution requirements for individual retirement plans (IRAs) substantially similar to those imposed by TEFRA for qualified plans.[7] The chief difference between the qualified plan required distribution rules and the IRA required distribution rules is that benefits must commence under an IRA by the end of the taxable year in which the owner attains age 70½, without regard to whether the owner has retired.

B. Outline of New Provisions

The TRA [8] completely revises §401(a)(9) to provide greater flexibility in the required distribution rules, particu-

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larly where such distributions are made to beneficiaries other than the spouse of a participant. The Senate Finance Committee Report [9] explains that the revision of §401(a)(9) stemmed from a concern that the section was unduly restrictive. The Committee observed that a participant may desire to provide one or more individuals, other than the participant's spouse, the right to receive a portion of the participant's retirement benefits remaining at death in a form based on the life or lives of the beneficiary or beneficiaries.

As amended by the TRA, §401(a)(9) provides that a plan must require distribution of a participant's entire interest no later than April 1 of the calendar year following the plan year in which the participant reaches age 70½, or retires, (unless the employee is a 5-percent owner), whichever is later. Alternatively, the participant's interest must commence on that April 1 and be paid over the life of the participant, the lives of the participant and the designated beneficiary, or a period not extending beyond the life expectancy of the participant or joint life expectancy of the participant and the designated beneficiary.

If the participant dies before his entire interest has been distributed and distributions have commenced before death, the remaining portion of the participant's interest must be distributed at least as rapidly as distribution would have occurred under the method in effect prior to death. If benefits had not begun before the participant's death, the participant's entire interest must generally be distributed within five years of the death of the participant, with two exceptions. The first exception permits distribution over the life or life expectancy of the designated beneficiary, provided distributions begin no later than one year after the participant's death. The second exception permits distribution of the participant's interest over the surviving spouse's life or life expectancy, with distributions commencing no later than the date on which the participant would have attained age 70½.

Under regulations to be prescribed, "similar" mandatory distribution rules will be provided for IRAs.

C. *Effective Dates*

1. In General

The amendments made to the required distribution rules by the TRA apply to "years" beginning after December 31, 1984.[10] Thus, §401(a)(9), as revised by the TRA, applies to plan years beginning after 1984, and the required distribution rules to be applied to IRAs pursuant to regulations authorized by §408(a)(6) and (b)(3) will apply to taxable years of the IRA owner beginning after 1984. Governmental plans, however, are not subject to the new required distribution rules until plan years beginning after 1986.[11] If a plan is maintained pursuant to one or more collective bargaining agreements ratified no later than July 18, 1984, the revised distribution rules do not apply to years beginning before the earlier of (i) the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension of such agreement after July 18, 1984), or (ii) January 1, 1988.[12]

2. Repeal of TEFRA Required Distribution Rules

The TRA [13] repeals the required distribution rules added by TEFRA. The repeal is effective as if it had been included in TEFRA.[14] Under a transitional rule in the TRA [15] distributions made subsequent to 1984 in accordance with a designation made before January 1, 1984, by an employee pursuant to a designation permitted under a TEFRA transitional rule [16] will not result in disqualification under revised §401(a)(9).

Observation: The repeal of the TEFRA required distribution rules by the TRA means that the pre-TEFRA required distribution rules, which applied only to H. R. 10 Plans, will remain in effect until the end of 1984. Although TEFRA also amended the IRA post-death distribution rules to require generally that IRA post-death distributions be completed no later than five years after the death of the owner or the owner's surviving spouse, thereby eliminating the formerly available option of purchasing an immediate annuity payable for the life of a beneficiary or beneficiaries of the owner or the owner's spouse upon death, the TRA does not repeal this change.[17] Accordingly, the more restrictive TEFRA post-death required distribution rules for IRAs will continue to apply to individuals dying during 1984, unless technical corrections are subsequently enacted restoring the pre-TEFRA post-death distribution rules for 1984.

D. *Detailed Analysis*

1. Qualified Plans

a. Pre-Death Distributions

As revised by the TRA, §401(a)(9)(A) requires that a qualified plan contain provisions providing for the distribution of the "entire interest of each employee to the employee no later than the required beginning date." Alternatively, the entire interest must be distributed over one of the following periods:

(i) The life of the employee;

(ii) The lives of the employee and the "designated beneficiary;"

(iii) A period not extending beyond the life expectancy of the employee; or

(iv) A period not extending beyond the life expectancy of the employee and the designated beneficiary.

If one of the above four alternatives is selected, the distributions must commence not later than the required beginning date, in accordance with regulations to be prescribed.

Although the employee's entire interest is subject to the foregoing required distribution rules, the Conference Committee states that this "entire interest" is not intended to include permissible and ancillary benefits, such as lump sum death benefits, that are not available to the employee.[18]

The "required beginning date" is defined in §401(a)(9)(C) as the April 1 of the calendar year following the later of (i) the calendar year in which the employee attains age 70½ or (ii) the calendar year in which the employee retires. If an employee is a 5-percent owner (as defined in §416(i)(1)(B)(i)) with respect to the plan year

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ending in the calendar year in which such employee attains age 70½, the "required beginning date" is the April 1 of the calendar year following such employee's age 70½ year, unless the plan involved is an Employee Stock Ownership Plan that is prohibited under §409(d) from distributing employer securities allocated to that employee for the 84-month specified in §409(d).

Example: Assume that a 5-percent owner is a participant in an employee stock ownership plan, and employer securities are allocated to this participant in April of 1985 and April of 1986. Further assume that the participant reaches age 70½ in 1987, and the only amounts allocated to his account on April 1, 1988, the date distributions otherwise must commence, are the employers securities allocated in 1985 and 1986. If the 5-percent owner does not die, become disabled, or retire, distributions with respect to the employer securities allocated in April 1985 need not commence until May of 1992 and distributions with respect to the securities allocated in April 1986 need not commence until May 1993.

Note: The rule that a 5-percent owner must commence distribution at 70½, without regard to retirement, is more liberal than the former rule mandating distributions at that age for key employees in a top-heavy plan. However, the 5-percent owner rule applies irrespective of whether the plan is top-heavy.

As mentioned above, the rule permitting the distribution of the participant's entire interest over a period based on life expectancy is to be implemented through regulations. The Conference Report [19] states an intention that these regulations will require that distributions over any of the permissible periods must satisfy a minimum distribution rule similar to the distribution rules presently provided. Under present law,[20] the annual distribution must not be less than the balance in the participant's account at the beginning of the particular year in the required distribution period divided by the life expectancy of the participant (or the joint life expectancy of the participant and the participant's spouse). Although the current rules allow life expectancy, and thus the minimum distribution period, to be determined only once,[21] §401(a)(9)(D) provides that life expectancy of a participant and the participant's spouse (other than in the case of a life annuity) may be redetermined. Such redeterminations may not take place more frequently than annually.

Observation: By stretching out the minimum distribution period through recalculation of life expectancy, greater income deferral can be achieved. Also, in the case of a defined contribution plan, the period during which the participant's remaining account balance can accumulate income tax-free is expanded, thereby increasing the total distributable amount.

If the minimum distribution is made over the joint life expectancy of the participant and a non-spouse beneficiary, it is intended that Treasury regulations provide a method of recalculation under the minimum distribution rule that takes into account the change in the life expectancy of the participant but not the change in the life expectancy of the non-spouse beneficiary.[22]

The minimum distribution rule will be satisfied by a defined benefit pension plan if distributions over a permissible period take the form of "substantially nonincreasing annual payments." [23] However, under certain circumstances, it is intended that the regulations will permit the defined benefit pension plan distributions to increase, such as to reflect cost-of-living increases, cash refunds of employee contributions upon an employee's death, an increase in annual benefit payments to the employee upon the death of the employee's beneficiary, and increases based on investment experience.[24] But in no event may increasing payments be permitted if the effect of the increase is avoidance of the minimum distribution rules.[25]

The Conference Report [26] provides that a defined contribution plan will satisfy the minimum distribution rule if the payments are subject to an irrevocable payout schedule that satisfies the minimum distribution rule. Moreover, a defined benefit pension plan or a defined contribution plan may satisfy the minimum distribution rule by distributing an immediate annuity contract providing for payments that satisfy the minimum distribution rule (*e.g.*, provides for substantially nonincreasing annual payments).

The Conference Report [27] also states that plan distributions, including distributions under annuity contracts, must continue to satisfy the incidental benefit rule of present law.[28] The incidental benefit rule generally requires that a qualified plan must not permit any form of distribution under which the present value of the payments projected to be made to the participant, while living, is not more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries.[29] However, distributions satisfying the rules relating to qualified joint and survivor annuities in §401(a)(11) will satisfy the incidental benefit rule.[30]

b. Post-Death Distributions

Section 401(a)(9)(B)(i) requires that a qualified plan specifically provide that if a participant's entire interest has commenced over one of the four permitted periods, and the participant dies before that entire interest has been distributed, the remaining portion of such interest must be distributed at least as rapidly as under the method of distribution in effect prior to death. The Conference Report [31] furnishes the following example:

Example: If a participant elected to receive benefits in the form of equal annual installments for a term of 20 years (a term not extending beyond the life expectancy of the participant), and the participant died after benefits had been paid for 10 years, the participant's remaining interest can be distributed in equal annual installments over a term not exceeding 10 years. The Conference Report further states, however, that the beneficiary can elect to accelerate payments of the remaining interest.

Comment: If the designated beneficiary of the participant who dies is the participant's spouse, and the method of distribution being used prior to the participant's death is to provide equal annual installments over the period measured by the joint life expectancy of the participant and the participant's spouse, it is not entirely clear whether the minimum distribution period can be recomputed after the

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participant's death to take into account increases in the spouse's life expectancy. Generally, a payment period based on two life expectancies will be substantially longer than a period based on a single life expectancy. However, if the spouse survives for a long enough period of time, the spouse's single life expectancy will exceed the minimum distribution period based on the joint life expectancy of the deceased participant and the participant's spouse. Since, as previously mentioned, §401(a)(9)(D) permits the redetermination of the life expectancy of an employee and an employee's spouse, there is a basis for permitting the post-death redetermination of the minimum distribution period using the surviving spouse's single life expectancy. However, a question exists as to whether a redetermination of the minimum distribution period after death satisfies the rule that the remaining portion of the participant's interest be distributed at least as rapidly as the distribution method being used prior to death. It should also be noted, as will be described below, that if distributions have not begun at death and post-death distributions are based on a beneficiary's life expectancy, the blanket position is taken that life expectancy may not be recalculated. Presumably, regulations will clarify this issue.

Under §401(a)(9)(B)(ii), a qualified plan must further provide that if a participant dies before distribution of the participant's interest has begun, the entire interest of the participant must be distributed within five years after the death of the participant. Two exceptions to the five-year rule are provided. Under the first exception,[32] if (i) any portion of the participant's interest is payable to (or for the benefit of) a designated beneficiary, (ii) such portion will be distributed in accordance with regulations for the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and (iii) the distributions begin no later than one year after the date of the participant's death or such later date as may be prescribed in regulations, then the portion payable to the designated beneficiary will be treated as having been completely distributed on the date on which such distributions begin. The Conference Report [33] states that it is intended that this exception will apply only if the amounts are paid to the beneficiary under rules satisfying the minimum distribution rule applicable to pre-death distributions. The Report further states that recalculation of life expectancy is not permitted under this exception.

Comment: The Conference Committee's blanket statement that redetermination of life expectancy is prohibited would appear to rule out a redetermination even if the surviving spouse is the designated beneficiary. Although, as will be described, the second exception applies a special rule for the surviving spouse of a participant, the principal effect of the second exception is to postpone the time when distributions to the surviving spouse must commence. Otherwise, the requirements of the exception are grafted from those of second the first exception.

Regulations may be issued under the first exception providing exceptions to the rule that benefits must commence to a designated beneficiary within one year after death. As one example, the Conference Report [34] notes that an exception may be appropriate if a beneficiary cannot be located. However, the Conference Report further states that the regulations could require that catch-up distributions be made with respect to amounts deferred under exceptions to the one-year commencement of distribution rule.

The second exception to the five-year rule for post-death distributions essentially provides a rule postponing the commencement date for post-death distributions if the designated beneficiary is the surviving spouse of the participant and the remaining portion of the participant's entire interest will be distributed over the surviving spouse's life or over a period not extending beyond the life expectancy of the spouse.[35] In this case, the date on which the distributions are required to begin will not be "earlier than the date on which the employee would have attained age 70½".

Observation: In contrast to the statutory language, the Conference Report [36] states that the distributions must commence "no later than the date" on which participant would have attained age 70½. Regulations can obviously reconcile this difference between the Conference Report and the statute by providing that distributions must commence on the day the participant would have reached the age 70½. However, in view of the statutory language, implying that a later commencement date may be established, it would not be surprising if the regulations provided some flexibility in selecting a commencement date beyond the exact date on which the participant would have reached age 70½, such as permitting payments to begin with the first month following the date in which that age would have been reached, in order to ease potential administrative burdens in complying with the special exception.

The second exception further provides that if the surviving spouse dies before the distributions to the spouse begin in accordance with the second exception, the five-year rule is to be applied as if the surviving spouse were the participant. Thus, any portion payable to the surviving spouse must be distributed within five years after the spouse's death.

Note: The Conference Report [37] states that it is intended that payments to the surviving spouse will satisfy the exception to the five-year distribution rule if payments are made pursuant to a qualified joint and survivor annuity meeting the requirements of §401(a)(11).

Section 401(a)(9)(F) contains an interesting rule that, under regulations to be prescribed, any amount paid to a child shall be treated as if it had been paid to the surviving spouse if such amount becomes payable to the spouse upon the child's reaching majority (or other designated event permitted under regulations). For example, if a participant dies before distributions commence, and the participant has elected that distributions after death be paid over spouse's life expectancy, the participant presumably will be able to designate that a portion of the annual minimum distribution payment be paid to one or more of his children during minority, which portion will revert to the participant's spouse when the children reach age of majority. Use of this income-splitting feature should lower the tax burden on the family of the participant during the period the children must be provided with support, yet it will not diminish the security of the surviving spouse since the portion directed to the children will eventually revert back to the spouse.

Comment: It does not appear that a plan must specifically provide for the application of the exceptions to the

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five-year rule for post-death distributions. Neither of the exceptions is prefaced by the requirement that the plan incorporate the exception in the plan document. Further, the exceptions are drafted in terms of providing that the five-year rule is satisfied if there is compliance with the exceptions.

2. IRAs

The TRA [38] repeals the mandatory distribution rules formerly contained in §§408(a)(6) and (7) and 408(b)(3) and (4), requiring instead that regulations be issued prescribing rules similar to the rules of §401(a)(9) for the distribution of IRA benefits. Presumably, the regulations will continue the rule that IRA benefits must commence when the owner reaches age 70½, but perhaps setting the commencement date for benefits as the April 1 of the calendar year following the year in which the IRA owner reaches 70½, which is the date provided in §401(a)(9).

The new TRA provisions overrule the Regs. §1.408-2(b)(6) rule that the determination of life expectancy is made only at the time the IRA owner attains age 70½ and cannot be recalculated to take into account subsequent increases in life expectancy.[39] Of course, life expectancy can be recalculated only with respect to the IRA owner and the owner's spouse.[40]

II. Rollovers of Partial Distributions

A. Introduction

In general, when a participant receives a distribution from a qualified plan or IRA, the participant is taxable on the distribution. If the distribution is from a qualified plan and consists of the balance credited to the participant, the participant has three options available: (i) the distribution may be taxed using the favorable 10-year income averaging rules of §402(e)(4); (ii) to the extent the distribution is attributable to amounts contributed in pre-1974 years, it is taxable at capital gain rates under §402(a)(2) unless the participant elects [41] to have the entire distribution treated under the 10-year income averaging rules; or (iii) the participant may elect to roll over all or part of the distribution to another qualified plan or IRA under §402(a)(5) and be subject to tax (at ordinary income rates) only on amounts not rolled over. If the distribution is from an IRA, only the third option, the rollover option, is available. However, in contrast to the requirement applicable to qualified plans that the distribution consist of the entire balance to the credit of the employee,[42] an IRA distribution may be rolled over even if it is only a partial distribution from the IRA.[43]

In order to qualify for rollover treatment, the distribution must be rolled over within 60 days of the date of distribution.[44] Rollover treatment is also available to a surviving spouse who is the recipient of a lump sum distribution from a qualified plan.[45] Substantially similar rollover rules are provided for qualified annuities and tax-sheltered annuities under §403.[46]

In addition to the foregoing options, if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation is generally not includible in the participant's gross income until the securities are sold or exchanged, regardless of whether all or a portion of the distribution is rolled over to another plan.[47]

B. Analysis

The TRA [48] amends §402(a)(5) to permit rollover treatment for partial distributions out of qualified plans, qualified annuity plans, and tax-sheltered annuity contracts. To qualify for rollover treatment, the partial distribution must meet the following requirements:[49]

> (1) The distribution must be at least equal to 50 percent of the balance to the credit of the employee in the plan, determined immediately before the distribution. Only the balance within the particular plan must be considered for purposes of the 50 percent requirement; amounts in other plans maintained by the same employer that otherwise must be aggregated for lump sum distribution purposes need not be taken into account under the partial distribution 50 percent test;
>
> (2) The distribution must not be one of a series of periodic payments;
>
> (3) The employee must elect rollover treatment for the partial distribution at the time and in the manner prescribed by regulations.

The entire partial distribution need not be rolled into the IRA; a taxpayer may retain a portion and be taxed on that amount.[50]

The election of rollover treatment for a partial distribution carries with it several detrimental tax consequences. The primary consequence is that 10-year income averaging and capital gains treatment will no longer be available with respect to any ensuing distribution out of that plan or out of any other plan maintained by the same employer that must be aggregated for lump sum distribution purposes.[51] A corollary to this rule is that any partial distribution rolled into the IRA may not subsequently be rolled back into a qualified plan or qualified annuity.[52] Consequently, it will not be possible to requalify the partial distribution for 10-year income averaging and capital gains treatment by the transfer of the distribution back to a qualified plan or annuity.[53] Moreover, upon a partial distribution that includes unrealized appreciation attributable to employer securities, taxation of the unrealized appreciation will no longer be deferred until the securities are sold or exchanged by the recipient.[54] Of course, if the securities are rolled into the IRA, taxation of the unrealized appreciation will be deferred until such time as the securities are distributed.

The maximum amount of a partial distribution that may be rolled into the IRA is the amount that would be includible in the participant's gross income.[55] Thus, any previously taxed amounts that the participant contributed to the qualified plan are not eligible for rollover, as is the case when the participant receives a lump sum distribution from the plan.

In a conforming change, §402(a)(7) has been amended to provide that the surviving spouse is to be treated in the same manner as the participant for purposes of the rollover rules. Thus, a surviving spouse who receives a qualifying distribution may elect to roll that distribution into an IRA and defer taxation.

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C. *Effective Date*

The new rules permitting the rollover of a partial distribution from a qualified plan to an IRA is effective for distributions made after July 18, 1984, in taxable years ending after that date.[56]

III. TRA Changes Affecting Taxation of Distributions

A. *Distributions from Employee-Funded Plans*

1. *Introduction*

Under present law, a qualified pension or annuity plan, tax-sheltered annuity contract, or government plan may be funded substantially or solely by employee contributions.[57] Although employee contributions to a qualified plan are generally not deductible,[58] an employee will enjoy a tax-free accumulation of earnings on the contributions until such time as they are distributed.

The chief limitation on employee contributions to a qualified plan, whether or not deductible, is that they may not have a discriminatory effect in favor of officers, shareholders, and highly compensated employees.[59]

Under §72,[60] nondeductible employee contributions may be withdrawn from a qualified pension or annuity plan without penalty, and amounts withdrawn before annuity payments begin from such a plan are treated as a return of nondeductible contributions not includible in gross income.[61] Withdrawals in excess of the amount of nondeductible contributions are, however, includible in income.[62]

The favorable treatment of nondeductible employee contributions to qualified pension plans and tax-sheltered annuities and government plans led to what Congress perceived to be an abuse.[63] According to the Senate Finance Committee Report,[64] certain financial institutions began promoting master and prototype qualified pension plans providing for no employer contributions but only nondeductible employee contributions. The Committee likened such plans to "tax-favored savings and brokerage accounts," noting "the ready availability of amounts attributable to employee contributions" to such plans, and stated its belief that the tax treatment of such plans should be changed to ensure their use as "bona fide retirement plans." [65]

2. *Analysis*

In response to the perceived abuse, Congress amended §72(e) to provide effectively that where substantially all of the accrued benefits under a qualified plan are derived from employee contributions, distributions from the plan will be treated as income until all income has been withdrawn.[66] A qualified plan for this purpose includes a qualified annuity plan and tax-sheltered annuity as well as a qualified plan described in §401(a). A plan is subject to this rule if 85 percent of the total contributions during a "representative period" are derived from employee contributions.[67] The "representative period" will be determined under regulations; the Conference Report suggests that five years might be representative under such regulations.[68] However, the Conference Report adds [69] that if less than 85 percent of the total contributions for all years during which the plan is in existence are employee contributions, the plan will not be subject to the new rules.

Comment: Under §72(g)(1), a 5-percent penalty tax is imposed on the amount of the distribution from an annuity contract includible in gross income, subject to several broad exceptions set forth in §72(g)(2). One exception to the penalty is provided for distributions from a qualified plan or annuity or tax sheltered annuity "described in subsection (e)(5)(D)." [70] It is not clear whether this exception will prevent the imposition of the penalty on taxable withdrawals from an employee-funded plan. Section 72(e)(7)(A) provides that §72(e)(5)(D) "shall not apply to any amount received" from an employee-funded plan. This language could be read as treating the withdrawal as being made from a plan not "described" in §72(e)(5)(D), in which case the 5-percent penalty would apply to the taxable portion of the withdrawal. However, the legislative history makes no mention of §72(g) or the penalty, potentially indicating that the penalty was not intended to be imposed on such withdrawals.

Under §72(e)(7)(C), a plan maintained by the Federal Government or instrumentality of the Federal Government will be aggregated with other such plans for purposes of the 85 percent test if the plan is "actively administered" by the Government or instrumentality. It will not be aggregated if administered by a commercial financial institution.[71]

The Conference Report [72] states that it is intended that contributions to a qualified cash or deferred arrangement under §401(k) pursuant to a salary reduction agreement not be treated as employee contributions to the extent the contributions are not currently includible in gross income.

The Conference Report [73] further states that it is intended that the 85 percent test will be applied by aggregating an existing thrift or savings feature associated with an employer-funded defined benefit arrangement. This aggregation is to be made only if the employer has consistently treated the two features as a single plan, such as by obtaining one determination letter and filing one annual return with respect to both features. Moreover, the Conference Report states that voluntary employee contributions to a qualified, defined benefit pension plan are not treated as a separate defined contribution plan merely because the voluntary contributions are considered contributions to a defined contribution plan in applying the overall §415(e) limits on contributions and benefits.

Note: The new rules treating amounts withdrawn from employee-funded plans as allocable first to income cannot be circumvented by characterizing the withdrawals as loans from the plan. Under §72(p)(3), as amended by the TRA,[74] an employee-funded plan described in §72(e)(7) will not be treated as a qualified plan for purposes of §72(p) which, as will be described below, permits certain loans of up to $50,000 from qualified plans to be received without income tax consequences. It should also be noted that under §72(e)(4), a loan out of an annuity contract or secured by an annuity contract will be treated at the distribution subject to the income characterization rules of §72(e)(2) and (e)(3).

3. *Effective Date*

The foregoing amendments to §72(e) and (p) will apply to any amount received or loan made by an employee-funded plan after October 16, 1984.

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B. Clarification of Loan Rules

1. Introduction

Effective generally for loans made after August 13, 1982,[75] TEFRA enacted §72(p) which provides that any loan from a qualified employer plan to a participant or beneficiary will be treated as having been received by such individual as a distribution.[76] Under §72(p)(2), a loan will not be treated as a distribution to the extent that the loan does not exceed the lesser of (i) $50,000 or (ii) "1/2 of the present value of the nonforfeitable accrued benefit of the employee under the plan (but not less than $10,000)." The exception is available only for a loan that must, by its terms, be repaid within five years, with an exception for certain loans related to a personal residence.

Although it was intended in TEFRA to set a $10,000 minimum for loans that would qualify under the foregoing exception, the statute did not clearly accomplish this result. The "but not less than $10,000" in the parenthetical could be regarded as establishing that an employee's vested benefit for purposes of the loan exception was a minimum of $10,000, in which case the minimum loan amount would be one-half of this amount or $5,000.

2. Analysis

a. Minimum Loan Amount

The TRA[77] amends §72(p)(2)(A) to clarify that the minimum loan amount is $10,000. Under the amended provision, the loan, together with other outstanding loans from the plan, will not be treated as a distribution to the extent that such loans do not exceed the lesser of (i) $50,000, or (ii) "the greater of (1) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or (2) $10,000." Thus, under the revised version of §72(p)(2), a loan of up to $10,000 would not be treated as a distribution regardless of the amount of the employee's vested benefit.

The TRA[78] makes two additional minor substantive changes to the loan provisions of §72. First, §72(o)(3)(A) is amended to provide that the §72(p)(2) exception does not apply to loans attributable to voluntary deductible employee contributions to a qualified plan. Since such voluntary deductible contributions are a substitute for an employee IRA, and the IRA provisions prohibit loans from IRAs,[79] this change brings such contributions into closer accord with the IRA provisions.

The second TRA change is an amendment to §72(p)(2)(A) providing that the present value of the employee's vested benefit for purposes of the loan exception is determined without counting any accrued benefit attributable to deductible employee contributions.

Note: One final TRA change[80] with a tangential relationship to the loan provisions is the repeal of §404(f). This section provided that the repayment of a loan from a qualified plan by an "owner-employee" (generally a 10-percent owner of the business sponsoring the plan) is treated as a contribution to the plan on behalf of the owner-employee for purposes of the deduction limitations of §404. It should be noted, however, that the TRA has made no change in the prohibited transactions rules to permit loans to be made to plans that cover "owner-employees."

3. Effective Date

All of the foregoing amendments are part of the technical corrections provisions of the TRA. Thus, they are effective as if they had been included in the TEFRA provisions to which they relate.[81] Since the loan provisions under TEFRA were generally effective for loans made after August 13, 1982, these provisions are also effective with respect to such loans.

It should be noted that under a transitional rule to the TEFRA effective date,[82] a "qualified refunding loan" is not treated as a distribution under §72(p) to the extent such loan was repaid before August 14, 1983. For purposes of this rule, a "qualified refunding loan" was any loan made after August 13, 1982, and before August 14, 1983, to the extent the loan was used to make a "required principal payment." A "required principal payment" was defined as any principal repayment on a loan made under the plan which was outstanding on August 13, 1982, if the repayment was required to be made after that date and before August 14, 1983.

The TRA makes two changes to this transitional rule. First, the qualified refunding loan rule is extended to demand loans outstanding on August 13, 1982.[83] Second, the TRA[84] extends the time for making and repaying a qualified loan to January 1, 1985 with respect to individuals who are not key employees within the meaning of §416(i)(2).

IV. Estate Tax Exclusion Repealed

A. Introduction

Section 2039(c) provides an estate tax exclusion for the value of an annuity or other payment receivable by any beneficiary, other than the participant's executor, under a qualified plan or retirement annuity contract, a §403(b) annuity contract, and certain Armed Forces and other governmental pension and survivor plans. The exclusion is available only if the annuity or other payment is not in the form of a lump sum distribution (except where the beneficiary elects to forego the favorable 10-year income averaging treatment accorded such distributions under §402(a)(2) and only if the annuity is not attributable to accumulated deductible employee contributions.[85]

A comparable estate tax exclusion is provided for IRAs under §2039(e).

TEFRA cut back what was an unlimited estate tax exclusion by adding §2039(g), effective for estates of decedents dying after December 31, 1982.[86] Under §2039(g), the exclusion under §2039(c) and (e) was reduced to a maximum of $100,000.

B. Analysis of Repeal

The TRA[87] completely repeals the estate tax exclusion in §2039(c) and (e) for qualified plans and annuities, governmental plans, and IRAs. Also repealed are the special provisions relating to the exclusion in §2039(f), requiring that the favorable income tax treatment for lump sum distributions not be elected, and §2039(g), limiting the exclusion after 1982 to $100,000.

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Section §2039(c) continues the limited exclusion of former §2039(d) for certain interests created under community property laws. If the spouse of an employee on whose behalf contributions or payments are made by an employer to a qualified plan, annuity, or tax-sheltered annuity predeceeases the employee, the spouse's gross estate does not include the value of any interest in such plan of annuity to the extent the interest (i) is attributable to employer contributions or payments, and (ii) arises solely by reason of the spouse's interest in community income under the community property laws of the state.

C. *Effective Date*

The repeal of the estate tax exclusion applies to the estates of decedents dying after December 31, 1984.[88] An exception to the repeal, subject to the $100,000 limitation, is provided the estate of any decedent who irrevocably elected the form of benefit before July 18, 1984, and is in pay status on December 31, 1984. Only the form of benefit must have been selected; it is not required in order for this exception to apply that a beneficiary also have been designated.[89]

A similar extension has been retroactively provided by the TRA, by amending the effective date provisions of TEFRA, to continue the unlimited estate tax exclusion with respect to the estate of any decedent who is a participant in any plan and in pay status on December 31, 1982, and who irrevocably elected before January 1, 1983 the form of benefit.[90]

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[1] §401(a)(9), prior to amendment by TEFRA. For "owner-employees", distributions were required to commence in the year age 70½ was reached.
[2] Act §242(a).
[3] *See* §§403(a)(1) and 404(a)(2) for the extension of the required distribution rules to qualified annuity plans.
[4] I.R.B. 1983-49, 15.
[5] Regs. §1.401-11(e)(4)(ii).
[6] TEFRA, §242(b)(1).
[7] The required distribution rules for IRAs were in effect prior to the TEFRA-imposed rules for qualified plans. However, TEFRA §243 amended §408(a)(7) and (b)(4) to eliminate the option previously available permitting the purchase of an immediate annuity payable for the life of the beneficiary or beneficiaries of the IRA plan owner or the owner's spouse. Thus, after TEFRA, IRA distributions were required to be completed no later than five years after the owner's or surviving spouse's death except when the distribution was for a fixed period of years not exceeding the owner's life expectancy of the joint life expectancy of the owner and the owner's spouse.
[8] Act §521.
[9] S. Rep. No. 169, 98th Cong., 2d Sess. 306 (1984).
[10] Act §521(e)(1).
[11] Act §521(e)(4).
[12] Act §521(e)(5).
[13] Act §521(a)(2).
[14] Act §521(e)(2).
[15] Act §521(e)(3).
[16] TEFRA §242(b)(2).
[17] The IRA changes were made in TEFRA §243.
[18] H. R. Rep. No. 861, 98th Cong., 2d Sess. 1138 (1984).
[19] *Id.*
[20] Regs. §1.408-2(b)(6).
[21] *Id.; See also* Notice 83-23, *supra.*
[22] H. R. Rep. No. 861, *supra.*
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *See,* for example, Rev. Rul. 74-325, 1974-2 C.B. 127.
[29] S. Rep. No. 169, *supra,* at 304.
[30] H. Rep. No. 861, *supra.*
[31] *Id.*
[32] §401(a)(9)(B)(iii).
[33] *Id.*
[34] *Id.*
[35] §401(a)(9)(B)(iv).
[36] H. R. Rep. No. 861, *supra.*
[37] *Id.*
[38] Act §521(b).
[39] S. Rep. No. 169, *supra,* at 307.
[40] *See* §401(a)(9)(D).
[41] §402(e)(4)(L).
[42] §402(a)(5)(A)(i).
[43] §408(d)(3)(A).
[44] §§402(a)(5)(C); 408(d)(3).
[45] §402(a)(7).
[46] §403(a)(4) and (b)(8).
[47] §402(e)(4)(J).
[48] Act §522.
[49] §§402(a)(5)(D); 403(a)(4); and 403(b)(8).
[50] *Id.*
[51] §§402(a)(5)(D)(iii) and 403(a)(4)(B).
[52] §402(a)(5)(D)(ii).
[53] *See* §402(e)(4)(A) and §402(a)(2) and (5)(E)(iv).
[54] §402(a)(5)(D)(iv).
[55] §402(a)(5)(D).
[56] Act §522(e).
[57] §401(a)(1); S. Rep. No. 169, *supra,* at 310.
[58] *See,* however, §401(k), relating to qualified cash and deferred arrangements, and §219(e) treating certain voluntary employee contributions to a qualified plan as deductible under the IRA limitations.
[59] S. Rep. No. 169, *supra; see also* Rev. Rul. 80-350, 1980-2 C.B. 133.
[60] §72 applies by reason of §§402(a)(1) and 403(a)(1) and (b)(1).
[61] §72(e)(5).
[62] *Id.*
[63] S. Rep. No. 169, *supra.*
[64] *Id.*
[65] *Id.*
[66] This is technically accomplished by enacting new §72(e)(7), which removes employee-funded plans from the list of exempt plans in §72(e)(5)(B) that continue to be treated under the pre-TEFRA rules for withdrawals from annuity contracts. Thus, such plans become subject to the post-TEFRA annuity rules in §72(e)(2) and (3) treating amounts withdrawn as first allocable to income accumulated on the annuity contracts.
[67] §72(e)(7)(B).
[68] H.R. Rep. No. 861, *supra,* at 1141.
[69] *Id.*
[70] §72(g)(2)(E)
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] Act §423(b)(2).
[75] TEFRA §236(c).
[76] TEFRA, §236(a).
[77] Act §713(b).
[78] *Id.*
[79] §408(e)(2) and (3); under these provisions the IRA is disqualified and all amounts in the account are treated as distributed.
[80] *Id.*
[81] Act §715.
[82] TEFRA §236(c).
[83] Act §713(b)(2).
[84] Act §554.
[85] §2039(f).
[86] TEFRA, §245(a) and (c).
[87] Act §525.
[88] Act §525(b).
[89] H.R. Rep. No. 861, *supra,* at 1142.
[90] Act §525(b)(3), amending TEFRA §245(c).

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Chapter 50

MISCELLANEOUS CHANGES AFFECTING QUALIFIED PLANS AND IRAs

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I. Amendments to the Top-Heavy Rules

A. *Introduction*

TEFRA [1] enacted the "top heavy" requirements in §416, effective generally for plan years beginning after December 31, 1983. If a qualified plan is top-heavy, it must meet stricter requirements relating to vesting, minimum benefits, includible compensation, and distribution of benefits. A top-heavy plan satisfies the vesting requirements if it provides for either three-year "cliff" vesting or six-year graded vesting.[2] The minimum benefit that must be provided to non-key employees by a top-heavy defined benefit plan must equal, for each year of service, at least 2 percent of the employee's average compensation over the five highest consecutive years of service in a top-heavy plan, but in no event is the total minimum benefit required to exceed 20 percent of the employee's average compensation over such five highest years of service.[3] The minimum contribution that must be provided non-key employees in a top-heavy defined contribution plan must equal at least 3 percent of the employee's compensation for the year, unless key employees receive a contribution which is a lesser pecentage of compensation, in which case the minimum contribution percentage for all non-key employees may equal the maximum percentage for any of the key employees.[4] The top-heavy minimum benefit or minimum contribution must be determined without consideration of Social Security benefits.[5] In addition, the minimum contribution requirement is determined for a defined contribution plan without regard to amounts contributed pursuant to a salary reduction arrangement. Similarly, salary reduction contributions are not counted for purposes of determining the amount that has been contributed to such a plan on behalf of a key employee.

Under §416(d), no more than $200,000 of compensation can be taken into account in determining contributions or benefits under a top-heavy plan. This $200,000 amount is subject to cost-of-living adjustments made in the same manner as adjustments to the annual addition limit for defined contribution plans in §415(c)(1)(A).

Under §401(a)(9), as enacted by TEFRA, a qualified plan was required to provide that distributions to a key employee in a top-heavy plan commence no later than the year in which the key employee reaches age 70-1/2, regardless of when the key employee retires. However, as explained in Chapter 49, I, *supra*, the TRA has revised the distribution rules of §401(a)(9) to require the commencement of distributions only with respect to "5-percent owners" without regard to whether the plan is top-heavy. An additional rule affecting distributions to key employees in top-heavy plans is that a distribution to a key employee before the employee reaches age 59-1/2 is subject to a 10-percent penalty tax, unless the distribution is made on account of death or disability.[6]

The definition of a top-heavy plan is set forth in §416(g). Under the definition, a plan is a top-heavy plan if more than 60 percent of the aggregate account balances (in a defined contribution plan) or more than 60 percent of the present value of total accrued benefits (in a defined benefit plan) has been accumulated for the benefit of key employees. A plan may also be top-heavy if it is required to be aggregated in a "top-heavy group," as described in §416(g)(2)(B). Under §416(g)(2)(A), aggregation is required for any plan in which a key employee is a participant and for any other plan of the employer enabling a plan with a key employee participant to meet the nondiscrimination or participation requirements of §401(a)(4) or §410. In determining the accrued benefits of any employee or the amount of the account of any employee for purposes of classifying a plan as top-heavy, amounts distributed to the employee continue to be counted until five years after distribution.[7]

Section 416(i) provides that, for purposes of the top-heavy rules, key employees are: (i) officers of the employer, (ii) the 10 employees owning the largest interests in the employer, (iii) 5-percent owners of the employer, or (iv) 1-percent owners of the employer receiving annual compensation from the employer in excess of $150,000.

Section 401(a)(10)(B) requires that the top-heavy provisions must be specifically incorporated in a qualified plan. The top-heavy rules also apply to governmental plans.[8]

B. *Analysis of Top-Heavy Amendments*

1. *Treatment of Salary Reduction Arrangements*

The TRA [9] repeals §416(c)(2)(C), which provided that any employer contribution attributable to a salary reduction arrangement will not be taken into account for purposes of the minimum contribution requirements to a top-heavy defined contribution plan. Under §401(k), an amount deferred at the election of the employee into a qualified cash-or-deferred arrangement is considered an employer contribution. Salary reduction amounts will thus have a two-fold effect on the minimum contribution rules for top-heavy defined contribution plans. On the one hand, amounts deferred to key employees will be treated as

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employer contributions on their behalf and may result in the imposition of, or increase in, a minimum benefit for non-key employees. On the other hand, amounts deferred by non-key employees (treated as employer contributions) may result in the elimination or decrease in the minimum contribution required of the employer. The ensuing examples illustrate the two potential consequences.

Example 1: Assume that a top-heavy profit-sharing plan has a qualified cash or deferred arrangement. Further assume that the only contributions to the plan for the year are pursuant to employee elections under the cash or deferred arrangement. If the plan covers three key employees, two of whom defer 2 percent of their salary and the third of whom defers 4 percent, the 3-percent minimum benefit must be provided all non-key employees under §416(c)(2). Prior to the repeal of §416(c)(2)(C), no minimum benefit would have been required since the salary deferred by the key employees would not have been considered for purposes of the minimum contribution rules.

Example 2: Assume the same facts as in the preceding example. Further assume that all the non-key employees deferred 1.5 percent of their compensation to the profit sharing plan. The 1.5 percent of compensation deferred will be considered in determining the additional amounts that the employer must contribute to satisfy the minimum contribution requirement. Thus, the employer must contribute an additional 1.5 percent of each non-key employee's compensation to satisfy the minimum contribution requirement.

Comment: As a practical matter, the deferral rates among non-key employees may vary considerably. Some may defer at a substantial rate; others may not defer any compensation. Although, in such a case, the employer theoretically might satisfy the minimum contribution test by contributing sufficient amounts on behalf of only those employees who fail to defer at least 3 percent, in practice it is likely the employer will be compelled to make a 3-percent contribution on behalf of all non-key employees as a matter of fairness. A 3-percent (or greater) contribution may prove advantageous in any event since it should allow "highly compensated" employees to increase their rates of deferral.[10]

A second change made by the TRA [11] relating to the minimum contribution requirement for top-heavy plans is to specify that the minimum contribution requirement applies to a top-heavy Simplified Employee Pension (SEP). Under §416(i)(6), a SEP is treated as a defined contribution plan for purposes of the top-heavy requirements. The TRA revises the qualification requirements of SEPs to provide that a top-heavy SEP must meet the 3-percent minimum contribution requirement in §416(c)(2) for top-heavy defined contribution plans.

Note: The minimum contribution requirement is the only top-heavy requirement that must be extended to SEPs since the IRA and SEP requirements are generally at least as stringent as the other top-heavy requirements. Under §408(a)(4), a contribution to an IRA or a SEP must be 100 percent vested when made. Section 401(k)(3)(C) requires that no more than $200,000 of total compensation of each employee covered by a SEP be considered in computing contributions to the SEP. Sections 408(a)(6) and (b)(3) require that IRA and SEP distributions begin no later than the April 15th of the year following the year in which the plan owner attains age 70-1/2, and §408(f) imposes a 10-percent penalty tax on distributions to a plan owner before the attainment of age 59-1/2.

2. Changes Affecting Top-Heavy Classification

The TRA amends the top-heavy definition in §416(g) in two respects. First, the TRA [12] clarifies that, for purposes of the rule requiring that distributions within the preceding five years be taken into account in determining top-heavy status, distributions within the past five years from a terminated plan must be taken into account. Distributions from a terminated plan must be considered, however, only if the terminated plan would have been required to be included in an aggregation group. That is, the terminated plan must have covered one or more key employees, or the terminated plan must have been a plan enabling a plan covering a key employee to meet the nondiscrimination or participation requirements of §401(a)(4) or 410.

Second, the TRA [13] adds a rule to the effect that, if any individual has not received any compensation from any employer maintaining the plan (other than plan benefits) at any time during the five-year period ending at the time top-heavy status must be determined, any accrued benefit or account of such individual shall not be taken into account in determining the plan's top-heavy status. Thus, for example, if an employee retires and benefits from the plan are distributed to him over his life expectancy, all amounts previously distributed as well as the remaining accrued benefit or account balance will not be taken into account in determining top-heavy status once five years have elapsed from the retirement date to the top-heavy determination date.

Observation: This rule should also apply to beneficiaries of the employee if the employee dies before benefits commence or during the period benefits are paid, assuming the beneficiaries are not employed by the former employer of the employee. If the beneficiary of the employee is employed by the same employer, the beneficiary does not appear to fall within this rule by reason of the receipt of "compensation" from the employer maintaining the plan. Thus, the deceased employee's remaining interest in the plan, plus distributions in the preceding five years, must continue to be taken into account for top-heavy determination purposes until five years after the beneficiary retires from the employer maintaining the plan. It is unclear whether this result is intended since the legislative history does not address this issue.

3. Key Employee Definition Liberalized

The TRA makes several clarifying and liberalizing changes in the definition of a key employee. The first change [14] is to revise the definition of "key employee" to include any employee, rather than merely any participant in an employer plan.

The second TRA amendment [15] provides that, for purposes of the key employee definition, an officer of the employer is treated as a key employee only if the officer has annual compensation greater than 150 percent of the amount in effect under §415(c)(1)(A) (the annual addition

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limit for defined contribution plans, which for 1984 is $30,000) for any of the five plan years considered in testing whether an employee is a key employee. Thus, for example, if a plan's top-heavy status is being tested for 1984, an officer will not be counted as a key employee if the officer's compensation in the 1980-84 testing period did not exceed $45,000, which is 150 percent of the §415 defined contribution plan limit. A related TRA change [16] provides that any of the 10 employees owning the largest interest in the employer will be treated as key employees only if their compensation exceeds the §415(c)(1)(A) defined contribution plan limit, which as previously mentioned is $30,000 for 1984.

A further TRA amendment [17] provides that, for purposes of treating the 10 employees owning the largest interests in the employer as key employees, if two employees have the same interest in the employer, the employee having the greater annual compensation from the employer shall be treated as having the larger interest.

Finally, the TRA [18] makes it clear that the aggregation rules of §414(b), (c), and (m) do not apply for purposes of determining ownership of the employer by the top 10 employees, as well as by the 1-percent and 5-percent owners.

4. Qualification Requirements

The TRA [19] amends §401(a)(10)(B) to exempt all governmental plans from the top-heavy requirements. Thus, governmental plans will not be subject to the top-heavy requirements and will not have to incorporate the top-heavy rules in plan documents.

The TRA [20] sets forth rules on the steps that may be taken if final regulations implementing the top-heavy rules are not published by January 1, 1985. If final regulations are not published under §416 (as in effect before the date of enactment of the TRA changes, July 18, 1984) before January 1, 1985, the Secretary is instructed to publish before such date plan amendment provisions that may be incorporated in the plan to meet the top-heavy requirements. If a plan is amended to incorporate the Secretary's plan amendment provisions (assuming no regulations are published by 1985), the plan will be treated as meeting the top-heavy requirements during the period such amendments are in effect, but not later than six months after final regulations implementing §416, as in effect before the TRA amendments, are published. If neither final regulations nor plan amendments are published by January 1, 1985, the plan will meet the top-heavy requirements if the plan is amended to incorporate such requirements by reference.

The plan should designate, in incorporating the top-heavy requirements by reference, the specific top-heavy alternatives that will be utilized where options exist. Otherwise, the employer will be treated as having elected the requirements with respect to each employee that provide the maximum vested accrued benefit for such employee. The Conference Report [21] furnishes the following example.

> *Example:* If a plan is amended to incorporate the top-heavy plan rules by reference without specifying the vesting schedule, the plan is deemed to provide a vesting schedule that maximizes the vested, accrued benefits of each non-key employee. Thus, if a particular non-key employee separates from service after two years of service, the plan is considered to have incorporated the graduated vesting schedule with respect to that employee, and that employee would have a 20-percent vested accrued benefit. If another non-key employee covered by the same plan has at least three years of service, the plan is considered to have incorporated the three-year, 100 percent vesting schedule as to that employee. Similarly, in a top-heavy group of plans that are amended to incorporate the top-heavy requirements by reference without specifying the plan or plans under which the minimum benefits or minimum contributions are provided, then a non-key employee in any plan required to be aggregated in the top-heavy group must be provided with the minimum contribution or benefit under each plan that is within the top-heavy group in which the employee participates.

Note: The Conference Report [22] states that the publication of final regulations substantially similar to the proposed regulations, issued in question-and-answer format March 15, 1983, (48 Fed. Reg. 10868), will constitute the issuance of final regulations for purposes of the foregoing plan amendment rules.

C. Effective Dates

The foregoing TRA provisions are effective for plans years beginning after December 31, 1983,[23] except that the provisions excluding benefits of an employee not employed for the last five years and the provisions providing for consideration of amounts contributed under salary reduction arrangements for minimum contribution purposes are effective for plan years beginning after December 31, 1984.[24]

II. Qualified Cash or Deferred Arrangements

A. Introduction

Section 401(k) permits a qualified profit-sharing or stock bonus plan to offer participants an election to defer compensation and have that deferred compensation be contributed by the employer to the participant's behalf. This option may be provided only if certain requirements are met. One requirement is that the deferred amounts contributed to the plan must be fully vested after contribution. Second, the deferred amounts may not be distributable to participants or beneficiaries earlier than upon retirement, death, disability, separation from service, hardship, or the attainment of age 59-1/2.

Under §401(k)(3), a cash or deferred arrangement is treated as satisfying the nondiscrimination requirements of §401(a)(4) and §410(b)(1)(B) if amounts deferred by highly compensated employees satisfy either of two tests. The first test is met if the actual deferral percentage for highly compensated employees is not more than the actual deferral percentage for all other eligible employees multiplied by 150 percent. The second test is met if (i) the actual deferral percentage for highly compensated employees does not exceed that percentage for all other eligible employees by not more than 3 percentage points, and (ii) the actual deferral percentage for highly compensated employees is not more than 250 percent of the actual deferral percentage of all other eligible employees. For purposes of these alter-

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native tests, an employee is considered highly paid if the employee is one of the highest paid one-third of the employer's employees.[25]

Under either of the alternative tests, Social Security taxes paid by the employer may not be considered. Prop. Regs. §1.401(k)-1(a)(3), however, provides that a cash or deferred arrangement will be qualified, even though neither test is satisfied, if the general nondiscrimination requirements of §401(a)(4) and §410(b)(1) are satisfied. Since the general nondiscrimination rules permit employer-paid Social Security taxes to be treated as employer contributions for purposes of the nondiscrimination tests, highly compensated employees may defer wages in excess of the Social Security wage base, ($37,800 for 1984) based on the employer's Social Security tax rate (5.7 percent for 1984).[26]

Section 401(k) was enacted by the Revenue Act of 1978.[27] The 1978 Act grandfathered cash or deferred money purchase pension plans, as well as profit-sharing and stock bonus plans, in existence on June 27, 1974, through 1979. Section 401(k) was made applicable, however, as mentioned above, only as to profit-sharing and stock bonus plans, effective for years beginning after 1979, and no new rules were provided for pre-ERISA money purchase pension plans with salary reduction arrangements after such time.

B. Analysis of TRA Changes

1. Mandatory Application of Alternative Tests

In response to Congress's concern [28] that utilization of Social Security integration, as permitted under the general nondiscrimination rules, permits too great a difference between the actual deferral by highly paid employees and the deferral by other employees, §401(k)(3) has been amended to make mandatory the satisfaction of one of the alternative tests under which the deferral percentages of highly-compensated employees are compared to the deferral percentages of all other employees.[29]

If a cash or deferred arrangement is not qualified because of a failure to meet one of the tests, an elective deferral made under the arrangement is treated as an employee contribution that is not automatically excludible under §402(a)(8), but which may be wholly or partially deductible by the employee under §219(a) and (e) as a qualified voluntary employee contribution, assuming the plan accepts such contributions. A plan will continue to be a qualified plan under §401(a) even if the cash or deferred arrangement is not qualified if the plan continues to meet the usual qualification requirements.[30]

A second change made by the TRA to §401(k)(3) [31] is to insert a requirement that, if two or more plans including cash or deferred arrangements are treated as one plan under the general nondiscrimination requirements, the cash or deferred arrangements included in such plans must also be treated as one arrangement for purposes of satisfying either of the alternative tests. If two or more cash or deferred arrangements of an employer must be aggregated, the deferral percentage for any employee is the sum of the deferral percentages for that employee under each of the arrangements.

Note: The Conference Report [32] states that the foregoing amendments are not intended to change the rule contained in Prop. Regs. §1.401(k)-1(a)(2) that nonelective contributions by an employer to a cash-or-deferred arrangement may be considered in applying the alternative tests. The Report adds that such contributions are taken into account only if the contributions are fully vested when made and satisfy the withdrawal restrictions (such as the age 59-1/2 or hardship rules) applicable to elective deferrals under a qualified cash or deferred arrangement.

2. Pre-ERISA Money Purchase Pension Plans

The TRA [33] makes permanent the grandfather rules for pre-ERISA money purchase pension plans. Post-TRA §401(k)(5) extends the qualified cash-or-deferred arrangement rules of §401(k) to "pre-ERISA money purchase plans," which are defined as a pension plan that is a defined contribution plan that was in existence on June 27, 1974, and, which on that date, included a salary reduction arrangement. Section 401(k) will apply, however, to such a plan only if neither employer nor employee contributions under the plan exceed the limits under the plan's contribution formula in effect on June 27, 1974. Further, amounts in the plan attributable to salary reduction contributions may not be distributable to participants or other beneficiaries of a pre-ERISA money purchase plan earlier than upon retirement, death, disability, or separation from service. The rule permitting distribution of such amounts from a profit-sharing or stock bonus plan in the case of hardship or attainment of age 59-1/2 does not apply to pre-ERISA money purchase plans.

C. Effective Dates

The TRA provisions requiring satisfaction of one of the alternative tests are effective for plan years beginning after December 31, 1984.[34] An exception is provided, however, for a cash or deferred arrangement maintained on June 8, 1984, by a state government that was issued a determination letter on December 6, 1982.[35]

Note: The Conference Report [36] states that no inference should be drawn from this effective date provision as to whether a state government may maintain a profit-sharing plan. Note, however, that the Service has ruled in GCM 38283 that a non-profit organization exempt from tax under §501(c)(3) can establish a qualified profit-sharing plan for its employees despite the absence of "profits" in a conventional sense.

The TRA provisions extending §401(k) to pre-ERISA money purchase plans are effective with respect to plan years beginning after July 18, 1984.[37] Under a transitional rule, applicable for plan years beginning after 1979 and on or before July 18, 1984, rules similar to those in §135(c)(2) of the Revenue Act of 1978 shall apply to such plans.[38]

III. Contribution, Benefit, and Deduction Limits for Qualified Plans

A. Introduction

Section 415 imposes limits on contributions and benefits that may be provided to participants under qualified plans. Under §415(c)(1), as amended by TEFRA,[39] the limit on annual additions (generally consisting of the sum of employer contributions, plan forfeitures, and a specified percentage of employee contributions) allocated to a par-

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ticipant's account in a defined contribution plan for a year may not exceed the lesser of $30,000 (for 1984) or 25 percent of the participant's compensation. The §415(b)(1) limit on the annual benefit that may be provided a participant under a defined benefit plan is the lesser of $90,000 (for 1984) or 100 percent of the participant's average compensation for his high three consecutive years. TEFRA [40] imposed the requirement that actuarial adjustments be made to a defined benefit plan's normal retirement benefit if it begins before age 62 or after age 65 for purposes of testing whether the $90,000 limitation has been satisfied.

Section 415(e) imposes an overall limit on contributions and benefits if an employee participates in both a defined contribution and defined benefit pension plan maintained by the same employer. The overall limit is computed by determining the fraction of each separate limit used in each plan by an employee and adding the two fractions together. TEFRA [41] generally reduced the overall limit on the sum of the two fractions from 1.4 to the lesser of 1.25 times the applicable dollar limitation or 1.4 times the applicable percentage of compensation limit. In so reducing the overall limit, TEFRA [42] provided a special transition rule for computing the defined contribution plan fraction for years ending after December 31, 1982, in §415(e)(6). The fraction created by this rule is known as the "transition fraction."

Under §401(h), a pension or annuity plan may provide post-retirement medical, sickness, accident, and hospitalization benefits to participants, their spouses and their dependents if (i) such benefits are subordinate to the retirement benefits provided by the plan, (ii) a separate account is established and maintained for such benefits, (iii) the employer's contribution to such separate account are reasonable and ascertainable, (iv) amounts in such account cannot be diverted to any other purpose than providing post-retirement medical benefits, and (v) any amount remaining in such account after satisfaction of post-retirement medical benefits must be returned to the employer. Post-retirement medical benefits are not taken into account for purposes of the §415 limits on contributions and benefits that may be provided under a defined benefit pension plan.

Although §415(d) provides that the dollar limits under §415 are adjusted annually for cost-of-living increases, determined in the same manner as Social Security benefits are adjusted, TEFRA [43] suspended cost-of-living adjustments until 1986. Beginning in 1986, the limits were to be adjusted for post-1984 cost-of-living increases.[44]

B. Analysis

1. Clarification of the §415 Limits

In a technical change, the TRA [45] amends §415(e)(6) to clarify that the special transitional rule for computing the defined contribution plan fraction for years ending after 1982 applies only to plans that were in existence on or before July 1, 1982.

2. Cost-Of-Living Adjustments Suspended

The TRA [46] amends §415(d)(2) and (3) to suspend the cost-of-living adjustments in the dollar limits for defined contribution and defined benefit plans until 1988. Commencing in 1988, these limits will be adjusted for post-1986 cost-of-living increases in accordance with the formula for providing cost-of-living increases in Social Security benefits.

3. Post-Retirement Medical Benefits for 5 Percent Owners

The TRA [47] enacted a new §401(h)(6) to provide that a defined benefit plan providing medical benefits for retired employees must maintain a separate medical benefit account for any participant who, at any time during any of the five preceding plan years, is a 5-percent owner of the sponsoring employer (as defined in §416(i)(1)(B)(i)). Post-retirement medical benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is considered a 5-percent owner) must only be payable to such employee, the employee's spouse and the employee's dependents, from such separate account. As noted in the Ways and Means Committee Report accompanying the TRA,[48] the medical benefits provided under a defined benefit plan must meet the general nondiscrimination standards. The TRA [49] further amends §415 to provide that contributions allocated to an individual medical account, as described in post-TRA §401(h)(6), which is part of the defined benefit plan, must be treated as an annual addition to a defined contribution plan for purposes of §415(c). Thus, the amount allocated to the individual medical account must be included in determining whether the defined benefit plan and any defined contribution plan of the employer meet the separate limits and the overall limit provided with respect to such plans. According to the Ways and Means Committee Report,[50] regulations may be issued providing that an amount allocated to a medical benefit account under a defined benefit plan before the effective date of the TRA provision can be reallocated to the individual medical account of a participant without treatment as an annual addition described in §415(c).

4. Repeal of Special Limits on H.R. 10 Plans

Continuing the policy of TEFRA to eliminate the distinctions between plans for self-employed individuals and corporate plans, the TRA [51] repeals several additional limits on plans for self-employed individuals that were overlooked in TEFRA. For example, the special limitation in §401(e) on plan contributions to pay premiums on annuity or life insurance contracts on the life of owner-employees under a H. R. 10 plan is repealed.

An additional change of note is the amendment of §404(a)(8)(D) to provide that the earned income of the self-employed individual for purposes of determining the maximum allowable deduction for contributions to a qualified plan is determined without regard to the deductions allowable for contributions to such plan.

C. Effective Dates

The TRA changes clarifying (i) that actuarial adjustments are made to the dollar benefit limitation and not to the benefit itself and (ii) that the special transition rule for defined contribution plan fractions applies only to plans in existence on or before July 1, 1982, are effective as if included in TEFRA.[52] The postponement of cost-of-living

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adjustments to the §415 dollar limits until 1988 is effective for plan years beginning after December 31, 1983.[53] The amendments requiring the establishment of individual medical accounts for post-retirement medical benefits for 5-percent employees and subjecting such plans to the §415 limits are effective for plan years beginning after March 31, 1984.[54]

The technical corrections repealing additional special limits on plans covering self-employed individuals are effective as if included in TEFRA.[55] Note that, in a clarifying change, the TRA [56] provides that the repeal of the special deduction rules in §§404(e) and 1379(b) (as in effect before the enactment of TEFRA) shall not be applied to any defined benefit H.R. 10 plan subject to §401(j).

IV. Affiliated Service Groups, Employee Leasing and Collective Bargaining Agreements

A. Introduction

1. Affiliated Service Groups

Under §414(m), all employees of organizations constituting an "affiliated service group" must be treated as employed by a single employer for purposes of various plans qualification requirements. The plan qualification requirements covered by §414(m) include nondiscrimination requirements under §401(a)(3) and (4), the vesting requirements under §§401(a)(7) and 411, and the top-heavy requirements of §416. An affiliated service group consists of a service organization, including organizations performing management functions, and one or more related organizations for whom the services are performed.[57] Section 414(m)(6) defines "organization" for purposes of these provisions to include a corporation, partnership, or other organization, and further provides that, in determining ownership, the constructive ownership rules of §267(c) apply.

Section 414(m)(6) provides that regulations may be issued to prevent avoidance of any employee benefit requirement covered under §414(m) by the use of separate organizations with respect to service organizations.

2. Leased Employees

Section 414(n), added by TEFRA,[58] requires that certain leased employees be treated as employees of the recipient of the leased employee's services for purposes of various qualified plan requirements similar to the requirements covered by §414(m). Under §414(n), to be classified as a "leased employee," the person providing services to the recipient must meet three requirements:

(i) The services must be provided pursuant to an agreement between the recipient and the leasing organization;

(ii) The person must have performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for at least one full year; and

(iii) The services must be of a type historically performed in the business field of the recipient by employees.

Section 414(n)(5) provides a safe harbor under which a leased employee will not be treated as an employee of the recipient of the services if the leased employee is covered by a plan maintained by the leasing organization meeting certain requirements.

3. Collective Bargaining Agreements

Many of the requirements imposed by the qualified plan rules and the Code sections governing statutory fringe benefit programs do not apply to plans or programs maintained pursuant to a collective bargaining agreement. For example, §416(i)(4) provides that the vesting, minimum contribution or benefit, and compensation requirements of the top-heavy rules do not apply to any employee included under a collective bargaining agreement where retirement benefits have been the subject of good faith collective bargaining.

B. Analysis

1. Affiliated Service Groups

The TRA [59] amends §414(m)(6)(B) to provide that the broader constructive ownership rules of §318(a) will apply in determining ownership for purposes of the affiliated service group rules, rather than the narrower §267(c) constructive ownership rules.

Observation: In the same section of the TRA that amends §414(m)(6) to substitute the constructive ownership rules, the TRA [60] repeals §414(m)(6) in a conforming amendment to another TRA change, new §414(o), providing the Treasury with broader regulatory authority to prevent the avoidance of the affiliated service group rules and the leased employee rules. The repeal appears inadvertent. In all likelihood, Congress intended to repeal former §414(n)(6), redesignated as of 1984 as §414(m)(7), which provides the Treasury with comparable authority to issue regulations to prevent avoidance with respect to the affiliated service group rules.

2. Employee Leasing

The TRA [61] makes two changes in the employee leasing area. First, §414(n)(2) is amended to clarify that a leased employee includes only those individuals who are not otherwise employees of the lessee. This clarification was made in response to a concern that certain individuals have interpreted the present safe-harbor rule for employee leasing under §414(n)(5) as overriding traditional common-law employee rules.[62]

A second change, as mentioned above, is to extend the Treasury's regulatory authority to prescribe regulations to prevent the avoidance of the qualified plan requirements and other employee benefit requirements through the use of the employee leasing and other arrangements as well as separate organizations.[63]

The Conference Report [64] states that it is not implied that regulations issued under this provision could be applied only prospectively. This statement appears to constitute an open invitation to the Treasury to issue retroactive regulations.

The Conference Report [65] gives as an example of a situation that might be covered under these regulations the situation where professionals are hired as leased employees of their own professional corporations to avoid the nondiscrimination rules applicable to qualified plans. The Report further states that this is not the sole situation in which

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employee leasing is used to avoid the qualified plan requirements, but adds that it is not intended to imply that legitimate uses of employee leasing are necessarily abuses, giving as an illustration the historical business practice of temporarily assigning company employees to temporary projects. This situation is not subject to the new regulatory authority provided the project has an ascertainable termination date and it is not customary under the circumstances to hire permanent employees for such a project.[66]

3. Determination of Collective Bargaining Agreement

In response to the concern that owners, officers, and executives of certain employers were forming collective bargaining units to qualify for the exception to various qualified plan rules for collective bargaining agreements, the TRA [67] adds §7701(a)(46) to provide that, in determining whether a collective bargaining agreement between an employee representative and one or more employers exists, the term "employee representative" does not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer.

C. *Effective Dates*

The TRA amendments substituting the broader constructive ownership rules of §318(a) are effective for taxable years beginning after December 31, 1984.[68] However, the inadvertent repeal of §414(n)(6) is effective on July 18, 1984, the date the TRA was enacted.[69]

The clarification of the definition of a leased employee for purposes of the leased employee provisions is also effective for taxable years beginning after December 31, 1983.[70]

The broadening of the Treasury's regulatory authority in §414(o) is effective July 18, 1984, although, as discussed above, the regulations issued under this provision may be retroactive in effect. The provision relating to collective bargaining agreements is effective on April 1, 1984.[71]

V. Amendments Affecting IRAs and SEPs

A. *Introduction*

Sections 219(a) and (b) allow a deduction for an annual deductible contribution to an individual retirement plan (IRA) equal to the lesser of $2,000 or 100 percent of compensation. Under §219(f)(3), a contribution can be made to an IRA and be deducted for the taxable year if it is made no later than the time prescribed by the law for filing the return for that taxable year, including extensions thereof. Thus, if a calendar year taxpayer decides to make a $2,000 contribution to an IRA for 1983, and the taxpayer extends the time for filing his 1983 return to August 15, 1984, the taxpayer will have until August 15, 1984 to contribute the $2,000 to the IRA and obtain a deduction for 1983.

Under §219(b)(4), alimony received by a divorced individual can be taken into account for purposes of determining an IRA contribution and deduction if certain requirements are met. This special provision applies to a divorced individual only if (i) an IRA was established for the benefit of that individual at least five years before the beginning of the calendar year in which the decree of divorce or separate maintenance was issued, and (ii) for at least three of the five most recent taxable years of the former spouse of the divorced individual ending before the taxable year in which the decree was issued, the former spouse paying the alimony was allowed a deduction under the spousal IRA rules for contributions for the benefit of the individual. If the foregoing conditions are met, the IRA deduction limit for such divorced individual is not less than the lesser of (i) $1,125 or (ii) the sum of the individual's compensation and qualifying alimony includible in the individual's gross income for the year.

Section 219(b)(2) raises the dollar limit for an IRA deduction from $2,000 to $15,000 in the case of a simplified employee pension (SEP). However, the percentage of compensation limit on deductions to a SEP is 15 percent, in lieu of the 100 percent limit generally applicable to IRAs under §219(b). SEPs, the requirements for which are set forth in §408(k), are generally IRAs established on behalf of qualifying employees to which the employer makes nondiscriminatory contributions.

B. *Analysis*

The TRA shortens the period during which a contribution for a taxable year may be made to an IRA. Under §219(f)(3)(A), as amended by the TRA,[72] the contribution must be made by the time for filing the return for a taxable year, *not* including extensions thereof. Thus, a taxpayer on a calendar year who desires to make a contribution to an IRA for 1984 must make that contribution by April 15, 1985, regardless of whether the taxpayer obtains an extension of time for filing the 1984 return.

The TRA simplifies considerably the rules under which a divorced spouse can make a deductible contribution to an IRA based on alimony. Under §219(f)(1), as amended by the TRA,[73] all alimony received by a divorced spouse is treated as compensation for purposes of the IRA deduction limit. The eligibility restrictions in §219(b)(4) have been repealed, including the restriction limiting the IRA deduction based on alimony to $1,125. Thus, a divorced spouse may now contribute up to $2,000 of alimony, which is the general IRA maximum, and obtain a deduction for the amount contributed.

Finally, the TRA raises the dollar limit on deductions to a SEP from $15,000 to the limitation in effect for defined contribution plans under §415(c)(1)(A). As described above, the defined contribution limit is $30,000 for years 1984 through 1987.[74]

Note: In a technical oversight, the TRA failed to make a conforming change in §219(b)(2)(C), which provides a special rule reducing the $15,000 dollar limit by the amount of Social Security or self employment taxes taken into account under the SEP integration rules in §408(k)(3)(D) in the case of officers, shareholders, or owner-employees.[75]

C. *Effective Dates*

The TRA amendment shortening the period during which IRAs may be funded applies to contributions made after December 31, 1984.[76] The provisions liberalizing the IRA rules for alimony apply to taxable years beginning after December 31, 1984.[77] The TRA change raising the

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SEP dollar limit to $30,000 is effective for years beginning after December 31, 1983.[78]

VI. Repeal of Qualified Bond Purchase Plans and Individual Retirement Bonds

A. *Introduction*

Section 405 provides that an employer-sponsored bond purchase plan will be a qualified plan if it satisfies various requirements. Bonds under such a plan must be issued in the names of the individual employees on whose behalf they are purchased and must be nontransferable. The bonds, and interest earned thereon, are not includible in an employee's gross income until the bonds are redeemed, which cannot occur until the employee dies, becomes disabled or attains age 59-1/2. The bond proceeds may be rolled over to an IRA but do not qualify for 10-year forward averaging or long-term capital gains treatment under §402.

Under §219, a taxpayer is allowed a deduction under the IRA limits, generally equal to the lesser of $2,000 or 100 percent of compensation, for the purchase of a qualified retirement bond described in §409. A qualified retirement bond is one issued under the Second Liberty Bond Act that accumulates interest until the time of redemption. The bonds are issued in the name of the individual on whose behalf they are purchased and are not transferable. Upon redemption, the bonds may be rolled into an IRA but are otherwise fully includible in gross income. A 10-percent additional income tax is imposed on redemption proceeds if the bond is redeemed before the owner attains the age 59-1/2, dies, or becomes disabled. In addition, a retirement bond ceases to bear interest in the year the owner becomes age 70-1/2, and the value of the bond at such time must be included in the owner's gross income.

In a news release dated April 27, 1982, the Treasury announced that the sales of bonds issued for the purposes of these provisions would be discontinued effective April 30, 1982.[79]

B. *Analysis*

The TRA[80] repeals as deadwood the qualified bond purchase plan and qualified retirement bond provisions. As a transitional measure, §405(d)(3)(A) (as in effect before its repeal) is amended to provide that the redemption proceeds of a bond purchased under a qualified bond purchase plan may be rolled over tax-free to a qualified plan. If such a rollover is made, the rollover amounts must be subject to separate accounting in the recipient plan, and are not eligible for capital gain, or 10-year forward averaging, or the special nonrecognition treatment accorded the net unrealized appreciation in employer securities.[81]

C. *Effective Dates*

The repeal is generally effective for obligations issued after December 31, 1983. The provisions relating to rollovers are effective with respect to redemptions made after July 18, 1984.[82] A transitional rule[83] provides that a bond purchased under a qualified bond purchase program may be redeemed at any time notwithstanding the attainment of age 59-1/2.

VII. Special Interest Provisions

The TRA contains various qualified plan provisions providing relief to certain classes of taxpayers. These provisions will be briefly mentioned here.

First, the TRA[84] eliminated the retroactive application of the withdrawal liability rules of the Multiemployer Pension Plan Amendments Act of 1980. The MPPAA was enacted on September 26, 1980, and it provided that its withdrawal liability rules applied retroactively to employers withdrawing from multi-employer defined benefit pension plans after April 28, 1980. The Supreme Court, in *PBGC v. R.A. Gray & Co.*,[85] ruled that such retroactive application of the withdrawal liability rules was constitutional. The TRA nullifies the retroactive application of the withdrawal provisions of the Act, providing for refunds of amounts paid by a withdrawing employer who fell within the period of retroactive application.

Second, the TRA[86] provides specific pension portability rules for the employees of AT&T and its former subsidiaries in order to reflect the split-up of AT&T. These provisions are extensively described in the Conference Report accompanying the TRA.[87]

Third, the TRA provides special relief for certain pension plan distributions received during 1976 and 1977 and rolled over into an IRA.[88]

Fourth, the TRA[89] provides relief from partial termination provisions in the case of the turnover of Trans-Alaskan Pipeline employees if certain requirements are met.

Finally, under the TRA,[90] the required distribution rules for qualified plans and IRAs do not apply to the extent that plan balances are held by an insuer that, on March 15, 1984, is engaged in a rehabilitation proceeding under an applicable state insurance law, such as Baldwin-United.

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[1] TEFRA, P.L. 97-248, §240.
[2] IRC §416(b). All section references herein are to the Internal Revenue Code of 1954 as amended and the regulations promulgated thereunder unless otherwise specified.
[3] §416(c)(1).
[4] §416(c)(2).
[5] §416(e).
[6] §72(m).
[7] §416(g)(3).
[8] *See* H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1132 (1984).
[9] Act §524(c).
[10] *See* Prop. Regs. §1.401(k)-1(b)(2); *see also* the discussions of cash-or-deferred arrangements at II, *infra*.
[11] Act §713(f)(2).
[12] Act §713(f)(4), amending §416(g)(3)(B).
[13] Act §524(b), adding §416(g)(4)(E).
[14] Act §713(f)(1)(A), amending §416(i)(1)(A).
[15] Act §524(a) amending §416(i)(1)(A)(i).
[16] Act §713(f)(1)(B), amending §416(i)(1)(A)(ii).
[17] Act §713(f)(1)(C), amending §416(i)(1).
[18] Act §713(f)(1)(D), amending §416(i)(1)(C).
[19] Act §524(d).

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[20] Act §524(e).
[21] H.R. Rep. No. 98-861, *supra* at 1133.
[22] *Id.*, at 1134.
[23] *See, generally,* Act §§524 and 715.
[24] Act §524.
[25] §401(k)(4).
[26] §3111(a).
[27] Revenue Act of 1978, §135.
[28] H.R. Rep. No. 98-432, Part II, 98th Cong., 2d Sess. 1301 (1984).
[29] Act §527(a).
[30] H.R. Rep. No. 98-432, *supra,* at 1302.
[31] Act §527(a).
[32] H.R. Rep. No. 98-861, *supra,* at 1145.
[33] Act §527(b).
[34] Act §527(c).
[35] Act §527(c)(1)(B).
[36] H.R. Rep. No. 98-861, *supra.*
[37] Act §527(c)(2)(A).
[38] Act §527(c)(2)(B).
[39] TEFRA, §235(a).
[40] TEFRA, §235(e).
[41] TEFRA, §235(c).
[42] TEFRA, §235(d).
[43] TEFRA, §235(b).
[44] §415(d)(3).
[45] Act §713(a)(1) amends §415(b)(2) to clarify that the actuarial adjustments required by TEFRA for retirement benefits paid prior to age 62 or after age 65 are applied to the $90,000 dollar limit on annual benefits rather to the benefit itself.
[46] Act §15(a) and (b).
[47] Act §528(b).
[48] H.R. Rep. No. 98-432, *supra,* at 1295.
[49] Act §528(b).
[50] H.R. Rep. No. 98-432, *supra.*
[51] Act §713(d).
[52] Act §715.
[53] Act §18(a).
[54] Act §528(c).
[55] Act §715.
[56] Act §713(d)(8).
[57] §414(m)(2), (3), and (5).
[58] TEFRA §248(a).
[59] Act §526(a).
[60] Act §526(d)(2).
[61] Act §528(b).
[62] S. Rep. No. 98-169, *supra,* at 314.
[63] Act §526(d), adding §414(o).
[64] H.R. Rep. No. 98-861, *supra,* at 1143.
[65] *Id.*
[66] *Id.*, at 1143 to 1144.
[67] Act §526(c).
[68] Act §526(a)(2).
[69] Act §526(d)(3).
[70] Act §526(b)(2).
[71] Act §526(c)(2).
[72] Act §147(c).
[73] Act §529(a).
[74] Act §713(d)(2).
[75] Note that the TRA §713(f) has amended §408(k)(3)(D) to provide that old age, survivors', and disability insurance employer contributions may be taken into account as contributions by the employer to an employee's SEP if the employer does not maintain an integrated plan at any time during the taxable year and if such OASDI contributions are taken into account with respect to each employee maintaining a SEP.
[76] Act §147(d)(1).
[77] Act §529(c).
[78] Act §715.
[79] H.R. Rep. No. 98-432, *supra,* at 1587.
[80] Act §491.
[81] §402(e)(5), as added by Act §491(c).
[82] Act §491(f).
[83] Act §491(f)(4).
[84] Act §558.
[85] 52 U.S.L.W. 4810 (June 18, 1984).
[86] Act §559.
[87] H.R. Rep. No. 98-861, *supra,* at (1150-54).
[88] Act §551.
[89] Act §552.
[90] Act §553.

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CHAPTER 51

CHANGES AFFECTING EMPLOYMENT TAXES

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I. Application of SECA to Commodity and Option Dealers [Act §102(c)]

A. Self-Employment Tax — Section 1402 Amended

Act §102(c) amends §1402 (relating to definitions for purposes of the tax on self-employment income) to add a new subsection (i). Under this subsection, notwithstanding §1402(a)(3)(A) (which excludes gain or loss from the sale or exchange of a capital asset), there is not to be excluded any gain or loss (for purposes of determining income subject to the self employment tax) from §1256 contracts or property related to such contracts where such gain or loss is attributable to the normal course of the taxpayer's activity of dealing in or trading §1256 contracts. Further, the §1202 capital gains deduction is not to apply. *See* §1402(i)(1)(A) and (B).

"Section 1256 contracts" is defined in §1256(b), as amended by Act §102(a) (*see* discussion in Chapter 27). For purposes of these provisions, §1402(i)(2) defines "options dealer" as having the same meaning as in §1256(g)(8) *(i.e.*, a market maker or specialist registered with a national exchange subject to CTFC regulation), and "commodities dealer" as a person actively engaged in trading §1256 contracts who is registered with a domestic board of trade under CTFC regulations.

B. Amendments to the Social Security Act

The same Act section (§102(c)) amends §211 of the Social Security Act by adding a new subsection (h)(1) containing provisions identical to those of the amendments to §1402, *supra.*

II. FUTA "Wages" to Include Tips

A. Introduction

Under the Federal Unemployment Tax Act ("FUTA"),[1] an employer is subject to a minimum net federal tax of 0.8 percent on the first $7,000 of "wages" paid annually to each employee. Under pre-TRA law, tips and gratuities were excluded from the definition of "wages" if paid directly to an employee by a customer of the employer and not accounted for by the employee to the employer.[2] For purposes of this rule, tips received by an employee are "accounted for" only to the extent the employee reports the tips to his employer and the tips bear a relationship to the total amount of the employee's remuneration. Applying these regulations, the Service has held that tips received by an employee constitute "wages" when they are reported in writing by the employee to the employer and taken into the account by the employer to the extent permitted in determining the employee's compensation under state or federal minimum wage laws.[3]

By contrast, for purposes of the Federal Insurance Contributions Act ("FICA"),[4] tips are treated as "wages" and are taxable as such except to the extent they are not paid in cash or, if paid in cash, are less than $20 per employee per month.[5] Every employee who receives tips in the course of his employment constituting "wages" for FICA purposes must report tips to his employer on a monthly basis.[6]

B. Overview

The Act has brought the FUTA definition of "wages," where tips are concerned, into conformity with the FICA definition of the same term.

C. Detailed Analysis

Section 1073 of the Act adds Code §3306(f), under which "wages," for FUTA purposes will, henceforth, include tips received while performing services constituting employment and included in a written statement furnished the employer pursuant to §6053(a). The legislative history indicates that, in enacting this provision, Congress wished to expand the eligibility for unemployment insurance benefits for employees who receive tips.[7] This result is thought likely to follow since the definitions of "wages" under state unemployment insurance statutes generally follow the FUTA definition and eligibility for benefits generally depends upon the amount of an employee's "wages" under the state statute to which he is subject.

The amendment will generally become effective on January 1, 1986.[8] The effective date is one year later, however, in the case of any state where the legislature did not meet in a regular session sometime during 1984 after the TRA's enactment date (July 18, 1984) and did not meet in any session before the enactment date and continuing for at least 25 calendar days after such date.[9]

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[1] Code §§3301-11. All section references are to the Internal Revenue Code of 1954 as amended and the regulations promulgated thereunder unless otherwise specified.
[2] Regs. §31.3306(b)-1(j)(3).
[3] Rev. Rul. 66-369, 1966-2 C.B. 451; Rev. Rul. 78-335, 1978-2 C.B. 254.
[4] §§3101-26.
[5] *See* §3121(a)(12).
[6] §6053.
[7] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1748 (1984).
[8] §1073(b)(1).
[9] §1073(b)(2).

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Chapter 52

ESTATE AND GIFT TAX CHANGES — GENERAL

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I. Deferral of Scheduled Reductions in Maximum Gift and Estate Tax Rates [Act §21]

A. Introduction

The Economic Recovery Tax Act of 1981 (ERTA) reduced the maximum rate of transfer tax [1] from 70 percent on taxable estates over $5 million, to 50 percent on taxable estates over $2.5 million.[2] This reduction was to be accomplished by simply removing the top brackets from the rate scale and imposing a maximum rate of 50 percent at $2.5 million.

However, the reduction in the maximum rate was not immediate; rather, the reduction from 70 to 50 percent was to be accomplished in 5 percent increments over four years, fully effective in 1985. Thus, for gifts made and decedents dying in 1982, the maximum tax rate was 65 percent on transfers in excess of $4 million, for 1983, the maximum rate was 60 percent on transfers in excess of $3.5 million; and for 1984, 55 percent on transfers in excess of $3 million. The rate was scheduled to be 50 percent on transfers in excess of $2.5 million in 1985 and thereafter.[3]

B. Overview

1. TRA Amendment

The maximum gift and estate tax rate remains at 55 percent on transfers in excess of $3 million in 1984 through 1987. The rate will be reduced to 50 percent on transfers in excess of $2.5 million in 1988.

2. Effective Date

The provision is effective for gifts made, and estates of individuals dying, after December 31, 1983.

C. Detailed Analysis

Section 21 of the Tax Reform Act of 1984 delays the completion of the scheduled incremental reduction in the maximum transfer tax rate. The incremental reduction does not resume until 1988; the effective result is a postponement of three years in the reduction of the maximum rate to 50 percent.

Observation: The change will have no impact on all but the largest estates, and even then the impact may be slight. For example, assuming pre-TRA law, in 1985, the federal estate tax would have imposed a 50 percent tax on transfers in excess of $2.5 million. Therefore, assuming a $10 million estate, as to the first $5 million of value ($2.5 million times two spouses), the analysis of how to split the estate to minimize taxes would revolve around the normal conflict between estate equalization and estate tax deferral, tempered by individual family considerations.

However, for the second $5 million of net worth, the marginal tax bracket applicable to the transfer would have been 50 percent regardless of which estate (husband's or wife's) bore the tax.

This result would hold true even if appreciation occurred between the deaths of the two spouses. However, at the death of the second spouse, only those assets included in the surviving spouse's estate would receive a stepped-up basis. Thus, in situations where no real tax savings can be obtained by equalizing the estates, the general practice is to utilize the unlimited marital deduction to pass the balance of the estate directly to the surviving spouse, and not through a bypass or family trust, so as to achieve a higher basis for eventual sale of the family's assets.

The Tax Reform Act's mandated delay in the reduction in the maximum transfer tax rate for another three years would seem only to buttress already existing planning considerations set forth above, because of the possibility of the estate of the surviving spouse being subject to tax at a lower rate than the estate of the prior deceased spouse.

II. Estate and Gift Tax Treatment of Property Settlements Incident to Divorce

Act §425 amends §§2043 and 2516 of the Code. The amendment of §2516 extends the period to enter into a property settlement agreement (for purposes of avoiding gift tax) to one year after the divorce. By virtue of the amendment of §2043, an estate tax deduction is allowed for transfers pursuant to claims arising under a written property settlement agreement if (1) the transfers are in satisfaction of marital or property rights and (2) the agreement would have qualified the transfers as non-taxable for gift tax purposes under §2516.

These amendments are applicable to estates of decedents dying after, and to lifetime transfers after, July 18, 1984.

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The amendments are discussed in greater detail in Chapter 13 of this portfolio.

III. Interest-Free and Below-Market Loans Give Rise to Gift Tax Consequences [Act §172]

A. Background

In *Dickman v. Commissioner*,[4] the Supreme Court held that an interest-free demand loan in an intrafamily setting results in a taxable gift. At the very moment the Supreme Court was issuing this landmark decision, Congress was considering legislative proposals to impose income as well as gift tax consequences with respect to below market and interest-free loans.

After the Seventh Circuit Court of Appeals held in *Crown v. Comr.*[5] that interest-free demand loans did not result in gift tax liability, the use of interest-free loans among family members enjoyed wide popularity as a tax planning tool. Touted as superior to the *Clifford* trust as a means of shifting income, it seemed to offer many of the benefits of the short-term trust without the related restrictions and formalities. Moreover, its purpose of shifting income from a higher-bracket taxpayer (usually a parent) to a lower-bracket taxpayer (usually the parent's child) could be accomplished without subjecting the lender to a ten-year wait before the property could be reclaimed. The dramatic facts in the Crown case (the taxpayer and his two brothers made interest-free loans in excess of $18 million to 24 different trusts) further encouraged taxpayers to utilize the interest-free loan arrangement as long as the courts and Congress were willing to sustain it.

The Internal Revenue Service had consistently argued that interest-free loans made in an intrafamily setting are within the reach of the federal gift tax laws. However, until *Dickman*, taxpayers successfully argued that interest payments imputed with respect to interest-free loans were not gifts for Federal gift tax purposes.

In *Dickman*, the Supreme Court held that the gift tax was designed to encompass all transfers of property and property rights having significant value and that the interest-free loan of funds is a "transfer of property by gift" within the meaning of that statute. The Court concluded that transfers of property "by whatever means effected" are subject to gift tax.

Even though the facts of *Dickman* involved use of a substantial amount of cash for an indefinite time, the opinion seems to extend to the use of any type of valuable property interest. The opinion discusses the rent-free use of property and the interest-free use of cash as similar grants of the use of property. In each case, the Court found that there is a measurable economic value associated with the use of the property transferred.

While the Supreme Court held that interest-free loans are subject to the gift tax, the Court remanded the case so the Tax Court could determine how the gift should be valued. Untouched by the *Dickman* decision was the question of the income tax consequences of such a loan. The Service had taken the position that, in the case of an interest-free loan to an employee or shareholder, the borrower derives an economic benefit that should be included in income. However, the Service's position on this issue had been rejected by a long line of cases.[6]

In the Act, Congress incorporated both income and gift tax provisions in a comprehensive and complex set of rules to be applied if a loan is interest-free or is made at an interest rate below the "market rate" designated by the statute. The income tax treatment of such loans is discussed at Chapter 39. This section will discuss the gift tax consequences of such loans.

B. Overview

1. Explanation of Provision

Act §172 adds new Code §7872, which imposes a set of rules for interest-free demand and term loans, and for loans made at below-market rates. Generally these rules provide as follows:

(1) The lender is deemed to have made a loan to the borrower requiring payment of interest at a stated applicable Federal rate of interest;

(2) The borrower is deemed to have paid interest to the lender at the stated applicable Federal rate of interest as of the end of each year; and

(3) The lender is deemed to have either (i) made a gift, (ii) paid compensation, or (iii) paid a dividend to the borrower of the imputed interest which is deemed paid on the loan.

The statute divides such loans into two categories, "gift loans" defined as any below-market loan where the foregoing of interest is in the nature of a gift, and "compensation-related loans", "corporation-shareholder loans" and other loans which have interest arrangements found to have a significant effect on any federal tax liability of the lender or borrower. In the case of gift loans, the lender is taxed on the imputed interest and is deemed to have made a gift of the interest back to the borrower.

2. Effective Dates

The new law applies generally to term loans made after June 6, 1984, and demand loans outstanding after that date. If a demand loan that is outstanding on June 6, 1984 is repaid within 60 days of the date of enactment, (*i.e.*, September 16, 1984), the Act will not apply. If the loan is not repaid by September 16, 1984, it will be subject to the new rules as of June 7, 1984.

The Conference Report states that no inference as to the proper treatment of loans before June 6, 1984 is intended.[7] Neither the statute nor the Reports prohibit the retroactive applicaton of *Dickman*.

C. Detailed Analysis

If a gift loan is below-market both income and gift tax liability may result. Different rules govern the income and gift taxation of such gift loans. This section deals with the gift tax rules. The income tax rules are discussed in Chapter 39.

1. Loans Covered by New Law

Act §172 adds new Code §7872 entitled "Treatment of Loans with Below-Market Interest Rates." A demand loan will be subject to this provision if the interest is payable on

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the loan at a rate less than the "applicable Federal rate." A term loan will be subject to this provision if the amount loaned exceeds the present value of all payments due under the loan.

Section 7872(a), providing for the treatment of gift loans, defines such loan as any below-market loan where the foregoing of interest is in the nature of a gift. The Act treats the value of the foregone interest as though it had been paid to the lender and then transferred back to the borrower as a gift. In the case of a demand loan the deemed gifts of the foregone interest to the borrower are treated as gifts for each year the loan is outstanding and are to be valued semi-annually. The gift term loan will be valued based on the discount rate in effect when the loan is made.

2. Foregone Interest

The term "foregone interest" means the excess of the amount of interest which would have been payable if interest accrued at the applicable Federal rate and was payable annually on the last day of the calendar year over any interest actually payable on such loan. This amount is deemed to be transferred to the lender and retransferred to the borrower (which is the gift transaction).

If the loan is a demand loan, the gift is valued as of December 31 each year the loan is outstanding. If the demand loan continues beyond one calendar year there will be annual gift tax consequences.

If the loan is a term loan the gift is valued at the time the loan is made as if the borrower received that day cash equal to the excess of the loan over the present value of all payments due under the loan, using a discount rate, compounded semi-annually, equal to the applicable Federal rate. The amount is deemed to be transferred on the date of the loan so there will be only one gift transfer in a term loan situation.

3. Applicable Federal Rate

Under the Act, the amount of the gift resulting from a below-market loan is based on the applicable Federal rate. The applicable Federal rate is determined under Code §1274(d) each October and April and is effective the following January 1 and July 1. This rate is based on the average market yield during the preceding 6 months on outstanding U.S. obligations with maturities under 3 years. For demand gift loans, the applicable Federal rate is the Federal short term rate in effect under §1274(d) for the period for which the amount of foregone interest is being determined. Because the rate is subject to change every six months, the amount of foregone interest and thus the amount of the gift must be valued semi-annually.

For term gift loans, the applicable Federal rate is the applicable Federal rate in effect under §1274(d), as of the day on which the loan was made, compounded semi-annually. Thus, term loans are valued based on the discount rate in effect when the loan is made.

Act §172(c)(4) states that for both demand and term loans the applicable Federal rate until January 1, 1985, shall be 10 percent, compounded semiannually.

4. $10,000 De Minimis Exception for Gift Loans

In the case of a gift loan, the Act provisions do not apply if the aggregate of all lender's loans to the same borrower does not exceed $10,000, regardless of the interest rate charged. This exception is applicable to loans "directly between individuals" so apparently the exception will not apply to estates, trusts, family partnerships, corporations and the like. For purposes of determining whether this exemption applies, a husband and wife are considered one person. However, the exception will not apply if the loan is "directly attributable to the purchase or carrying of income producing assets." This exemption also applies for income tax purposes.

Thus, if a father loans his daughter $9,000 and she pays for her law school tuition and buys a new car with the money, the loan will not be subject to gift tax. If the daughter puts the money in an interest bearing account, the Act provisions will apply. In the latter case, the gift still may be exempt from gift tax under the father's annual gift tax exclusion.

5. Regulatory Exception for Loans with No Tax Consequences

The Act provides that regulations should be issued exempting transactions "the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower." The House Report cites student loans, father's loan to son to pay for his current educational expenses, and insurance policy loans.[8]

6. Loans Made before June 6, 1984

a. Application of Dickman Case

The Act provisions cover the period from June 6, 1984. A vigorous lobbying effort to include a provision in the Act prohibiting the retroactive application of *Dickman* failed. As a consequence, the *Dickman* decision applies to pre-June 6, 1984 loans. Where no gift tax return has been filed for the period, the gift tax statute of limitations will not have begun to run.

The *Dickman* case also could apply to certain post-June 6, 1984 loans. The statutory rule appears to apply only to cash loans, not to the rent-free or low-rent use of property in kind, while the *Dickman* decision seemed to include such transfers within its reach. Since *Dickman* was not repealed by the statutory provision, the Supreme Court case still should control the gift tax consequences of the use of such in-kind property.

b. IRS Information Release 84-60

In Information Release 84-60,[9] the Internal Revenue Service explained the circumstances under which it would not require the reporting of pre-1984 interest-free demand loans and detailed the method for valuing the gifts resulting from such loans for which reporting is required. The Service stated that the value of gifts resulting from interest-free demand loans outstanding prior to January 1, 1984 could be determined by imputing interest at the lesser of the statutory interest rate for federal tax refunds and deficiencies or the annual average rate for three-month Treasury Bills. The release then set forth the applicable rate for 1960 through 1983:

1983	8.6%
1982	10.6%
1981	12.0%
1980	11.5%

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1979	6.0%
1978	6.1%
1977	5.2%
1976	4.9%
1975	5.8%
1974	6.0%
1973	6.0%
1972	4.0%
1971	4.3%
1970	6.0%
1969	6.0%
1968	5.3%
1967	4.3%
1966	4.8%
1965	3.9%
1964	3.5%
1963	3.1%
1962	2.7%
1961	2.3%
1960	2.9%

The Service stated that, for administrative convenience, it will not require gift tax reporting for interest-free demand loans made before January 1, 1984, if the amount of the gift, valued as set forth above, is less than the annual exclusion for the year, or, alternatively, if the average outstanding balance for all interest-free demand loans made in a particular year to a single donee did not total, in the aggregate, more than $50,000 (if made by a single taxpayer) or $100,000 (if made by a married taxpayer).

For example, in 1978, if a married donor has made a loan of $98,360 to a donee, he would not have to report the transfer. The amount of the gift ($6,000) comes within the annual exclusion, which was $6,000 for a married donor in 1978. Moreover, because the principal amount did not exceed $100,000, the transfer also would fall within the second reporting exception.

This "rule of administrative convenience" applies regardless of whether the donor has otherwise made gifts to the same donee during the same year. If the above rules do not exempt a donor from being required to report a gift resulting from an interest-free loan, the gift is calculated on the entire amount of the interest-free loan, without reduction for the amount that would fit within the above rules.

IR 84-60 does not apply to loans outstanding on or after January 1, 1984. There is thus a gap in coverage from the period January 1, 1984 to June 6, 1984.

7. Application of New Rules and Planning Considerations

a. New §7872 is so broadly structured that it could apply to almost any situation involving below-market and interest-free loans. Consider the following common situations: trustee makes loan to beneficiary, estate beneficiary makes loan to executor, trustee of decedent's irrevocable life insurance trust makes loan to decedent's executor, grantor makes loan to trusts he has created. Loans between these types of entities are often made because of the temporary liquidity needs of the borrower and, in many cases, the borrower and the lender, although separate entities and separate taxpayers, have the same beneficial owners. The gift tax consequences of these arrangements now must be considered in view of the Act provisions.

b. The Act probably will eliminate the appeal of interest-free and below-market loans in most estate plans, although the use of small loans which come within the available exclusions and exceptions still may be attractive. Of course, the income tax consequences of such transactions must be analyzed. The estate planner will be considering alternatives to these devices and may once again turn to the *Clifford* trust. Practioners should keep in mind the effect of the new ten percent actuarial tables in valuing the income interest. The present value of an income interest for ten years under the ten percent tables is approximately 61 percent of the corpus, in contrast to approximatey 44 percent under the six percent tables.

The term of a *Clifford* trust must be at least ten years. In some cases, the grantor may not want to wait ten years for the return of his property. In those cases, if the grantor is married, a practical alternative to the *Clifford* trust may be the spousal remainder trust. The spousal remainder trust is similar to the *Clifford* trust, but, instead of the property reverting to the donor, the property will pass to the donor's spouse when the trust terminates. Because the donor has retained no reversionary interest, the provisions of Code §673, which mandate the ten-year term, should not be applicable. In a situation in which there is marital harmony, the use of the spousal remainder trust may be a satisfactory alternative. However, this arrangement would be open to challenge if both spouses created identical trusts.

Another way to transfer funds to persons in a lower income tax bracket is by use of the annual gift tax exclusion. The higher income taxpayer may transfer up to $10,000 per donee ($20,000 with gift-splitting) per year without gift tax consequences.

c. If gift loans are to be made and the lender wishes to avoid application of the Act, the interest payable may not be less than the "applicable Federal rate." In the case of a term loan the applicable Federal rate is fixed as of the day the loan is made. The note thus could provide for interest payable at a rate equal to the current applicable Federal rate.

However, in the case of a demand loan, the gift is treated as a series of one-day term loans, requiring computation of the foregone interest semi-annually because the Federal short-term rate may change every six months. Even if the interest payable is not less than the applicable rate at the creation of the loan, the Federal short-term rate could increase. If this occurs the interest payable would be below-market and the loan would be subject to the Act provisions.

In order to avoid this result, the note could be written with a self-adjusting clause which is tied to the applicable Federal rate. For example, the note could state that "interest shall be payable at a rate equal to the 'applicable Federal rate' as that term is used in Section 7872(e)(1)(A) of the Internal Revenue Code of 1954, as amended."

IV. Repeal of Estate Tax Exclusion for Qualified Plans and IRAs

Section 2039(c) provides an estate tax exclusion for the value of an annuity or other payment receivable by any beneficiary, other than the participant's executor, under a

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qualified plan or retirement annuity contract, a §403(b) annuity contract, and certain Armed Forces and other governmental pension and survivor plans. The exclusion is available only if the annuity or other payment is not in the form of a lump sum distribution (except where the beneficiary elects to forego 10-year income-averaging for purposes of the income tax) and only to the extent the annuity is not attributable to accumulated deductible employee contributions.[10] A comparable estate tax exclusion is provided for IRAs under §2039(e).

TEFRA diminished considerably the value of the estate tax exclusion for qualified plans and IRAs by reducing the maximum exclusion to $100,000, effective for the estates of decedents dying after 1982.[11]

The TRA [12] completes the work begun by TEFRA, repealing the estate tax exclusion entirely with respect to the estates of the decedents dying after 1984. Certain exceptions are provided. For a discussion of the exceptions, see Chapter 49, IV.

Comment: If the spouse of the decedent is designated as the beneficiary of the qualified plan or IRA benefits, repeal of the estate tax exclusion should have no impact due to the availability of the unlimited marital deduction. If the qualified plan or IRA benefits are payable to a beneficiary other than the decedent's spouse, and the value of such benefits when added to the value of the other property includible in the decedent's taxable estate exceed the unified credit, the value of the benefits will be subject to the estate tax. However, since the qualified plan or IRA benefits will constitute income in respect of the decedent,[13] the estate tax attributable to such benefits will provide the recipient of the benefits with an income tax deduction under §691(c).

Observation: Although the repeal of the estate tax exclusion is an unfavorable development from an estate planning standpoint, another TRA change in the qualified plan and IRA requirements may prove beneficial. The TRA revises and liberalizes the post-death required distribution rules for qualified plan and IRA benefits that have not yet commenced at the time of the participant's death. Under the new post-death required distribution rules where distributions have not commenced, the benefits may be paid over the life of the designated beneficiary (who need not be the participant's spouse) or over a period not extending beyond the life expectancy of the designated beneficiary, so long as distributions begin no later than one year after the date of the participant's death. An even more favorable rule is provided if the designated beneficiary is the participant's spouse. In such case, the payment of benefits need not commence until the date on which the participant would have reached 70-1/2. More significantly, §401(a)(9)(F), as added by Act §521, contains an interesting rule that permits income-splitting of the qualified plan or IRA benefits among the participant's spouse and minor children without diminishing the security of the surviving spouse. Under this new provision, any amount paid to a child shall be treated as if it had been paid to the spouse if such amounts become payable to the spouse upon the child's reaching majority (or other event permitted under the regulations). Thus, the distribution of the qualified plan or IRA benefits can be pegged to the spouse's life expectancy, split among the children and the spouse during the children's minority, and eventually revert to the spouse. It should be kept in mind, however, that to the extent the benefits are diverted to the children during minority, such amounts will not qualify for the marital deduction. For a complete analysis of the new required distribution rules, see Chapter 49, I.

V. New Rules Under Which ESOPs Assume Liability for Certain Estate Tax Payments

Under §2210 of the Code, which was enacted in Act §544, liability for estate taxes may be assumed by an ESOP in return for a transfer from the estate of stock of an equal value, provided the company sponsoring the ESOP guarantees payment of the taxes.

Section 2210 is analyzed in depth in Chapter 48 of this Portfolio.

VI. Housing Bonds Not Exempt From Estate and Gift Taxation [Act §§641 and 642]

A. Introduction

In *Haffner v. U.S.*[14] an Illinois Federal court held that public housing agency notes and bonds are not only immune from income tax but also are not subject to gift and estate taxes. The obligations in *Haffner* were "project notes" issued pursuant to the Housing Act of 1937, which was intended to aid slum clearance and low-rent housing projects. Section 11(b) of the 1937 U. S. Housing Act, provides that such obligations are "exempt from all taxation now or hereafter imposed by the United States. . ."

In *Haffner*, the decedent died on March 15, 1979, owning project notes valued on the date of his death at over $1,000,000. His executors disclosed the existence of these notes on his federal estate tax return but stated that they were not taxable as a result of §11(b). The *Haffner* court, holding that the §11(b) exemption from "all taxation" includes estate and gift taxation, wrote an exhaustive summary of the history of this legislation and concluded that it showed a clear intent on the part of Congress to exempt these obligations from all taxation.

The Government has filed an appeal in *Haffner*, which will be heard by the Court of Appeals for the Seventh Circuit. In addition, in Information Release 84-89 (August 14, 1984) the Service announced that it will continue to follow Rev. Rul. 81-63, which concluded that a decedent's transfer of project notes was includable in his gross estate.

The provision of the Act which deals with the issue raised in *Haffner* did not appear in either the House or Senate bills but was added in conference. Although the Conference Report gives no indication of the reason for changing (or clarifying) the law, during discussions at a conference committee meeting the conferees indicated that they felt the Housing Act provision did not exempt project notes from estate and gift taxation.

B. Overview

1. Description of New Provision

Section 641 of the Act provides that, for estates of decedents dying after June 18, 1984 and gifts made after that date, any statute exempting property from taxation will not exempt the transfer from estate, gift and generation-skipping taxes. Section 642 of the Act imposes a

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reporting requirement on taxpayers who transferred project notes between January 1 and June 18, 1984 and imposes a penalty tax if the transfers are ultimately held to be taxable.

2. Effective Dates

The provision applies to estates of decedents dying, and transfers made, on or after June 19, 1984. The Act also states that the rule denying exemption from estate and gift taxes applies to any transfer, even if made before June 19, 1984, if an estate or gift tax return was filed reporting the transfer as subject to tax. The Act also provides that no inference should be made that a transfer before June 19, 1984 is exempt from federal estate and gift taxes. With respect to transfers of project notes from January 1, 1984 to June 18, 1984, the Act requires a taxpayer to report certain information regarding any transfers of such notes.

C. Detailed Analysis

1. Project Notes Not Exempt from Transfer Tax

Section 641 of the Act, a non-Code provision, reflects Congress' intention to clarify the provisions of the Housing Act. Section 641(a), which attempts to overrule the *Haffner* decision, states that any existing law which exempts property from taxation does not exempt the transfer of such property from federal estate, gift and generation-skipping transfer taxes.

Even if the *Haffner* case is affirmed on appeal, §641(a) of the Act, denying exemption from estate, gift and generation-skipping taxes, will apply to transactions occurring on or after June 19, 1984. Accordingly, if project notes are owned by a decedent, or transferred by a donor, on or after June 19, 1984, they will be subject to such taxes.

In cases where a decedent owned project notes and died before June 19, 1984, or where transfers were made before that date, the Act provides different rules, the application of which depends on how the decedent's executor, or the donor, treated the transaction. Where the executor or the donor filed an estate or gift tax return reporting the transfer as subject to Federal estate or gift tax, §641(b)(2) makes the rule of §641(a) applicable to such transfers, even if the transfers were made before the general effective date of June 19, 1984. This provision purports to prevent claims for refunds, based on *Haffner*, where an estate or gift tax return was filed reporting the transfers as subject to federal estate or gift tax.

Section 641(b)(3) of the Act states that no inference shall arise from the above rules that any transfer before June 19, 1984 is exempt from Federal estate and gift taxes. Presumably the "no inference" provision applies only where the transfer was not reported as subject to tax.

The Act thus provides a double standard for transfers made before June 19, 1984. Accordingly, if reported as taxable, a transfer would be subject to the provision denying exemption, even if the *Haffner* case is affirmed. In cases where the transfer was not reported as taxable, "no inference" arises with regard to the transfer. Thus, under the Act, the estate or donor is decidedly better off if the transfer was not reported as taxable. Presumably, where the executor or donor disclosed the transfer on the return but did not report it as taxable, the transaction would be within the "no inference" category.

Whether or not the Act's attempt to apply the legislation to pre-existing obligations, and its double standard for such application, is unconstitutional will no doubt be challenged in the courts. However, such challenge would become moot if the *Haffner* case is overturned on appeal. Until these issues are resolved, it may be prudent to file refund claims or amended returns in cases which are not barred by the applicable period of limitations, even in cases where the statute purports to bar such claims.

2. Reporting Requirements

Section 642 of the Act requires the taxpayer to report the date and amount of any transfers of project notes made after December 31, 1983 and before June 19, 1984 and such other information regarding the transfer as regulations to be prescribed by the Secretary may require. Any taxpayer failing to provide the information required will be liable for a penalty equal to 25% of the excess of the tax payable assuming the transfer is subject to tax, over the tax payable assuming such transfer is not subject to tax. If *Haffner* is overturned by the Seventh Circuit, this provision will allow the Service to determine which transfers may be subject to tax.

VII. Special Interest Provisions

Section 1028 of the Act is a special interest provision which provides a special credit for Federal estate tax imposed on the estates of Nell J. Redfield and Elizabeth Schultz Rabe for transfers of real property to Toiyabe National Forest.

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[1] I.R.C. §2001(c).
[2] Economic Recovery Tax Act of 1981, P.L. 97-34, §402(b), August 13, 1981.
[3] I.R.C. §2001(c)(2).
[4] 104 S.Ct. 1086, 84-1 USTC §13, 560, 627 (1984).
[5] 585 F.2d 234 (7th Cir. 1978).
[6] *Dean v. Comr.*, 35 T.C. 1083 (1961). The *Dean* case was followed in seven circuits.
[7] Conf. Rept. No. 98-861, 98th Cong. 2nd Sess. p. 1023 (1984).
[8] H. Rept. No. 98-432 (Part 2), 98th Cong. 2d Sess. p. 1378 (1984).
[9] I.R.B. 1984-23, 58 (June 4, 1984).
[10] §2039(f).
[11] TEFRA, §2045(a) and (c).
[12] Act §525.
[13] *Hess v. Comr.*, 271 F.2d 104 (3rd Cir. 1959); see also §691(c)(5).
[14] 84-1 USTC ¶13,571 (N.D. Ill. 1984).

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CHAPTER 53

INSTALLMENT PAYMENT ELECTION UNDER SECTION 6166 PERMITTED FOR CERTAIN HOLDING COMPANY STOCK; REPEAL OF INVESTMENT ASSET EXCEPTION

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I. Introduction

A. *Corporate Holding Company*

Prior to the effective date of the 1984 Tax Reform Act (P.L. 98-369), it was unclear whether a corporation the sole asset of which was all of the stock of an active corporation would be treated for tax purposes as carrying on the trade or business of its subsidiary. In two private letter rulings, PLR 8130175 (May 1, 1981) and PLR (TAM) 8134012 (April 30, 1981), the Service ruled that the §6166 election to pay federal estate tax in installments would not be available for a decedent's interest in a corporate holding company, even if the parent owned 100 percent of the stock of an operating subsidiary.

The Service's pre-TRA position was not necessarily required by the statute. First, the entity attribution rule could apply to attribute the assets constituting a trade or business of an active subsidiary to a passive holding company because §6166(b)(2)(C) attributes "property" from a corporation to its shareholders. Second, pursuant to the mandate to issue regulations in §6166(i), the Service has the authority to prescribe rules permitting corporate holding companies to qualify under appropriate circumstances for §6166 treatment.

Section 6166 is intended to prevent illiquid estates from having to dispose of interests in active businesses solely to pay estate taxes where a substantial amount of the estate's value is concentrated in closely held businesses. As stated in the Senate Finance Committee Report:[1]

> "Because liquidity problems may arise whether the closely held business interest is owned directly or indirectly through a holding company, the committee believes it is appropriate to permit certain holding companies to be 'looked through' to determine whether an individual owned a qualifying interest in a closely held business."

B. *Investment Asset Exception*

Under the existing regulations,[2] if a partnership or corporation carries on a trade or business, "it is not necessary that all of the assets of the partnership or the corporation be utilized in the carrying on of the trade or business." Section 20.6166A-2(c)(2) of the regulations is to the same effect:

> "[T]he decedent's entire interest in the partnership, or . . . the corporation, constitutes an interest in a closely held business even though a portion of the partnership or corporate assets is used for a purpose other than the carrying on of a trade or business."

It was unclear, under pre-TRA law, what percentage of the total assets of the partnership or corporation could be investment assets. Assuming that an appropriate percentage of business assets can be determined, there does not appear to be any requirement that the contribution of investment assets to a partnership or corporation be motivated by a bona fide business purpose. Finally, since the date for testing a stock or partnership interest as a closely held business interest is the "time immediately before the decedent's death," transfers of investment assets in "contemplation of death" should be recognized for purposes of §6166.

By comparison, in the case of a proprietorship, the estate tax attributable to investment assets is not eligible for §6166 treatment. However, working capital can qualify as a trade or business asset.

According to the Senate Finance Committee Report,[3] the investment asset exception should be repealed because similar rules should be applied in valuing a decedent's closely held business interest regardless of whether that business is operated as a proprietorship, a partnership, or a corporation.

II. Overview

Section 6166, as amended by §1021 of the Act, permits the executor to elect to qualify holding company stock for the deferral provisions of §6166; however, the 15-year deferral period is reduced to 10 years and the special 4 percent interest rate is eliminated. Appropriate adjustments to the acceleration rules are provided.

Passive assets owned by partnerships and corporations will be disregarded when determining whether the business qualifies for the benefits of §6166. This provision applies whether or not the executor makes the election relating to holding company stock. This is the same rule that now applies to proprietorships.

III. Detailed Analysis

A. *Corporate Holding Company*

1. *Qualification of Certain Holding Company Stock as Business Company Stock*

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The Act added §6166(b)(8) to permit an executor to elect to treat stock in certain holding companies, which own stock in a "business company" (defined in §6166(b)(8)(D)(ii)), as stock in such business company. If the executor makes the election, the special 4-percent interest rate and the five-year deferral of principal payments are not available.[4]

A complicated and stringent set of rules must be applied in utilizing the TRA election as follows:

1. The business company must meet the requirements of §6166. Thus, the business company must have 15 or fewer shareholders or the decedent must own 20 percent or more of the corporation's voting stock.[5]

2. The value of the business company must exceed 35 percent of the value of the decedent's adjusted gross estate.[6]

3. Indirectly owned business stock can be combined with other directly owned business stock (plus stock attributed from family members) to qualify the estate under §6166.

4. In case of multiple holding companies, a corporation will be looked through only if at least 20 percent of the total value of the corporation is included in the decedent's gross estate, either directly, or indirectly through a qualifying interest in another, higher tier, corporation. The following is an example from the Senate Finance Committee Report.[7] If the business company were a fourth-tier subsidiary, the value of that company could be considered for purposes of §6166 only if the decedent directly owned at least 20 percent of the value of the first-tier holding company, and indirectly owned at least 20 percent of each of the second-tier and third-tier holding companies.

5. The look-through provision for multiple holding companies is applied successively to the stock of each business company in the chain, stopping at the earlier of (i) the corporation of which the decedent owns less than the required 20-percent interest, or (ii) the business company which the executor elects not to look through.

6. Pursuant to §6166(b)(8)(C), the value of voting stock in a business company may only be reflected through the value of voting stock in higher-tier holding companies to determine whether the decedent satisfies the 20 percent voting stock requirement in §6166(b)(1)(C)(i). The value of lower-tier voting stock may not be reflected through the value of nonvoting stock in any higher-tier corporation for purposes of the 20-percent test because that test requires voting stock to be owned by the decedent. By comparison, for purposes of the 35-percent test, the value of both voting and nonvoting stock in the business company may be reflected through the value of stock in higher-tier holding companies since, unlike the 20-percent test, the 35-percent test in §6166(a)(1) does not require the decedent to own voting stock.

7. According to the Senate Finance Committee Report,[8] the value of holding company stock that is treated as business company stock is the value of such stock for federal estate tax purposes, unaffected by the treatment of such stock as stock of a lower-tier active business corporation.

2. Special Acceleration Provisions If Holding Company Rules Apply

The Act adds the following three special rules under the acceleration provisions if the executor makes an election to treat holding company stock as business company stock:

1. Under post-TRA §6166(g)(1)(E), any disposition of holding company stock or withdrawal of money or other property from the holding company is treated as a disposition of, or withdrawal from, the business company.

2. Under post-TRA §6166(g)(1)(F), if the holding company disposes of any stock in the business company or withdraws money or other property from the business company, the disposition or withdrawal is included in determining whether an acceleration occurs. According to the Senate Finance Committee Report,[9] the "Treasury Department will issue regulations to ensure that dispositions or withdrawals from the corporation carrying on an active business are considered only once in determining whether tax is accelerated."

3. Finally, under post-TRA §6166(g)(2)(C), if an estate has undistributed net income in any year, dividends paid to any holding company by the business company are treated as if the dividends were paid to the decedent's estate to the extent of the decedent's ownership (direct or indirect) of the holding company.

3. Repeal of Investment Asset Exception for Corporations and Partnerships

The Act added §6166(b)(9) to provide that, in the case of an interest in a partnership or corporation, passive assets (property not directly related to the reasonable needs of the conduct of the active trade or business) are to be disregarded for purposes of §6166. This rule applies to all estates electing under §6166, whether or not the special holding company election is made.

Property contributed to the qualified business must be used directly in the active conduct of the trade or business. Assets will be considered passive unless they form part of a partnership's or corporation's working capital or constitute reasonable reserves for financing of a specifically identified project. The following example is contained in the Senate Finance Committee Report.[10] A reserve for expansion of a factory building that is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made would be a reasonable reserve.

Section 6166(b)(9)(B)(ii) defines "passive asset" to include stock in another corporation unless the stock of such subsidiary is (i) treated as business company stock pursuant to the post-TRA election procedure contained in §6166(b)(8), or (ii) the stock of an active corporation. To be an active corporation, a corporation must own 20 percent or more in value of the voting stock of the active corporation or such active corporation must have 15 or fewer shareholders, and 80 percent or more of the value of such corporation must be attributable to assets used in carrying on a trade or business.

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The Senate Finance Committee Report [11] also recognizes three situations in which stock held by one corporation in another corporation may not be a passive asset. First, where a group of corporations (whether or not controlled for purposes of §6166) is functionally related (*e.g.*, a manufacturing corporation may own all or a part of the stock in one or more of its supplier corporations). Second, where a group of corporations (whether or not controlled for purposes of §6166) are engaged in unrelated lines of business but are subject to varying degrees of common ownership and managerial control and direction. Third, where corporations form a controlled group of corporations as defined in §1563.

According to the Senate Finance Committee Report,[12] the regulations will provide rules similar to the rules governing the accumulated earnings tax (§531).

> "However, the committee does not intend that the accumulated earnings tax rules be followed in any case where those rules differ from the present rules under the installment payment provision pursuant to which business and personal assets are segregated in the case of proprietorships unless the difference is necessary because of the partnership or corporate form of business operation."

Finally, the Senate Finance Committee Report [13] provides that, where only a portion of a partnership interest or of stock in a corporation qualifies for purposes of §6166, and a part of such partnership interest or stock is disposed of (or property withdrawn from such partnership or corporation) only a portion of the sales proceeds or property withdrawn will be counted against the 50-percent threshold amount specified in §6166(g)(1)(A). For example, if 75 percent of the stock in a corporation qualified under §6166 and the stock was sold, only 75 percent of the sales proceeds would be treated as a disposition for purposes of the acceleration rules. However, it may be appropriate to trace proceeds where specific assets are withdrawn from the business.

4. Effective Dates

The TRA rules apply to estates of individuals dying after the Act's date of enactment, July 18, 1984.[14] Thus, with respect to individuals dying before the date of enactment, the availability of §6166 for holding company stock will remain an open and troublesome issue.

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[1] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 712 (1984), (hereinafter "Senate Report").

[2] Regs. §20.6166A-2(c)(1).

[3] Senate Report at 712.

[4] §6166(b)(8)(A)(ii) and (iii).

[5] §6166(b)(1)(B).

[6] §6166(a)(1).

[7] Senate Report at 713.

[8] *Id.*

[9] *Id.* at 714.

[10] *Id.*

[11] *Id.*

[12] *Id.* at 715.

[13] *Id.*

[14] Act §1021(e).

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CHAPTER 54

CHANGES AFFECTING DEDUCTIONS FROM GROSS ESTATE

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I. Rules for Reforming Governing Instruments Creating Charitable Split-Interest Trusts Made Permanent [Act §1022]

A. *Introduction*

To correct certain perceived abuses in the use of charitable split-interest trusts, the Tax Reform Act of 1969[1] introduced a series of complex and technical requirements which must be met to obtain the desired charitable income, gift, or estate tax deduction. The 1969 Act added Code §§2055(e)(3) and 2522(c) which provide that an estate or gift tax deduction is not allowed for transfers of property to a trust which has both charitable and noncharitable interests unless, in the case of a remainder trust, the trust takes one of three qualifying forms: (i) a charitable remainder annuity trust;[2] (ii) a charitable remainder unitrust;[3] or (iii) a pooled income fund.[4] A deduction also is allowed for a remainder interest in a farm or personal residence and for an income interest passing to a charity, if the income interest is either a guaranteed annuity or a unitrust.

To assist practitioners, the Service published Rev. Rul. 72-395,[5] which provides detailed sample provisions, drafting requirements, and options that can be used to satisfy the §2055(e)(2) requirements for charitable remainder trusts. No comparable ruling was issued with respect to charitable lead trusts. In 1974, Congress enacted Code §2055(e)(3), which allowed reformations of defective trusts during a transitional period to comply with the requirements of the 1969 TRA. The transitional period was extended several times.[6] The last relief provision allowed corrected trusts to qualify if the trust or will was executed before December 31, 1978, and the reformation was completed by December 31, 1981.

Note: After the transitional rule expired, courts were willing to "construe" split-interest trusts to allow the estate to obtain the sought-after estate tax charitable deduction when they found that such a result was warranted by the facts and was consistent with the testator's intent.[7]

The Congressional committees considering the 1984 TRA found that disqualification under the split-interest rules remained a problem and usually resulted in reduced amounts passing to charity. The committees believed that a permanent rule permitting reformation of split-interests trusts should be permitted, with safeguards to avoid abuse.

B. *Overview*

1. *Description of the TRA Provision*

Act §1022 amends Code §2055(e)(3) to provide a permanent rule for reforming split-interest trusts if certain requirements are satisfied. Reformation will be allowed, in the case of a charitable remainder trust, where the noncharitable beneficiary's interest is expressed in terms of an annuity or unitrust interest. Reformation also is possible if judicial proceedings are begun within a specified time.

2. *Effective Dates*

The provision applies to reformations made after December 31, 1978. A special rule opens the statute of limitations for one year after the TRA's enactment date to permit credits or refunds of tax. In addition, in applying the 90-day period for commencement of judicial proceedings, where an instrument does not comply with the guaranteed annuity or fixed unitrust concepts of the 1969 TRA, the 1984 Act provides that the period will not expire before the 90th day after the 1984 Act's enactment date. Since enactment occurred on July 18, 1984, such reformation proceedings must begin on or before October 16, 1984.

C. *Detailed Analysis*

1. *Reformable Interest*

Under the 1984 TRA provision, reformation will be allowed if one of the following two requirements is met. First, the instrument must express the noncharitable beneficiary's interest in terms of an annuity or unitrust interest. The Senate Report states that a trust would not meet this requirement if the governing instrument provides powers of invasion for a non-charitable beneficiary.[8]

If the first requirement is not met, reformation may also be accomplished if a judicial proceeding to correct the trust is commenced within 90 days after the filing date (including extensions) of the estate tax return on which a charitable deduction is claimed. If no estate tax return is required, the proceeding must be commenced within 90 days after the due date (including extensions) for the first required income tax return of the trust.

Note: Although the statute itself does not include this requirement, the Senate Report[9] expresses Congress' intent that, for the commencement of a judicial proceeding to be timely, the pleading must describe the nature of the defect. According to the committee report, the filing of a general protective pleading will not suffice.

The first requirement was intended to allow reformation if, on the face of the document, there was an intent to comply with the 1969 Act. The statute states that, to be a "reformable interest," all payments to persons other than an organization described in Subsection (a) [*i.e.*, charitable organizations] are expressed either in specified dollar amounts or a fixed percentage of the fair market value of

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the property." [10] This language provides an objective test in cases involving a charitable remainder trust, where the unitrust or annuity payment must be made to persons other than charitable organizations. It is unclear, however, how this requirement should be interpreted in cases involving a charitable lead trust, where the unitrust or annuity payment is made to charitable organizations. Although it appears that the statute was intended to apply the same standards for reformation to both charitable lead and remainder trusts, the language of this section does not seem to be drafted to apply to charitable lead trusts.

2. Qualified Interest

If the interest meets one of the above two requirements, it is a "reformable interest." A "reformable interest" may become, through a qualified reformation, a "qualified interest" if two additional requirements are met. First, the reformation may not change the actuarial value of the charitable interest by more than 5 percent. Second, the durations of the charitable and noncharitable interests may not change. A noncharitable interest in a charitable remainder trust of more than 20 years, however, may be reduced to 20 years.[11] In that case, the Senate Report states that the annual distribution to the noncharitable beneficiary must be increased so that the actuarial value of the charitable and noncharitable interests remain the same.[12]

3. Qualified Reformation

Qualified reformation may be achieved by any method permissible under local law (reformation, amendment, contribution) as long as all relevant parties are bound by the change.

The Act also provides that a reformation of the trust is deemed to occur when: (i) the noncharitable beneficiary dies; or (ii) a specific portion of the trust passes to charity, before the estate tax return is due (including extensions). In the case of the death of the noncharitable beneficiary, presumably, the deduction still should take into account the beneficiary's interest.

Both *inter vivos* and testamentary trusts may be reformed. In the case of testamentary trusts, the reformation is retroactive to the date of death and, in the case of *inter vivos* trusts, it is retroactive to the date of creation.

If a qualified reformation is achieved, a deduction will be allowed for the lesser of the actuarial value of the charitable interest after the reformation or the amount of deduction that would have been allowed under the instrument prior to the reformation if such deduction had not been disallowed.

4. Conforming Changes in Other Code Sections

These rules are applied in the income and gift tax Code (§§(170)(f) and 2522(c)), by general incorporating references. Post-TRA Code §2055(e)(3)(H) directs the Secretary of the Treasury to prescribe regulations concerning the taxation of trusts under subchapter J which are reformed pursuant to the provision. These regulations should confirm that a reformed charitable remainder trust is exempt from federal income tax. The Secretary also is to prescribe comparable rules permitting the reformation of charitable transfers involving remainder interests in pooled income funds, farms, and personal residences, which are to be consistent with the rules for charitable remainder and lead trusts.

In addition, the Act amends Code §664, relating to charitable remainder trusts. Under this provision, a charitable remainder trust may provide for a "qualified contingency" without being disqualified. For instance, it will be permissible to provide for a charitable remainder trust to terminate either on the death of a beneficiary, or on the beneficiary's remarriage. This contingency will be disregarded in valuing the charitable remainder.

5. Planning Considerations

Under the TRA's reformation statute, the planner must carefully examine existing documents to see if reformation is necessary. If the trust does not substantially comply with the 1969 Act, or if it is unclear whether it does, federal proceedings may have to be instituted as quickly as possible. One way to give the planner more time for an analysis of the trust would be to seek an extension of time for filing the federal estate tax return. Problems often arise when the estate tax return is audited, however, which usually will occur after the 90-day period.

II. Availability of Marital Deduction for Usufruct Interests Clarified [Act §§1027(a) and (b)]

A. Introduction

ERTA (P.L. 97-34) enacted Code §2056(b)(7), which permits an executor to elect to claim an estate tax marital deduction for certain qualifying life income interests ("QTIP" property) transferred to the spouse. In civil law jurisdictions such as Louisiana, a surviving spouse may receive a usufruct interest in property, which is comparable to a legal life estate. A usufruct interest may be in consumable or nonconsumable property.

There was some question whether the QTIP election could be made with respect to usufruct interests for life in consumable property under the Louisiana Civil Code because that law does not trace the usufruct property to find if the property is later included in the surviving spouse's estate.

B. Overview

1. Description of Provision

The Act provides that a QTIP election is available with respect to a usufruct interest for life under Louisiana law.

2. Effective Date

The provision applies as if included in ERTA §403.

C. Detailed Analysis

1. Usufruct Interest Qualifies as QTIP

Act §1027(a) amends Code §2056(b)(7)(B)(ii) to provide that a usufruct interest for life qualifies as QTIP property. The Act accomplishes this by redefining "qualified income interest for life" to include interests under which "the surviving spouse is entitled to all of the income from the property, payable annually or at more frequent intervals, or has a usufruct for life in property . . ."

The Conference Report clarifies that the QTIP election will be available for both consumable and non-consumable

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property.[13] This is significant because, under Louisiana law, consumable property is commingled with the spouse's own property and Louisiana law does not provide for tracing. The Conference Report explains that, in the case of a usufruct for life in nonconsumable property, if a QTIP election is made with respect to such property, it is to be treated as included in the surviving spouse's estate under Code §2044. In the case of a usufruct for life in consumable property, if a QTIP election is made with respect to such property, it will be treated as included in the surviving spouse's estate under Code §2044 to the extent of the remainderman's claim against the spouse's estate and includable under Code §2033 to the extent of any excess value. The claim of the surviving spouse's estate for contribution from the remainderman under Code §2207A would be limited to the amount of tax attributable to the portion of property includable under Code §2044.

2. No Deduction Allowed Under Code Section 2053(c)

TRA §1027(b) amends Code §2053(c) to provide that no deduction will be allowed to the surviving spouse's estate for a claim against the estate by a remainderman if the claim relates to a usufruct interest included in the surviving spouse's estate under Code §2044. These rules make the tax consequences of a QTIP election with respect to a usufruct interest consistent with the QTIP rules in common law states.

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[1] P.L. 91-172.
[2] Code §664(d)(1). All section references herein are to the 1954 Internal Revenue Code as amended and the regulations promulgated thereunder unless otherwise specified.
[3] §664(d)(2).
[4] §642(c)(5).
[5] 1972-2 C.B. 340. This ruling has been modified by Rev. Rul. 80-123, 1980-1 C.B. 205 and Rev. Rul. 82-128, 1982-1 C.B. 71 and clarified by Rev. Rul. 82-165, 1982-2 C.B. 117.
[6] Tax Reform Act of 1976, P.L. 94-455, §1304; the Revenue Act of 1978, P.L. 95-600, §514(a); the Tax Act of 1980, P.L. 96-605, §301(a)(1).
[7] *See* Pearle, "Avoiding Disallowance Under the Split-Interest Trust Rules," Tax Management Memorandum ____ (1984).
[8] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 733 (1984) (hereinafter "Senate Report" or "S. Rep.").
[9] S. Rep., p. 733 (1984).
[10] §2055(e)(3)(C)(ii).
[11] To comply with §§664(d)(1)(A) or 664(d)(2)(A), charitable remainder annuity and trusts and unitrusts may not be more than 20 years in duration.
[12] S. Rep., p. 733 n.3 (1094).
[13] Conf. Rep. No. 861, 98th Cong., 2d Sess., p. 1239 (1984).

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Chapter 55

CHANGES IN ALTERNATE VALUATION DATE ELECTION RULES

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I. Background

Code §2032 provides that an executor may elect to value assets for estate tax purposes on the alternate valuation date instead of on the date of death. The alternate valuation date is six months after the decedent's death or, if earlier, the date of disposition of the assets. Prior to the 1984 TRA, §2032(c) provided that the executor must elect the alternate valuation on a timely-filed federal estate tax return. The estate tax value becomes, under §1014(a)(2), the income tax basis of the assets.

Although §2032 was intended as a relief provision, the election to use the alternate valuation date could be made regardless of whether the assets increased or decreased in value. The executor generally makes the election when assets declined in value. Where assets increase in value but the estate has no federal estate tax liability because of available credits or deductions, however, executors have found it advantageous to elect alternate valuation to increase the estate tax value and thereby increase the basis of the assets to the heirs. Congress felt that use of the alternative valuation date in these circumstances was an abuse.

II. Overview

A. Explanation of Provision

The Act provides that the alternate valuation date may be elected only if the election will decrease both the value of the gross estate and the estate's federal estate tax liability. The Act also provides that the election may be made on a late return.

B. Effective Date

The provision is effective with respect to estates of decedents dying after the TRA's enactment date, July 18, 1984.

TRA §1024(b)(2) provides a special transitional rule for electing the alternate valuation date for estates of decedents dying before enactment of the Act. A late election may be made if: (i) the time to seek a credit or refund has not expired; (ii) the election would have complied with the TRA (*i.e.*, alternate valuation would result in both a reduction of tax and a reduction of the gross estate); and (iii) such a claim for credit or refund is filed within 90 days of the Act's enactment date. If an election is made under this transitional rule, the period for assessing deficiencies which are attributable to the election is extended to two years from July 18, 1984.

III. Detailed Analysis

A. Restriction on Use of Alternate Valuation Date

Act §1023 added Code §2032(c) to permit an executor to elect the alternate valuation date only where both the total value of the gross estate and the federal estate tax liability of the estate are reduced. The approach taken in the Act, requiring both the total value of the estate and the tax liability to decrease by the election, however, could lead to some unintended results. For example, assume decedent dies in 1984 bequeathing his shares of closely-held stock to his children and his highly speculative real estate investment to his spouse. The stock is worth $400,000 at his death and $325,000 six months later. The real estate is worth $1,000,000 at death and $1,125,000 six months later.

If an election could be made to use the alternate valuation date, this estate would have no federal estate tax liability because the real estate passing to the spouse would qualify for the marital deduction and the stock passing to the children would absorb the unified credit exemption equivalent amount of $325,000 for decedents dying in 1984. Under the TRA, however, the executor would not be eligible to make the election because the total gross estate is greater at the alternate valuation date than at the date of death. Under these facts, because the alternate valuation date could not be elected, the estate would incur some federal estate tax liability.

B. Availability of Alternate Valuation Date

TRA §1024 added Code §2032(d) which provides that the election to use the alternate valuation date may be made on a federal estate tax return that is not timely filed.

The TRA provision states that the election may be made on the estate tax return filed for the estate, provided the return is filed no more than one year after the time prescribed by law (including extensions) for its filing. The Act also provides that, once the election is made, it is irrevocable.

A further requirement, that the alternative valuation must be elected on the first estate tax return filed for the estate, appears in the Conference Report [1] but not in the statute. This requirement should not apply in the case of a timely filed return. If the return is not timely filed, however, the election may have to be made on the first filed return.[2]

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[1] Conf. Rept. No. 98-861, 98th Cong. 2nd Sess. 1243 (1984).

[2] *See* PLR 8418005, where the Service held that an election to treat certain property as qualified terminable interest property ("QTIP") was invalid because it was made on a second estate tax return that was filed after the due date. Section 2056 provides that a QTIP election must be made on "the return of tax imposed by §2001." According to the Service in PLR 8418005, this means the last return filed on or before the due date of the return or, if a timely return is not filed, the first estate tax return filed after the due date. The same reasoning could apply with respect to the alternate valuation election.

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Chapter 56

TAX TREATMENT OF PROPERTY DISTRIBUTED IN KIND BY AN ESTATE OR TRUST [ACT §81]

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I. Introduction

Under pre-TRA law, if property was distributed in kind and if such property had appreciated in value since it was acquired by an estate or trust, the beneficiary would receive a stepped up basis equal to the fair market value of the property on the date of distribution, to the extent that the distribution attracted distributable net income (DNI).[1] This tax-free basis adjustment provided a rare opportunity to obtain an increase in basis without realizing gain. The tax-free basis adjustment was available in the case of any distribution of appreciated property which attracted DNI except a distribution of appreciated property in satisfaction of a pecuniary bequest. In that case, the beneficiary received a stepped up basis but the adjustment was not tax-free because the estate or trust realized gain on the distribution.[2]

II. Overview

A. Description of Provision

Act §81 enacted Code §643(d) which provides that, where appreciated property is distributed in kind to a trust or estate beneficiary, the fiduciary may elect to have the gain or loss recognized at the trust level. If such an election is made, the property will carry out distributable net income to the beneficiary to the extent of the property's fair market value and the beneficiary's basis will be stepped-up to fair market value. If no election is made, the distribution will be treated as carrying out distributable net income only to the extent of the lesser of the adjusted basis of the property or its fair market value and the beneficiary will receive a carryover basis in the property.

B. Effective Date

The provision applies to trust distributions after June 1, 1984 in taxable years ending after that date.

III. Detailed Analysis

Act §81 added Code §643(d). Under §643(d)(1) and (2), if the executor or trustee does not make an election, when the fiduciary makes a distribution to a beneficiary of an asset in kind (as opposed to cash) the basis of the property in the hands of the beneficiary will be the fiduciary's adjusted basis of the property, (i.e., the beneficiary will receive a carryover basis). In this case, no gain or loss is recognized by the trust or estate.

Code §643(d)(1) and (3) provide that the fiduciary may elect to recognize gain or loss at the trust or estate level. If this election is made, the beneficiary's basis will be stepped up to fair market value.

The tax-free basis adjustment provided tax planners with a significant income tax planning tool. The planner must now consider that one taxpayer, either the trust/estate or the beneficiary, will recognize gain or loss and determine which one it should be. Several factors will have to be considered, including the relative tax brackets of the trust/estate and the beneficiary, the type of asset to be distributed and the amount that asset has appreciated or depreciated, whether the asset will appreciate or depreciate in the future, and whether the beneficiary plans an immediate sale of the asset.

These rules do not apply to distributions such as specific bequests and charitable distributions, which do not carry out distributable net income. Moreover, the rules do not affect the rule providing a basis adjustment for property received in a satisfaction of a pecuniary bequest, where, under current law, gain is realized by the trust or estate.

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[1] Regs. §1.661(a)-2(f).
[2] Regs. §1.661(a)-2(f)(2).

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Chapter 57

STRICTER RULES FOR AGGREGATION OF MULTIPLE TRUSTS

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I. Introduction

Multiple trusts have been used by tax planners to split income among several entities to take advantage of the progressive rate tables. After the 1969 Tax Reform Act, regulations were promulgated [1] which provided that trusts with substantially the same grantor and beneficiaries and with no substantially independent purposes are to be treated as one trust for income tax purposes, if the principal purpose of the trusts was tax avoidance.

The courts, however, have been liberal in finding the existence of separate trusts, particularly where the trusts have been separately administered.[2] Further, the Tax Court, in *Stephenson Trust v. Comr.*,[3] a 1983 case, ruled that the Treasury regulation was invalid because it was inconsistent with the Code.

II. Overview

A. Description of Provision

The Act reverses *Stephenson Trust v. Comr.* and provides a statutory rule for aggregating trusts for income tax purposes. Under the Act, two or more trusts will be treated as a single trust if: (i) the trusts have substantially the same grantors and beneficiaries; and (ii) a principal purpose of the trusts is the avoidance of federal income tax.

B. Effective Date

The provision applies to taxable years beginning after March 1, 1984.

III. Detailed Analysis

Act §82 enacts Code §643(e) entitled "Treatment of Multiple Trusts." The subsection provides a rule for aggregating multiple trusts, similar to that of the regulation invalidated by *Stephenson Trust v. Comr.* The statutory rule, however, is more restrictive than the regulation and should make it easier for the Service to assert that multiple trusts should be consolidated for income tax purposes.

The regulation provided that multiple trusts shall be aggregated if three conditions existed: the trusts must have: (1) "no substantial independent purposes (such as independent dispositive purposes);" (2) "the same grantor and substantially the same beneficiary;" and (3) "the avoidance or mitigation" of income taxes "as their principal purpose." By contrast, §643(e) provides that consolidation will result if two conditions exist: (1) the trusts must have "substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries;" and (2) "a principal purpose" of the trusts must be the avoidance of federal income tax.

Under the regulation, if it could be shown that the trusts had substantially independent purposes (expressed by different dispositive provisions) the trusts would not be consolidated. In planning to avoid consolidation under the regulation, it was important to carefully consider the purposes of each separate trust and to articulate those differences in each trust's dispositive provisions. The statutory rule, however, does not look to the purposes of the trusts (except with regard to the tax avoidance test). Thus, if the trusts express different purposes by their dispositive provisions, this may not avoid consolidation under §643(e).

The regulation provided that consolidation would occur if the trusts have the "same grantor and substantially the same beneficiary." Section 643(e) reads: "substantially the same grantor or grantors and substantially the same *primary* beneficiary or beneficiaries. . . ." [emphasis added]. Again, the statute is stricter than the regulation. If multiple trusts have the same life income beneficiaries but different remaindermen, the trusts probably would not be consolidated under the regulation. Since §643(e) requires only that the "primary beneficiary or beneficiaries" be the same, however, trusts having different remaindermen could be treated as one trust. Moreover, the statute states that a husband and wife shall be treated as one person, a requirement that was not found in the regulation.

Finally, the regulation provided for consolidation if the trusts have tax avoidance as "their principal purpose. . . " The statute provides for consolidation if "a principal purpose" is tax avoidance. Thus, under §643(e), the Service only has to show that the trusts serve a tax avoidance purpose (which could be one among several other non-tax motivated principal purposes), to aggregate the trusts. Under the regulation, the Service had to find that the single "principal purpose" of the multiple trusts was tax avoidance.

The Senate Report sets forth two examples to be considered by the Treasury when it issues regulations with respect to §643(e).[4] The first illustrates a situation where the Committee expects that the regulations would treat the multiple trusts as one trust:

> "A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the

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benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries."

The second example illustrates a situation in which the Committee feels that the multiple trusts should not be aggregated:

"X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death."

In setting forth the second example the Senate Report states:

"Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existence of separate trusts, the trusts will not be aggregated." [5]

Note: Although the statute does not include a substantially independent purpose test (as the regulation did), the Senate Report seems to indicate that this test still should be considered in determining whether the multiple trusts should be aggregated. It may be that the regulations will impose this test, even if it is not required by the statute.

[1] Regs. §1.64(a)-0(c).
[2] *See Commercial Bank at Winter Park v. U.S.*, 450 F.2d 330 (5th Cir. 1971); *Estelle Morris Trusts*, 51 T.C. 20 (1968), aff'd, 427 F.2d 1361 (9th Cir. 1970).
[3] 81 T.C. 283 (1983).
[4] S. Rep. No. 98-169 (Vol. I), 98th Cong. 2nd Sess. 248 (1984) (hereinafter "S. Rep.").
[5] S. Rep. 248 (1984).

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CHAPTER 58

NET GIFTS MADE BEFORE MARCH 31, 1981, DO NOT RESULT IN INCOME TO THE DONOR

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I. Introduction

A "net gift" arises when a donor makes a gift on the condition that the donee pay the gift tax imposed on the transfer. In *Diedrich v. Comr.*,[1] the U.S. Supreme Court affirmed an Eighth Circuit case which held that net gifts will result in gain to the donor to the extent that the gift taxes exceeded the donor's adjusted bases in the transferred property. The Eighth Circuit case was decided on March 4, 1981. Prior to the Eighth Circuit and Supreme Court *Diedrich* cases, several courts had held that net gifts did not result in income to the donor even if the donee pays a gift tax in excess of the donor's basis in the transferred property.[2]

II. Overview

A. Description of New Provisions

Section 1026 of the Act provides that no income will be recognized to donors who made net gifts before March 4, 1981. This is a non-Code provision.

B. Effective Date

The provision is effective on the date of enactment, July 18, 1984. The period of limitations for filing a refund claim resulting from inclusion in income by a donor making a pre-March 4 net gift is extended or reopened for up to one year after July 18, 1984, so that refund claims may be filed in cases where the period of limitations has expired.

III. Detailed Analysis

The House report states that the provision applies to both Federal gift tax and to any gift tax imposed by a state.[3] The House Report also states that this provision does not apply where the gift tax actually was paid by the donor and not the transferee.[4] This seems to be an unnecessary restriction because the *Diedrich* case only applies when the gift tax is paid by the transferee.

By barring the retroactive application of the *Diedrich* decision, Congress recognized that taxpayers had relied on prior cases which had held that net gifts do not result in any amount realized by the donor. This provision reflects Congress' sensitivity to the problems created when taxpayers have relied on case law favorable to their position. However, with respect to the issue of the gift tax consequences of interest-free loans, where there also was prior case law favorable to the taxpayer on which taxpayers had relied, Congress refused to bar the retroactive application of another Supreme Court decision, *Dickman v. Comr.*[5]

The *Diedrich* provision was included only in the House bill. The Senate bill originally included a provision relating to disclaimers which would have allowed a person to disclaim interests created by transfers occurring before November 15, 1958, within 90 days of enactment. This provision would have created a 90-day window during which disclaimers could be made even if such disclaimer would not be allowed under present law. Present law is controlled by *Jewett v. Comr.*,[6] where the Supreme Court ruled that the period for making a disclaimer is measured by the original transfer and not when a contingent interest becomes vested. However, this provision was dropped in conference and was not enacted.

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[1] 457 U.S. 191 (1982).
[2] *Turner v. Comr.*, 410 F.2d 752 (6th Cir. 1969); *Hirst v. Comr.*, 572 F.2d 472 (4th Cir. 1978).
[3] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1708 (1984).
[4] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1708 (1984).
[5] 84-1 USTC ¶13,560 (S. Ct., February 22, 1984).
[6] 455 U.S. 305 (1982).

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CHAPTER 59

REVISION OF PRIVATE FOUNDATION RULES

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In the Tax Reform Act of 1969, Congress created an elaborate regulatory structure for private foundations. A series of hearings before the House Ways and Means Committee and the Senate Finance Committee brought forth examples of numerous foundation practices which Congress decided should be prevented. The rules enacted in 1969 included sanctions against self-dealing, preventing sales, leases, loans and other transactions between a private foundation and its "disqualified persons";[1] a minimum distribution requirement, limiting the ability of foundations to accumulate funds;[2] a limitation on the ability of foundations to hold interest in business enterprises such as corporations and partnerships;[3] a prohibition on investments which might jeopardize the ability of a private foundation to carry out its charitable purposes;[4] and limitations on expenditures for certain purposes, such as lobbying, grants to individuals, grants to other private foundations, and electioneering, as well as any grants for non-charitable purposes.[5]

These restrictions were imposed in the form of a set of two-level excise taxes. Upon committing a transgression, the offending foundation would encounter a first-level excise tax at a relatively low level (*e.g.*, 5 percent to 15 percent). Thereafter, if the violation was not corrected by discontinuing or reversing the offending act, a second-level tax at a much higher rate (*e.g.*, 25 percent to 200 percent of the amount involved) would apply.

In addition to these taxes imposed on the foundation, several of these provisions also impose a two-tier tax on foundation managers who participate in the violation or refuse to correct the violation. The 1969 Act also imposed an excise tax on the investment income of private foundations.[6] This tax, originally imposed at a 4 percent rate, was reduced to 2 percent by the Revenue Act of 1978 (P.L. 95-600).

These rules were made applicable to "private foundations," which were defined in §509(a) as all organizations exempt under §501(c)(3) with the exception of four specific categories of organizations; the excepted group included traditional charities such as churches, schools and the like, publicly-supported organizations, and related organizations which provide support to other public charities.[7]

Since the 1969 Act, Congress had never given these provisions a thorough review. The 1984 Act represents the first re-examination of the overall operation of the private foundation rules since their enactment in 1969. The Subcommittee on Oversight of the House Ways and Means Committee held extensive hearings in the Summer of 1983 on the operation of the private foundation rules. As a result of this re-examination, the 1984 Act includes a number of provisions designed to alleviate operating problems under the existing rules.

I. Liberalization of Excise Tax Rules Pertaining to Investment Income of Private Foundations [Act §§302 and 303]

A. Exemption of Certain Operating Foundations

1. Overview

Private operating foundations are typically museums, libraries, or other organizations which devote their assets or income to the active conduct of charitable operations, rather than making grants to other organizations. Such organizations often have difficulty meeting the public support tests of §§509(a)(2) and 170(b)(1)(A)(vi), particularly when they have sizable endowments. Investment income does not qualify as public support. Thus, unless it can raise substantial contributions from the general public, such an organization will be a private foundation, subject to all of the private foundation rules and excise taxes, including the 2 percent tax on the net investment income of private foundations.

The Act alleviates the application of the tax on investment income by creating a new classification, the "exempt operating foundation." An organization which qualifies as an exempt operating foundation is exempt from the §4940 tax, and also may receive grants from private foundations without causing the granting foundation to encounter the "expenditure responsibility" rules of §4945.

2. Detailed Analysis

Section 302(a) of the Act enacts new Code §4940(d) to grant certain private operating foundations (as defined in §4942(j)(3)) exemption from the tax on investment income, effective for taxable years beginning after 1984. The beneficiaries of this change are "exempt operating foundations" as defined in new §4940(d)(2). These include any private foundation which meets four tests:

(a) The foundation must be a private operating foundation as defined in §4942(j)(3);

(b) It must have been publicly supported (*i.e.*, meet the requirements of either §170(b)(1)(A)(vi) or §509(a)(2)) for the year in question.[8] Note that this test is not applicable in the case of an organization which qualified as a private operating foundation as of January 1, 1983;

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(c) At all times during the year, at least 75 percent of the organization's governing body must consist of individuals who are not "disqualified individuals," and the governing body must be broadly representative of the general public.[9] A disqualified individual for this purpose is defined as a substantial contributor (as defined in §507(d)(2)), any owner of more than 20 percent of the voting power in a corporation (or a like percentage of the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise) which is a substantial contributor to the foundation, or any member of the family (within the meaning of §4946(d)) of any of the foregoing disqualified individuals.[10] For purposes of determining ownership in other entities, the constructive ownership rules of §§4946(a)(3) and (4) are applicable; and

(d) None of the officers of the foundation at any time during the year in question may be "disqualified individuals" as defined above.

Effective Date: Although the new rule is generally applicable for taxable years beginning after December 31, 1984, a special transition rule is provided for certain existing foundations. A foundation which was a private operating foundation (as defined in §4942(j)(3)) as of January 1, 1983, will be treated as meeting the requirement of new §4940(d)(2)(B) that it be publicly supported for at least 10 taxable years. This, in effect, provides a permanent exemption for most of these private operating foundations. It seems likely that many of such organizations will have difficulty in meeting the 10-year public support test; if this proves to be the case, the exclusion for exempt operating foundations will serve primarily to benefit these existing organizations.

In addition to exemption from the tax on investment income, the new category of "exempt operating foundation" also provides relief from the expenditure responsibility requirements of §4945(d)(4). Under this change, a private foundation which makes a grant to an exempt operating foundation need not exercise expenditure responsibility with respect to the grant.[11] The expenditure responsibility rules are discussed in greater detail *infra*. This change is applicable to grants made after December 31, 1984, in taxable years ending after that date.

B. Reduction in Tax for Private Foundations Meeting Increased Payout Requirement

1. Overview

The second change in the excise tax on net investment income is potentially applicable to any private foundation. In essence, the tax on investment income is reduced from 2 percent to 1 percent for a given taxable year if the amount the foundation distributes for charitable purposes, computed on a five-year average, is increased by an equivalent amount.

2. Detailed Analysis

Section 303(a) of the Act creates new Code §4940(e), which reduces the investment income tax from 2 percent to 1 percent if the following requirements are met:

(a) The qualifying distributions (as defined in §4942(g)) made by the foundation for the year are at least equal to a required amount;[12] and

(b) The foundation's distributions during the five taxable years preceding the year in question have averaged at least 5 percent of its assets.[13]

The required amount of qualifying distributions referred to in item (a) above is determined by adding together two elements. First, the amount of the foundation's assets for the year [14] multiplied by the "average percentage payout for the base period." [15] This refers to the average percentage of assets distributed as qualifying distributions over the five preceding taxable years.[16] Second, the amount determined in the preceding step is added to 1 percent of the foundation's net investment income for the current taxable year. If the current year's qualifying distributions equals or exceeds the amount calculated in this fashion, the current year's tax on net investment income under §4940 will be assessed at a 1 percent rate rather than 2 percent.

If a private foundation is a successor, by merger or otherwise, to another foundation, the experience of that predecessor is taken into account for purposes of the five-year average computation described above. The treatment of foundations which have participated in reorganizations, etc., will be dealt with in Regulations.[17]

Effective Date: This amendment is applicable to taxable years beginning after December 31, 1984.

II. Amendments to Taxes on Failure to Distribute Income [Act §304]

A. Introduction

Section 4942 imposes an excise tax on the failure of a private foundation to make payouts at specified minimum levels, either as direct expenditures to accomplish charitable purposes or as grants to public charities or private operating foundations.[18] In general, to avoid excise tax under §4942, a private non-operating foundation must make qualifying distributions, by the end of the following year, at least equal to 5 percent of the fair market value of its net investment assets for the year, less the amount of tax under §4940 on its net investment income for the year. The payout requirements of §4942 are inapplicable to a private operating foundation as defined in §4942(j)(3). However, to qualify for private operating foundation status, a foundation must meet certain minimum payout requirements.

B. Overview

1. Grant Administrative Expenses

To avoid the excise tax on failure to distribute income, a private foundation must make "qualifying distributions" in the prescribed amount. Under prior law, all administrative expenses incurred for charitable purposes could be taken into account as qualifying distributions. Section 304(a) of the Act amends Code §4942(g) to impose (in new §4942(g)(4)) an additional limitation on the extent to which grant administrative expenses may be counted in satisfaction of the payout requirements.

The purpose of this limitation is to insure that more foundation expenditures will actually reach charitable beneficiaries.[19] Under this rule, a foundation must actually pay out an amount equal to 4.35 percent of its net investments assets; this payout may take the form of grants or

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contributions, program-related investments, expenditures directly for the act of conduct by the foundation of its exempt activities, or qualified administrative expenses. Thus, the amount of grant administrative expenses which may be taken into account for this purpose is limited to 0.65 percent of net investment assets (5.00 percent distribution requirement less the 4.35 percent amount described above).

2. Technical Amendment Requiring Redistribution of Program-Related Loan Repayments, Etc.

Immediately prior to the Economic Recovery Tax Act of 1981, §4942 required a private non-operating foundation to distribute the greater of 5 percent of its net investment assets or all of its net income. The 1981 Act repealed the rule that had required distribution of any excess of net income over the minimum investment return, thus limiting the payout requirement to a straight 5 percent of net investment assets. This amendment set the stage for a technical inconsistency.

Some of the amounts taken into account as qualifying distributions for purposes of the minimum distribution requirement may eventually be returned to the foundation. An example would be a program-related loan, such as a scholarship loan. Such amounts are loaned to accomplish a charitable purpose, and hence give rise to a qualifying distribution allowance in the year in which the loan funds are disbursed. Subsequently, when the borrower repays the loan, the foundation has in effect received a return of the amount originally distributed. Other examples include proceeds received from the sale of an asset originally used in the foundation's charitable operations, or amounts set aside (and claimed as a qualifying distribution under §4942(g)(2)) but not eventually used for the anticipated charitable purpose.

Prior to the 1981 Act, such a recovery would increase the net income of a foundation and, thus, would increase correspondingly the amount the foundation would be required to distribute. Repeal of the income approach in 1981, however, left no mechanism for requiring a foundation to redistribute amounts recovered in this fashion.

Section 304(b) of the Act amends Code §4942(d)(1) to add back to the foundation's required minimum payout, loan repayments, proceeds from asset dispositions, and unused set-asides, where such items were previously taken into account as qualifying distributions.

Effective Dates: Both the limitation on administrative expenses and the increase in the required distribution for certain repayments are effective for taxable years beginning after December 31, 1984.

C. *Detailed Analysis*

1. Grant Administrative Expenses

Section 304(a) of the Act enacts new Code §4942(g)(4), providing that the maximum amount of grant administrative expenses which may be counted as qualifying distributions toward the minimum payout requirement is 0.65 percent of net investment assets (*i.e.*, of the minimum investment return base as computed under §4942(e)(1)).[20] This computation is made on the basis of a three-year average, so that the grant administrative expenses taken into account are limited to the excess of 0.65 percent of the net investment assets of the foundation for the current year and the two immediately preceding taxable years over the aggregate grant administrative expenses paid during the two preceding taxable years and taken into account as qualifying distributions.

The limitation does not apply with respect to administrative expenses incurred by a foundation directly for the active conduct of its exempt activities. Thus, if one activity of the foundation is to provide direct assistance to other charities, either in the conduct of their charitable operations or in fund raising, the salary of the foundation's employee performing such work for the other charity does not constitute a grant administrative expense. For example, assume that X Foundation is a private non-operating foundation whose principal purpose is to relieve poverty and suffering. X has salaried employees in various areas of the country. X devotes 75 percent of its expenditures to grants to charitable organizations, with the remaining 25 percent devoted to a soup kitchen and shelter for homeless individuals. The administrative expenses incurred by X in its grant making activities are considered grant administrative expenses. However, the administrative expenses associated with the operation of the soup kitchen and the provision of shelter are not considered grant administrative expenses for purposes of this rule. Thus, the expenses of the direct providing by X foundation through employees of food and shelter to individuals through the operation of the soup kitchen and the shelter are treated as incurred directly for the act of conduct of the foundation's exempt activities, rather than as expenses allocable to contributions of food and shelter.[21]

Under a transitional rule, the amount of grant administrative expenses in any base period year which began before January 1, 1985, cannot exceed 0.65 percent of the foundation's net investment assets for such year. For example, if a foundation's actual grant administrative expenses for 1983 amounted to 0.90 percent of net investment assets, the computation of the new limitation for 1985 would assume that the percentage for 1983 was only 0.65 percent.[22]

The limitation applies only with respect to the §4942 payout rules, and does not affect other private foundation rules governing payment of expenses by a private foundation. For example, if a foundation pays excessive compensation to a foundation manager, this would constitute an act of self-dealing under §4941(d) and a taxable expenditure under §4945(d)(5), whether or not such expenses violated the new grant administrative expense limitation. On the other hand, the mere fact that a foundation's grant administrative expenses exceeded the 0.65 percent limitation would not itself establish that any of such expenses constituted, for example, taxable expenditures under §4945(d)(5).[23]

The Conference Committee directs the IRS to modify Form 990-PF, the private foundation information return, to require more information on expenditures by both non-operating and operating foundations.[24] The new breakdown is to include in both categories of expenditures (such as grants, direct operating expenditures, program-related investments, other investments, administrative expenses, etc.) and types of administrative expenses (*e.g.*, separate line items within each of such categories for salaries, rent, legal

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fees, accounting fees, consultant fees, utilities, traveling expenses, etc.), as well as a statement of the accounting principles and practices used for these allocations.

The information gleaned from the revised forms will be used for a Treasury Department study of the administrative expenses incurred by foundations, to be submitted to Congress by January 1, 1988. This study is to examine the following issues:

(1) The amount of qualifying distributions which actually reach charitable beneficiaries;

(2) The administrative costs of such payouts;

(3) The effect of the revised general definition in §4942(g)(1)(A) of the administrative expenses which are eligible to be qualifying distributions; and

(4) The additional information provided by the revised form concerning categories and types of administrative expenses and the basis for allocation.

In addition, §304(a)(2) of the Act amends Code §4942(g)(1)(A) (the general definition of a qualifying distribution) to make it clear that only "reasonable and necessary" administrative expenses may be taken into account as qualifying distributions. Approval of the amount of a director's fee or other foundation expenditure by a state attorney general or other official is not to be taken as establishing that such amounts or expenditures are reasonable or not excessive for purposes of any of the private foundation tax provisions.[25]

Regulations are also authorized to provide special rules for the application of the new limitation to the qualification of "conduit" foundations under §170(b)(1)(E)(ii).[26] Under that provision and §170(e)(1)(B), contributions by individuals to a qualifying foundation (often referred to as a "conduit" foundation) receive favorable treatment if the foundation makes qualifying distributions (which are treated as corpus distributions) equal to 100 percent of the amount of contributions received in the year; the required distributions must be within two and one-half months after the close of that year. The newly authorized regulations will provide that the grant administrative expense limitation can be expressed solely for this purpose as 15 percent of the amount of such redistributed contributions.[27] In addition, appropriate conforming and coordinating rules with respect to a statement of the grant administrative expense limitation as a percentage of net investment assets are also authorized.

2. *Technical Amendment Requiring Redistribution of Program-Related Loan Repayments, Etc.*

Section 304(b) of the Act amends Code §4942(d)(1) to provide that the basic distribution requirement is the sum of the minimum investment return (*i.e.*, 5 percent of net investment assets) plus the amounts described in §4942(f)(2)(C). The latter section refers to (1) repayment to the foundation of amounts previously treated as qualifying distributions (*e.g.*, scholarship loans); (2) amounts received on dispositions of assets, the acquisition cost of which was previously treated as a qualifying distribution; and (3) amounts previously set aside for a charitable project but not used for such purpose.

III. Amendments Affecting the Excess Business Holdings Rules [§§307-310]

A. Introduction

A central concern of Congress in the 1969 Act was the ownership by foundations of large holdings in businesses. Congress concluded that the abilities of a private foundation to hold such interest should be limited for several reasons. First, it was felt that ownership of business interests would distract managers of such foundations from the charitable activities which should be their principal focus. In addition, it was felt that a business owned by a tax-exempt organization might realize an unjustified competitive advantage over businesses owned by taxable interests.

As a result, the 1969 Act enacted §4943, which generally limits the combined ownership of a business corporation and its disqualified persons to not more than 20 percent of voting stock.[28] Thus, if disqualified persons own 5 percent of the voting stock of a corporation, the foundation itself may hold 15 percent. The combined holdings may total 35 percent if persons other than disqualified persons have effective control of the corporation. A special *de minimis* rule permits a private foundation to own up to 2 percent of the voting stock of a corporation regardless of the amount owned by disqualified persons. Also, a foundation is not limited in its ability to hold an interest in a business functionally related to the foundation's charitable programs, or in any business which derives at least 95 percent of its gross income from passive sources.

If the foundation acquires holdings by gift or bequest after May 26, 1969, and such acquisition causes the foundation holdings to exceed the permitted limits, the foundation has five years to dispose of the gift or bequest. Purchases of stock by a foundation after May 26, 1969 do not qualify for the five-year grace period, and if purchases cause the holdings to exceed the permitted level, immediate excise tax penalties may result, as the five-year grace period is inapplicable. A limited 90-day grace period is provided for a foundation to reduce its holdings as required after purchases by a disqualified person.

A key date in applying the excess business holdings rules is May 26, 1969. If a foundation's holdings on that date exceeded the applicable 20 percent or 35 percent limitation, such rulings could be retained for a period, subject to gradual reduction over several phases. Under the first phase, deadlines were imposed for combined foundation-disqualified person holdings to be reduced to 50 percent of voting stock (or, if less, 50 percent of the value of all outstanding shares), as follows:

Ownership on May 26, 1969	Deadline to Reach 50 percent Combined Holdings:
Over 95% (foundation alone)	May 26, 1989
Over 75% (combined holdings)	May 26, 1984
Over 50% (combined holdings)	May 26, 1979

After expiration of the first phase, a second set of requirements comes into play. (1) If disqualified persons do not own over 2 percent of the business at any time during the second phase (*i.e.*, the 15-year period following the close of the first phase), the combined holdings of the foundation

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and its disqualified persons must be reduced to not more than 35 percent by the end of that 15-year period. If at any time after the end of the second phase, the holdings of disqualified persons exceed 2 percent, then the foundation itself cannot hold more than 25 percent. (2) If disqualified persons own more than 2 percent at any time during the second phase, then at all times thereafter the combined holdings of the foundation and its disqualified persons are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

In addition, a "downward ratchet" rule applies to limit certain acquisitions. Under this rule, if, at any time, there is any reduction in the holdings of a private foundation or in the combined holdings of the foundation and its disqualified persons, then those holdings can never go up again to the former permitted level.

B. Detailed Analysis

1. Disposition of Post-1969 Holdings Acquired by Gift or Bequest

Section 307 of the Act amends Code §4943(c) to give the Internal Revenue Service discretionary authority to allow an additional five-year period for disposition of an unusually large post-1969 gift or bequest of diverse business holdings or holdings with a complex corporate structure.[29] The foundation must establish that it made diligent efforts to dispose of the holdings within the initial five-year period, and that because of the size and complexity or diversity of the holdings, disposition within the initial five-year period has not been possible except at a price substantially below fair market value.

In addition, the foundation must submit to the Service before the end of the initial five-year period a plan for disposing of all the excess business holdings involved in the extension, and the same plan must be submitted to the Attorney General or other state official having jurisdiction over the foundation's disposition of its excess business holdings. Any response received from the Attorney General or other official as to the plan must be submitted to the IRS. Finally, the IRS must determine that the foundation's plan for disposition of its excess business holdings can reasonably be expected to be carried out before the close of the extension period.

One possible technical flaw in the new statute may produce an unintended restriction in its availability. The opening clause of §4943(c)(7) indicates that relief may be available with respect to "diverse business holdings or holdings with complex *corporate* structures" (emphasis supplied). This may be read as limiting the applicability of this relief provision to a complex *partnership* structure. No legislative purpose for such a limitation appears. Perhaps the Regulations could be drafted in such a manner to interpret "corporate" in this context as a generic term referring to business entities, and not to corporations alone.

Effective Dates: As a general matter, a five-year extension is available for business holdings with respect to which the initial five-year period of §4943(c)(6) ends on or after November 1, 1983. However, any plan submitted to IRS by the 60th day after the date of enactment (*i.e.*, on or before September 17, 1984) shall be treated as being submitted before the close of the initial five-year period as required by new §4943(c)(7)(B).

2. Exception to "Downward Ratchet" Rule

Section 308 of the Act amends Code §4943(c)(4)(A)(ii) to provide a limited exception to the downward ratchet rule. Under that exception, reductions of less than 2 percent in a foundation's holdings will be disregarded if (1) decreases are due solely to the issuance of stock in the business enterprise (or to an issuance of stock coupled with subsequent redemptions); (2) the net percentage decrease to be disregarded does not exceed 2 percent; and (3) the number of shares held by the private foundation is not affected by the issuance of stock or any redemption of stock which was coupled to the issuance of stock. Any increase in the number of shares held by the foundation resulting solely from a stock split applicable to all holders of the same class of stock will likewise be disregarded.[30]

If this exception applies to a given situation, the limitations on the holdings of the foundation and the combined foundation/disqualified person holdings will not be reduced by the amount of the net decrease. Should the net percentage decrease exceed 2 percent, the exception is completely inapplicable and, as under prior law, the limit on the maximum holdings of the private foundation will be permanently reduced by the amount of the decrease.[31]

Effective Date: This amendment is applicable to increases and decreases occurring after the date of enactment of the 1984 Act (*i.e.*, after July 18, 1984).

3. Eligibility for 20-Year First Phase

Section 309 of the Act amends Code §4943(c)(4)(B)(i) to modify the divestiture rules applicable during the first phase. Under the new rule, the 20-year first phase period to reduce pre-1969 excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969. Prior to this amendment, the 20-year period was applicable only where holdings of the foundation alone exceeded 95 percent.

Effective Date: This amendment is effective as if originally included in §101(b) of the Tax Reform Act of 1969.

4. Modification of Second and Third Divestiture Phases

Section 310 of the Act amends Code §4943(c)(6) to provide a private foundation with five years to dispose of excess business holdings in certain circumstances. Section 4943(c)(6) provides a five-year period for disposition of gifts and bequests, as described above. The new relief under this provision is available where the private foundation's maximum business holdings must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than 2 percent of the business enterprise during either the second or third phase of the divestiture rules. Where this occurs the foundation is allowed five years to dispose of the excess over 25 percent.

The legislative history suggests in part that this five-year period may not be extended pursuant to new §4943(c)(7), as added to the Code by Act §307(a).[32] However, this limitation does not appear in the statute, and it is likewise absent from the Senate Report. Accordingly, there would appear to be a valid basis for seeking a discretionary extension under new §4943(c)(7), notwith-

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standing the gratuitous statement to the contrary in the House Report.

Effective Date: This amendment applies to acquisitions made after the date of enactment (*i.e.*, after July 18, 1984).

IV. Substantial Contributor Definition Relaxed [Act §313]

A. Introduction

The concept of the "disqualified person" is significant for purposes of several private foundation provisions. The prohibition on self-dealing applies to acts and transactions between a private foundation and those persons who are disqualified persons with respect to it. As noted above, the prohibition on excess business holdings relies upon the term as well. Under §4946(a), a foundation's disqualified persons generally include the following:

(i) Substantial contributors.

(ii) Foundation officers, directors or trustees ("foundation managers").

(iii) A more-than-20 percent owner of a business which is a substantial contributor.

(iv) Members of the family of any of the foregoing.

(v) A corporation, partnership, trust or estate in which other disqualified persons have a 35 percent or greater interest.

In general, a "substantial contributor" is a person who has contributed to the foundation more than 2 percent of all contributions received by the foundation through the close of the year in which the contribution is made; substantial contributor status follows only if the contributions in question exceed $5,000.[33] Reflecting the somewhat harsh approach taken by Congress in fashioning the private foundation rules, the law prior to the 1984 Act provided that a person who was once qualified as a substantial contributor would retain that status forever.

In connection with the 1984 Act, Congress decided on reconsideration that prior law was unnecessarily restrictive in requiring that a person once classified as a substantial contributor would forever remain a substantial contributor. To avoid unintended harsh circumstances, the Act provides that a person who has sufficiently terminated his or her connection with and control over a private foundation will no longer be treated as a disqualified person if a sufficiently long period of time has passed since that person has made any contribution to the foundation or has had any relationship with the foundation, and if much larger contributions to the foundation have been made by some other person.

A less restrictive rule was deemed especially appropriate for application in cases where a person makes relatively small contributions in the early years of a foundation and an unrelated person makes the substantially larger contribution later.

B. Detailed Analysis

Section 313 of the Act enacts new Code §507(d)(2)(C), providing that a person will no longer continue to be treated as a substantial contributor of a private foundation if three requirements are met.

First, neither the person in question nor any related person made a contribution to the foundation at any time within the 10-year period ending at the close of the taxable year in question.[34] For this purpose, a person is "related" if he or she would be a disqualified person under §4946 by reason of his or her relationship to the substantial contributor. In the case of a corporate contributor, any officer or director of the corporation is to be considered a substantial contributor.[35]

Second, at no time during the 10-year period described above was the person in question or any related person a foundation manager of the private foundation. In this instance again, the special definition of related person provided in new §507(d)(2)(C)(ii) is applicable.[36]

Third, the aggregate contributions made by such person and all related persons are determined by the Internal Revenue Service to be insignificant when compared to the aggregate amount of contributions to such foundation made by one other person.[37] For purposes of this rule, appreciation on contributed property occurring while held by the foundation is to be taken into account.[38]

The legislative history indicates that contributions "generally are to be considered insignificant" if they amount to less than 1 percent of a contribution made by the other person, adjusted for appreciation as indicated above. Thus, if a $250,000 cash gift was made in 1969, that would be considered insignificant in comparison to a gift of $100,000,000 made by another person in 1979. Likewise, a gift of stock worth $250,000 in 1969 would be considered insignificant in comparison to a gift of $107,000,000 in 1979, even if the value of the contributed stock appreciated from $250,000 in 1969 to $1.2 million as of the date of the $107,000,000 gift in 1979. However, a gift of $250,000 of stock in 1969 would not be insignificant in comparison to a gift of $107,000,000 by another person in 1979, if the contributed stock had appreciated in value to $15,000,000 over this 10-year period.[39]

Effective Date: The new substantial contributor rule of §507(d)(2)(C) is applicable to taxable years beginning after December 31, 1984.

V. Abatement of First-Tier Taxes in Certain Cases [Act §305]

A. Introduction

As a general matter, any violation of the private foundation rules (§§4941 thru 4945) results in an automatic penalty tax. The legislative history of the 1969 Act makes it clear that this result was intended, irrespective of whether there may be mitigating circumstances (*e.g.*, if the offense was inadvertent).[40]

The possibility of a tax, which may be quite substantial in amount, upon an innocent offender, created a significant potential for inequitable results. In the 1984 Act, Congress acknowledged that the automatic first-tier penalties were stricter than necessary to enforce the foundation requirements in some circumstances.[41] Thus, the Act grants Internal Revenue Service discretionary authority to relieve a foundation from the first-tier penalty tax provided (1) the violation was due to reasonable cause and not to willful

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neglect, and (2) the violation was corrected within the applicable correction period.

Congress determined, however, that there was no justification for extending the abatement authority to acts of self-dealing. The legislative history gives two reasons for this conclusion. In the first place, the penalty tax for self-dealing violations is payable by the self-dealer rather than the foundation. In addition, "commercial transactions between disqualified persons and foundations are generally prohibited." Presumably, the latter reason is meant to suggest that an inadvertent or innocent self-dealing offense is unlikely in any event because the self-dealing rules are designed to impose a blanket prohibition; as practitioners familiar with the application of those rules are well aware, however, it is deceptively easy to run afoul of the self-dealing rules unknowingly.

B. Detailed Analysis

Section 305 of the Act creates a new §4962 granting discretionary authority to the Internal Revenue Service to abate first-tier chapter 42 private foundation taxes other than the tax on self-dealing imposed under §4941(a). The definitions formerly set forth in old §4962 are moved to new §4963.

Abatement under §4962 will be available only if it is established to the satisfaction of the Secretary that (1) the taxable event was due to reasonable cause and not to willful neglect, and (2) such event was corrected within the applicable correction period for such event. Only a first-tier (*i.e.*, "initial" tax) under §4942(a), 4943, 4944(a), or 4945(a) may be abated; no abatement is to be available with respect to the second-tier or "additional" taxes imposed under the private foundation provisions. A violation due to ignorance of the law is not to qualify for abatement under this provision.[42]

Effective Date: The new abatement authority applies to taxable events occurring after December 31, 1984.

VI. Miscellaneous Changes [Act §306]

A. Introduction

1. Definition of Disqualified Person

As described above, the self-dealing rules of §4941 prohibit most transactions between a disqualified person and a private foundation. In addition, the excess business holdings rules of §4943 limit the aggregate ownership of voting stock or comparable interest in the business enterprise which a private foundation and all of its disqualified persons may own.

The individuals who are included in the category of disqualified persons are substantial contributors to the foundation, foundation officers, directors or trustees, over-20-percent owners of businesses which are substantial contributions, and members of the family of these individuals.[43] For the latter purpose, disqualified family members have since 1969 included an individual's spouse, ancestors, and all lineal descendants (and their spouses).[44]

Congress acknowledged that this rule created difficulties by making it necessary to keep in perpetuity all lineal descendants of a disqualified person. Weighing these difficulties against the need to preserve the integrity of the foundation rules, it determined that relaxation of the rule was appropriate.[45] Accordingly, lineal descendants more distant than great grandchildren will not be treated as disqualified persons, effective January 1, 1985.

2. Public Disclosure Requirements

A private foundation is required to file an annual information return with the IRS on Form 990PF. A copy of this return must also be furnished to the Attorney General or corresponding official in the state having jurisdiction over the foundation.[46] Form 990PF includes comprehensive information concerning income, expenses, assets, liabilities, contributions, employees and other information concerning the private foundation, its operations, grants, officers and employees, and the like.

Information required to be furnished on Form 990PF is made available to the public by the Internal Revenue Service.[47] Moreover, a copy of Form 990PF must be made available to the public at the principal office of the foundation. The foundation must publish a newspaper notice of its availability by the due date for filing the return. This notice must include the address of the foundation office and the name of its principal manager.[48]

A foundation which fails (without reasonable cause) to file its Form 990PF in timely fashion, incurs a penalty imposed on the foundation of $10 per day, up to a maximum of $5,000.[49] In addition, if the failure continues after reasonable demand by the Internal Revenue Service (without reasonable cause) an additional sanction of $10 per day, up to a maximum of $5,000 (as to any one return) is imposed upon the officer or employee failing to file the return.

Congress concluded that the reporting and disclosure requirements applicable to private foundations serve a dual function by providing valuable information for purposes of tax administration as well as informing the general public. To help accomplish these aims, the 1984 Act requires that the newspaper notice of availability of private foundation returns include, in addition to the address of the foundation's office, its telephone number. Also, the Committee Reports direct the Internal Revenue Service to increases its efforts to enforce the public disclosure requirements.[50]

B. Analysis

1. Definition of Disqualified Person

Section 306(a) of the Act amends Code §4946(d) to define the members of the family of a disqualified person as including only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren. This change means that descendants of a disqualified person more remote than great grandchildren will no longer themselves be disqualified persons with respect to the foundation. This would not be the case, of course, if such distant descendants, or any intervening generations, independently became disqualified persons (*e.g.*, by achieving substantial contribution status). That is, an individual will be relieved of disqualified person status only if neither he, his spouse, his parents, his grandparents, nor his great grandparents are disqualified persons.

Effective Date: The revised definition of family member takes effect on January 1, 1985. Thus, as of that date,

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the distant descendants affected by the change will cease to be disqualified persons.

2. Public Disclosure Requirements

Section 306(b) of the Act amends Code §6104(d) to include the telephone number of the private foundation's principal office and in the information which must be included in the public notice published in a newspaper regarding the availability of the foundation's annual information return. While this is a relatively straightforward statutory change, it seems likely that operating problems may arise. For example, many smaller foundations do not have a telephone listed in the name of the foundation. In this case, it seems likely that the Internal Revenue Service will require by regulations that some other appropriate phone number be included. Thus, if the foundation office is in the home of the founder, or in his or her place of business, the phone number of such home or business might be required.

While the amendment to §6104(d) is the only statutory amendment in this area, the legislative history of the provision directs the Internal Revenue Service "to enforce fully the present-law rules relating to foundation annual information returns (Form 990PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information." [51] The House and Senate Reports also call upon IRS to facilitate the flow of appropriate information to state officials entitled thereto, and to coordinate more closely with the states to maximize the benefits to be derived from this information.[52]

Effective Date: The amendment to §6104(d) takes effect on January 1, 1985. This is a curious effective date for a return provision; presumably, the foundation telephone number will be required to be included in notices published on or after January 1, 1985. Thus, if a foundation's taxable year ends August 30, 1984, its return would be due by January 15, 1985 (and the public notice would be required to be filed by the same date); it seems that such a foundation might avoid the telephone number requirement in this one instance by publishing its notice prior to January 1, 1985.

VII. Expenditure Responsiblity Rules

A private foundation which makes a grant to an organization other than a public charity must exercise "expenditure responsibility" over the grant.[53] In effect, this requires the granting foundation to monitor the grantee's use of the granted funds so as to be certain they are devoted solely to proper uses. In the hearings underlying this part of the 1984 Act, Congress heard testimony concerning difficulties encountered in complying with the expenditure responsibility rules.[54]

Without amending the Code or enacting any legislation on the subject, the Conference Committee included in its report, language directing the Treasury Department to review its regulations governing expenditure responsibility and modify any requirements found to be unduly burdensome or unnecessary.[55] As part of this review, Treasury is specifically instructed to modify the required grantor reports to IRS.

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[1] §4941.
[2] §4942.
[3] §4943.
[4] §4944.
[5] §4945.
[6] §4940.
[7] Also excepted were organizations organized and operated exclusively for testing for public safety (§509(a)(4)). This exception is designed primarily for a single organization (Underwriter's Laboratories), and is generally disregarded because contributions to such organizations are not deductible as charitable contributions notwithstanding their inclusion in §501(c)(3).
[8] *See* §4940(d)(2)(B) and 296 T.M., *Private Foundations — Definition and Classification*, for rules governing determination of public support.
[9] §4940(d)(2)(C).
[10] §4940(d)(3)(B).
[11] *See* §4945(d)(4)(A), as amended by §302(b) of the Act.
[12] §4940(e)(2)(A).
[13] §4940(e)(2)(B).
[14] The foundation's "assets" for this purpose are determined under §4942(e)(1).
[15] §4940(e)(3).
[16] For foundations with less than five years operating experience, the base period used is the number of years for which the foundation has been in existence.
[17] *See* §4940(e)(6).
[18] For a full discussion see 422 T.M., *Private Foundation Distributions — Section 4942*.
[19] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), 1086. (Hereafter, Conference Report.)
[20] *See* §4942(g)(4).
[21] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), 1469, footnote 7. (Hereafter, House Report.)
[22] §4942(g)(4)(E).
[23] House Report pg. 1470.
[24] Conference Report, pg. 1086.
[25] Conference Report, pg. 1087.
[26] Prior to the 1984 Act, this provision was §170(b)(1)(D)(ii).
[27] *See* Conference Report, pg. 1087.
[28] For partnership interests, comparable limitations are imposed, based upon the profits interest in the partnership. A private foundation may not own any interest in a business operated as a proprietorship.
[29] *See* §4943(c)(7).
[30] House Report, pg. 1480, footnote 13; S. Rep. No. 169, 98th Cong., 2d Sess. (1984) pg. 601, footnote 10. (Hereafter, Senate Report.)
[31] House Report, pg. 1481; Senate Report, pg. 601.
[32] *See* House Report at pg. 1481.
[33] §507(d)(2).
[34] §507(d)(2)(C)(i)(I).
[35] The term "related person" is defined in new §507(d)(2)(C)(ii).
[36] §507(d)(2)(C)(i)(II).
[37] §507(d)(2)(C)(i)(III).
[38] §507(d)(2)(C)(i) (last sentence).
[39] *See* House Report, pg. 1484, footnote 15; Senate Report, pg. 606, footnote 13.
[40] Senate Report No. 91-552, 91st Cong., 1st Sess. 33.
[41] House Report, pg. 1472, Senate Report, pg. 591.
[42] House Report, pg. 1472; Senate Report, pg. 591.
[43] §4946(a).
[44] §4946(d).
[45] House Report §1474; Senate Report, pg. 594.
[46] §6033.
[47] §6104.
[48] §6104(d).
[49] §6652(d).
[50] House Report, pg. 1475, Senate Report, pg. 596.
[51] Conference Report, pg. 1089; House Report, pg. 1476; Senate Report, pg. 596.
[52] House Report, pg. 1476, Senate Report, pg. 596.
[53] §§4945(d)(4) and 4945(h).
[54] Regs. §53.4945-5.
[55] Conference Report, pg. 1091.

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CHAPTER 60

CHANGES RELATING TO EXEMPT ORGANIZATIONS

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I. Exemption from the Unrelated Business Tax for Certain Games of Chance

A. *Introduction*

Organizations which are exempt from federal income taxation are nevertheless subject to tax on their income derived from an unrelated trade or business.[1] In general, the tax on unrelated business income applies to income received from any trade or business which is not substantially related to the organization's exercise or performance of its exempt activities. For this purpose, the determination of whether a business is related to the organization's exempt purpose is made without reference to the organization's need for income or funds or the use it makes of the profits derived.

Section 513(f) of the Code provides that any trade or business which consists of conducting bingo games will not give rise to unrelated trade or business income. For purposes of this exclusion, a qualifying bingo game must meet certain tests set forth in §513(f)(2). The 1984 Act extends the bingo exemption to certain games of chance which, under state law, are permitted to be conducted only by non-profit organizations.

B. *Overview and Analysis*

Section 311(a) of the Act provides (without amending the Code) that for purposes of Code §513, the term "unrelated trade or business" does not include any trade or business which consists of conducting any game of chance, provided three tests are met.

First, the game of chance must be conducted by a non-profit organization. Second, the conduct of such game by the organization must not violate any state or local law. And third, a state law in effect as of October 5, 1983, must have permitted the conduct of such game of chance by non-profit organizations but prohibited the conduct of such a game by other organizations.

The structure of this provision seems likely to create some ambiguities in practice. First, the fact that §513(f) is left unchanged, referring only to bingo games, may create some misunderstanding among exempt organizations which might be beneficiaries of the new rule. This coupled with the October 5, 1983 test date suggests reluctant acceptance of the underlying legislative policy by Congress.

As a practical matter, the drafting approach used for the state law test may present administrative difficulties in practice. For example, if one reads the statute literally it requires that "a State law" in effect as of October 5, 1983 must both permit non-profit organizations to conduct the games in question and forbid its conduct by organizations which are not non-profit in nature. This raises a question concerning the operation of this rule in a situation where, for example, the criminal code of a given state forbids their conduct of a game of chance, but the state's non-profit corporation statute permits the game in question to be conducted by non-profit corporations. Legislative history, to the extent it bears on this point, suggests that the exemption should be available under these circumstances; this rule is summarized in the House Committee Report by stating that "as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a non-profit organization."[2]

Even if this issue is favorably resolved, other questions will undoubtedly arise. The term "game of chance" is not defined in the Act or the legislative history, and there is no guidance as to whether games involving an element of skill, such as poker, would be covered by the new exemption.

Effective Date: The new rule is applicable to games of chance conducted after June 30, 1981, in taxable years ending after that date.

II. Non-Profit Day-Care Centers Qualify as §501(c)(3) Organizations [Act §1032]

A. *Introduction*

The categories of non-profit organizations granted tax exemption under §501(c)(3) include entities organized and operated exclusively for religious, charitable, educational, and other purposes, which meet certain other requirements. Contributions to such organizations are deductible for income, estate and gift tax purposes.[3]

Non-profit day-care centers have been granted exemption from tax under §501(c)(3) by the Internal Revenue Service under certain conditions. Where enrollment is based on a family's financial need or the need of a child for the program, or where the center provides an educational program through a professional staff of qualified teachers for pre-school children of working parents, exemption has been allowed.[4] While the parents of children enrolled in the program (or the employer of the parents) received some benefit from the operation of the programs in question, those private benefits were held incidental to the public benefits resulting from the center's operation, and tax exemption was thus granted. In *San Francisco Infant School, Inc. v. Comr.*,[5] the Tax Court held a child care organization exempt in circumstances where the custodial

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services of the center were found to be incidental to its educational activities. On the other hand, in *Baltimore Regional Joint Board Health and Welfare Fund v. Comr.*,[6] a center was denied exemption where its operation failed to serve the community as a whole.

Congress concluded that the definitional difficulties which had arisen with respect to non-profit child care organizations should be clarified. Accordingly, Congress determined that certain non-profit day-care organizations which make their services available to the general public should be considered to have educational purposes, without regard to the existing interpretation of that term as applied to such day-care organizations.[7]

Accordingly, the Act provides that the term "educational purposes" as used in §§501(c)(3), 170, 2055, and 2522, include the providing of care for children (away from their homes) provided two tests are met. First, substantially all of the child care provided by the organization must be designed to enable individuals to pursue gainful employment. Second, the services provided by the organization must be made available to the general public.

B. Overview and Analysis

Section 1032(a) of the Act creates new Code §501(k), prescribing the treatment of certain organizations providing child care. Under that rule, the term "educational purposes" as used in §§501(c)(3), 170(c)(2), 2055(a)(2), and 2522(a)(2), will include the providing of care of children away from their homes if two additional tests are met. First, substantially all of the care provided by the organization must be for purposes of enabling individuals to be gainfully employed. Second, the services provided by the organization must be available to the general public.

If these tests are met, the organization will be considered organized and operated for "educational purposes" for purposes of its own exemption from Federal tax. Additionally, contributions and bequests to the organization will be deductible for income, estate and gift tax purposes.

The legislative history indicates that new §501(k) is not intended to affect the meaning of the terms "educational" or "charitable" for any purpose other than considering the child care organizations described in the provision as having educational purposes.[8] Presumably this is designed to prevent organizations other than the type described in §501(k) from attempting to draw conclusions regarding the statutory purpose and legislative policy of the new provision as a basis for classifying its own program as "educational" or "charitable." Nevertheless, certain ambiguities are created. First, while new §501(k) provides only that the affected child care organizations will be deemed to have "educational" purposes, the admonition in the legislative history indicates that both "educational" and "charitable" are somehow involved. Presumably this is designed to foreclose reliance on new §501(k) as evidence of what might be "charitable" purposes for some other organization. Nevertheless, this reference in the legislative history may have the opposite effect, creating some inference that the affected organizations are "charitable" as well as "educational."

Another issue presented is whether new §501(k) does or does not describe an organization which is "educational" for purposes of other Code provisions which simply refer to "purposes described in §170(c)(2)" as a shorthand means of indexing all of the various types of activities which qualify for deductibility of contributions and tax exemption. For example, §4942(g)(1)(A) and §4942(g)(1)(B) make such a reference in describing the types of foundation distributions which may be taken into account toward discharging the foundation's distribution obligations under the private foundation excise tax provisions. Similarly, §170(e)(1)(B)(i) makes such a reference in describing certain property contributions to governmental units which are deductible at full fair market value. Query whether a private foundation grant benefiting a §501(k) organization, or a property contribution to a governmental unit to be used by such an organization qualify as made for an educational purpose under these provisions. Alternatively, does the admonition in the legislative history that §501(k) will not affect the meaning of the terms "educational" or "charitable" for any other purpose preclude such a conclusion. Tax Management believes that the legislative history should not be read in this restricted fashion, but presumably this must await clarification by eventual regulations.

III. Section 514(c)(9) Exception Extended to Certain Educational Institutions and Title Holding Corporations [Act §1034]

A. Introduction

Although tax-exempt organizations in general are subject to tax on their unrelated business taxable income, as discussed above, most types of passive income are excludible for this purpose. The general exclusion for passive income is not available, however, for income from a property which is debt-financed.[9] Section 514 of the Code taxes all exempt organizations on income from "debt-financed property." In general, property used for non-exempt purposes and with respect to which an "acquisition indebtedness" exists is generally classified as debt-financed property. There are numerous exceptions and limitations under §514, including transitional and "grace period" rules which enable the use or disposition of certain encumbered property without tax consequences.

Prior to the 1984 Act, an exception was provided to the rule requiring taxation of debt-financed property. Under the exception, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property was excluded from "acquisition indebtedness" under §514(c)(9).

The 1984 Act extends the §514(c)(9) exemption to certain educational institutions and affiliated support organizations.

B. Overview and Analysis

Section 1034 of the Act amends Code §514(c)(9) to provide generally that indebtedness incurred by a "qualified organization" in acquiring or improving real property will not constitute acquisition indebtedness for purposes of §514, provided certain conditions are met. Qualified organizations for this purpose include an educational organization (described in §170(b)(1)(A)(ii)), affiliated support organizations of such an institution, or any qualified pension, profit sharing or stock bonus trust qualifying under §401.[10]

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The exception of §514(c)(9) is unavailable in a variety of circumstances. *First*, the acquisition price for the real property acquisition or improvement must be a fixed amount determined as of the date of the acquisition (or the completion of the improvement). *Second*, the amount of the indebtedness or any amount payable with respect thereto, or the time for payment of any such amount, may not be dependent in whole or in part upon the revenue or profits derived from the property. *Third*, the real property may not, after its acquisition, be leased by the qualified organization to the seller or to any person related to the seller within the meaning of §§267(b) or 707(b). *Fourth*, the real property may not be acquired by a qualified pension trust from a person related to the plan under which the trust is formed, or a related person. *Fifth*, no seller or person related to the seller may provide financing in connection with the acquisition or improvement. *Sixth*, the real property may not be held by a partnership unless the partnership independently meets the tests of §§514(c)(9)(B)(i) through (v) and either (1) all of the partners are qualified organizations within the meaning of §514(c)(9)(C) as described above, or (2) each allocation to a partner of the partnership which is a qualified organization is a "qualified allocation" within the meaning of §168(j)(9). This latter provision refers to the tax-exempt entity leasing provisions, described, *supra*, in Chapter 18. In determining whether all of the partners are qualified organizations for purposes of the first part of this test, an organization will not be treated as a qualified organization if any of its income is unrelated business taxable income determined without regard to §514(c)(9).

The legislative history makes it clear that the Treasury is authorized to prescribe regulations dealing with the effect of guaranteed payments (as defined in §707(c)) under this rule. It is contemplated that those regulations will provide that guaranteed payments to partners will not disqualify an otherwise qualified allocation so long as the payments are reasonable in amount and are made to all partners in proportion to their capital in the partnership. The Conference Report indicates that a distribution which is equal to the most appropriate federal rate (referring to new §1274(d)) will be regarded as reasonable in amount for this purpose.[11] Despite this, the Conference Report contemplates that the regulations on this point will be drafted so as to prevent avoidance of the qualified allocation rules by a partnership making disproportionately large guaranteed payments to its tax-exempt partners for the use of their capital.[12]

Finally, the Conference Report contemplates that transfers of encumbered property with liabilities exceeding the transferor's basis will give rise to income to the transferor in the case of property transferred to a tax-exempt organization in accordance with present law; this is to be true particularly where the transfers are designed to avoid ordinary income recapture on the property.[13] The effect of this provision in the legislative history is not clear, since there would seem to be nothing in §514(c)(9) which would alter the present law regarding transfers of encumbered property.

Effective Date: In general, §514(c)(9) as amended takes effect with respect to indebtedness incurred after the date of enactment. Two special transition rules are provided, however.

Under the first transition rule, the amendment is not applicable to indebtedness incurred before January 1, 1985, by certain partnerships if the indebtedness is incurred with respect to property acquired before such date. Partnerships relying upon this transition rule must meet three rules. First, before October 21, 1983, the partnership was organized, had filed a request for exemption with the Department of Labor, and a private placement memorandum had been circulated stating the maximum amount of interests in the partnership that would be offered. Second, the interest in the property to be acquired by the partnership was described in this private placement memorandum. And third, the marketing of partnership interests in the partnership is completed within two years after the date of enactment of the 1984 Act (July 18, 1984) or the date the Department of Labor exemption is published in the Federal Register, whichever is later. The aggregate amount of interest subject to such transition rule may not exceed the maximum amount listed in the private placement memorandum.

The second transition rule relates to indebtedness on certain property acquired before January 1, 1986 by certain partnerships, provided the indebtedness is incurred with respect to property acquired before that date. The partnerships subject to this transition rule are those which were organized before March 6, 1984, and publicly announced by that date the maximum amount of interest which would be sold in the partnership; in addition, the marketing of partnership interests in the affected partnerships must be completed not later than October 16, 1984, and the aggregate amount of interest in the partnership does not exceed the maximum amount announced by the partnership before March 6, 1984. In the case of property acquired pursuant to a written contract which was binding on January 1, 1986 and at all times thereafter will be treated as acquired before that date, provided the property is placed in service not less than six months after the date the contract was entered into.

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[1] §§511-514.
[2] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at p. 1482.
[3] §§170, 2055 and 2522, respectively.
[4] *See* Rev. Rul. 68-166, 1968-1 C.B. 223; Rev. Rul. 70-533, 1970-2 C.B. 112.
[5] 69 T.C. 957 (1978), acq., 1978-2 C.B. 2.
[6] 69 T.C. 554 (1978).
[7] S. Rep. No. 169, 98th Cong., 2d Sess. (1984) at p. 897.
[8] Id. at p. 898; H.R. Rep. No. 861, 98th Cong., 2d Sess. at p. 1100. The House Report does not address this question.
[9] For full details, *see* generally, 339 T.M., *Unrelated Debt-Financed Income*.
[10] §514(c)(9)(C).
[11] H.R. Rep. No. 861, 98th Cong., 2d Sess. at p. 1098.
[12] *Id.*
[13] H.R. Rep. No. 861, 98th Cong., 2d Sess. at p. 1098.

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CHAPTER 61

DEFINITION OF A RESIDENT ALIEN

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I. Introduction

The United States applies a special tax regime to nonresident alien individuals. For example, a nonresident alien individual not engaged in a U.S. trade or business is subject to U.S. tax at a flat 30[1] percent (or a lower treaty rate) tax (collected by withholding at source)[2] on the gross amounts of U.S. source fixed or determinable, annual or periodical (FDAP),[3] and certain other types of income.[4] A nonresident alien individual engaged in a U.S. trade or business, who does not maintain an office in the United States, is subject to U.S. tax at graduated rates on the net amounts of all U.S. source income[5] except the amounts described in §871(a) which are not effectively connected with the alien's U.S. trade or business.[6] If a nonresident alien individual, who is engaged in a U.S. trade or business, maintains an office in the United States, specified categories of such individual's foreign source income are also treated as income effectively connected with a U.S. trade or business and, thus, fall within the U.S. tax net.[7]

Resident alien individuals, on the other hand, are taxed by the United States at graduated rates applicable to U.S. citizens on net income derived from U.S. as well as foreign sources.[8] Due to the differences in the tax regimes applicable to resident and nonresident alien individuals, the amount of U.S. tax liability varies under the two regimes depending upon the income mix (both as to source and type of income) of the individual. Thus, under one set of facts, the tax regime applicable to nonresident alien individuals may yield a lower U.S. tax while, under a different set of facts, the tax regime applicable to resident alien individuals may yield a lower U.S. tax. Consequently, an alien may desire to be classified as a "resident" or a "nonresident" alien of the United States depending upon which regime yields a lower U.S. tax. In the U.S. tax scheme applicable to aliens, the concept of "residence" occupies a highly significant place.

A. The Concept of Residence Under Prior Law

Oddly enough, prior to the Tax Reform Act of 1984 (P.L. 98-369), the term "residence" was not defined anywhere in the Code. The regulations under §871, however, did attempt to fill in the breach. Regs. §1.871-2(b) provides that:

> "An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances."

A determination of resident status began with the presumption that aliens, by reason of their alienage, are nonresident aliens.[9] On the other hand, physical presence in the United States for as little as one year raised a countervailing presumption that the alien was a resident.[10] This, however, did not mean that an alien present in the United States for less than one year could not be classified as a resident. The presumption of alienage could always be overcome by evidence showing a definite intention on the part of the alien to acquire U.S. residency, such as participation by the taxpayer and his/her family in the social and religious life of his/her community and enrollment of his/her children in local schools.[11] In many circumstances even a relatively short period of physical presence, when coupled with the purchase of a dwelling, was considered sufficient to constitute an alien a resident of the United States.[12] In the well-publicized case of *Park v. Comr.*,[13] the taxpayer came and stayed in the United States for brief periods of time in each of the taxable years (1972-1975) in question. Based on the facts that the taxpayer owned a home in the United States, made large and extensive real estate investments, engaged in extensive business activities in the United States, led an extremely prominent social life in the United States, and generally spent more time in the United States than in his native Korea, the Tax Court held that the taxpayer was not a mere "transient or sojourner" in the United States.

On the other hand, the mere fact that an alien was physically present in the United States for a year or more was never, in and of itself, considered enough to constitute an alien a resident of the United States. Physical presence within the United States for one year or more, while sufficient to displace the presumption of nonresidence, did not necessarily resolve the question of the taxpayer's intent

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regarding the nature and length of his/her stay; *i.e.*, whether he/she was a mere transient or sojourner. Thus, an alien present in the United States for one year or more could be regarded as a nonresident alien if it could be established by evidence that he/she was a mere transient or sojourner.[14] In a number of post World War II cases, aliens were held to be nonresident aliens despite their long physical presence in the United States.[15]

It is obvious from the foregoing that, prior to the Tax Reform Act of 1984, two factors were required to coincide before an alien could be considered a resident of the United States:

(i) Physical presence in the United States, and;

(ii) An intention to reside in the United States with some permanence.

1. The Physical Presence Factor

A nonresident alien could not be classified as a resident alien of the United States unless the alien was physically present within the borders of the United States and there was some permanence as to the physical presence. In *Begassiere v. Comr.*,[16] the Tax Court, in holding that the taxpayer was not a resident alien of the United States, observed:

> "It is obvious ... that a nonresident alien cannot establish a residence in the United States by intent alone since there must be an act or fact of being present, of dwelling, of making one's home in the United States for some time in order to become a resident of the United States. Some permanence of living within the borders is necessary to establish residence." [17]

The Tax Court, in *Adams v. Comr.*,[18] again made a similar observation:

> "In our opinion, [taxpayer's] occasional and limited stays in Florida (amounting to approximately 70 days in each year) and his other activities in Florida did not cause the line between nonresidency and residency to be crossed. Some permanence of living within borders is necessary to establish residence ... It takes more than the use of a house as a closet for golfing and other sporting gear, or even sporadically to sleep and eat, to convert it into a home. It may well be that [taxpayer] intended to make Florida his residence — perhaps as early as 1953 — but his intent was never accompanied by the requisit physical presence. Both elements are necessary to establish residence."

2. The Intent Factor

Once it was established that an alien's physical presence within the U.S. borders had some permanence, the alien could be classified as a resident of the United States only if it was further established that he/she was not a mere transient and that he/she intended to make the United States his/her home, if not permanently, then for an extended period of time.[19] Whether the alien is a transient is determined by his/her intentions with respect to the length and nature of his/her stay in the United States.[20] If he/she lives in the United States and has no definite intention with respect to his/her stay, he/she is classified as a resident of the United States.[21]

In making a determination with regard to the alien's intentions, such factors as the purpose and the character of the alien's visit,[22] the relocation of the alien's family,[23] acquisition of a home in the United States by the alien,[24] the alien's cultural and social ties with the United States,[25] the alien's business and investment ties with the United States,[26] maintenance of bank accounts in the United States,[27] and filing of tax returns by the alien with his home country as a resident [28] are considered.

Perhaps the most weighty factor bearing upon the alien's intent was the type of visa used to enter the United States. As noted earlier, Regs. §1.871-2(b) provides that "an alien whose stay in the United States is limited by the immigration laws is not a resident of the United States ... in the absence of exceptional circumstances." Aliens entering the United States whose stay is limited by immigration laws include: employees of foreign governments (A-visa holders); business visitors and tourists (B-visa holders); aliens in transit (C-visa holders), alien crew members of ships and aircraft (D-visa holders); treaty traders and investors (E-visa holders); students (F-visa holders); employees of international organizations (G-visa holders); temporary workers and trainees (H-visa holders); foreign correspondents (I-visa holders); exchange visitors (J-visa holders); and intra-company transfers (L-visa holders). The fact that an alien was present in the United States on one of the visa categories enumerated above was by no means itself sufficient to establish conclusively that he/she was a nonresident alien. If such an alien could establish that he/she was not a mere transient, then he/she was classified as a resident of the United States. In Rev. Rul. 64-285,[29] for example, an E-visa holder who was present in the United States for more than a year was held to be a resident of the United States. In Rev. Rul. 67-159,[30] F and J visa holders, who were present in the United States continuously for two years, were held to be residents of the United States. In *Siddiqi v. Comr.*,[31] the taxpayer came to the United States on an F-visa for five years. The Tax Court held that the taxpayer was a resident because his purposes in coming to the United States were of such a nature that required an extended stay. In some early cases, the Tax Court and the Fourth Circuit had similarly ruled that some A and B visa holders who repeatedly applied for extensions of stay were residents of the United States.[32] Finally, in *Escobar v. Comr.*,[33] the Tax Court ruled that the taxpayer was a resident of the United States despite the fact that she was a G-visa holder (employee of an international organization). In rejecting the Commissioner's argument that the taxpayer was a nonresident because her stay in the United States was limited by immigration laws, the Tax Court observed that the taxpayer and her family "own a home in Maryland, where they keep all their belongings. They have Maryland drivers' licenses and keep their bank accounts in the U.S. They maintain no residence in Chile, and are treated as nonresidents of Chile for Chilean income tax purposes. The family is involved in various social and community activities in Maryland."

Aliens who entered the United States on an immigrant visa (or who, after entering the United States on a nonimmigrant visa, applied for an immigrant visa) were generally regarded as resident aliens of the United States. Admission to the United States for permanent residence, however, was not a sure ticket to "resident status" either. It was possible

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that the alien's intentions did not coincide with the characterization given the alien's stay by his/her visa.[34] Consequently, notwithstanding the fact that an alien was admitted for permanent residence, if the alien's stay in the United States resembled that of a nonresident alien, the alien was classified as a nonresident alien for tax purposes.[35] In *Jellinek v. Comr.*,[36] the taxpayer entered the United States on an immigrant visa. After determining that he could not find immediate employment in the United States, the taxpayer left. Thereafter, the taxpayer came to the United States for brief periods of time in order to keep his re-entry permits alive. The Tax Court held that:

> "It appears that [taxpayer]'s intent to establish residence in the United States was at all times conditional upon his finding suitable employment here and when that condition was not met the intent was abandoned before the fact of residence was ever established."

In *Adams v. Comr.*,[37] the taxpayer, his wife and their children came to the United States on immigrant visas. The taxpayer bought a house in Florida for his wife and children and left for his native Canada while leaving the family behind in Florida. During each of the three taxable years in question, the taxpayer spent no more than 70 days in the United States. The Tax Court held that:

> "[Canada] was the center of gravity of his life ... [he] continued to spend the bulk of his time in Canada, his principal business activities continued to be centered there, he continued to live in the family residence in [Canada] ... his clothing and personal belongings remained there. Under all the facts and circumstances of this case and giving appropriate weight to the presumption of nonresidency contained in the respondent's regulations, we conclude that [taxpayer] was a nonresident alien of the United States during the taxable years before us."

Finally, in Rev. Rul. 76-82, the taxpayers commuted to work in the United States from Canada and Mexico and were classified as "special immigrants." The Service ruled that because the taxpayers came to the United States merely to work, their actions did not evidence any intention to abandon their residences in Canada and Mexico to take up new residences in the United States.

The foregoing discussion of the body of law dealing with the concept of "residence" makes it clear that the determination of residence was largely a subjective exercise requiring a careful analysis of the facts and circumstances of each case. It is not surprising, therefore, that tax planning and tax compliance for alien individuals with U.S. contacts was a difficult and uncertain practice at best.

B. Abandonment of U.S. Residence Under Old Law

Under the law in effect prior to the Tax Reform Act of 1984 (P.L. 98-369), U.S. residence was abandoned the same way it was acquired. In order to be regarded a nonresident alien of the United States, a U.S. resident was required to physically depart from the United States and establish an intent to abandon his/her U.S. resident status. Thus, an alien who acquired U.S. residence retains such status during periods of temporary absence in a foreign country, particularly if he/she obtained a valid re-entry permit and returned to the United States in time.[38] The alien individual was required to take some affirmative action evidencing an intent to abandon the resident status.[39] Such affirmative action could include: transfer of personal possessions out of the United States, relocation of the alien's family in a foreign country, sale of the U.S. residence, establishment of a home in a foreign country, securing of foreign residence permits, and lapse of affiliation with social, religious, and other organizations in the United States.[40]

In *Ermogeni v. Comr.*,[41] the Tax Court ruled that a French citizen, who was a U.S. resident for eight years before being transferred to Africa on an indefinite assignment by his employer, did not intend to abandon his U.S. residence because, among other reasons, he continued to own a home in New York and he claimed continuous residence in the United States when applying for naturalization on his return to the United States.

In *Marsh v. Comr.*,[42] a Japanese citizen married a U.S. citizen and established her residence in the United States. In 1966, she accompanied her husband to Vietnam and returned to the United States in 1970. She claimed that during 1966-1969, she was a nonresident alien. The Court ruled that the taxpayer's mere absence from the United States for four years did not, in itself, destroy her resident status and that she merely intended to accompany her husband.

It is apparent, therefore, that a U.S. residence, once acquired, is not easily abandoned. If anything, it requires more activity to establish an "intent to abandon" than to establish an "intent to acquire" U.S. residence.

C. The Impetus for Change

The House Ways and Means Committee Report summarizes the impetus for change as follows:[43]

> "The committee believes that the tax law should provide a more objective definition of residence for income tax purposes. The committee believes that present law does not provide adequate guidance with respect to residence status. The committee understands that an objective definition may allow some aliens who should be taxable as residents to avoid resident status, and would impose resident status on some aliens who are not residents under the current rules. On balance, however, the committee finds that certainty that the bill's objective definition provides outweighs other considerations."

II. Overview

Section 138 of the Tax Reform Act of 1984 (P.L. 98-369), inserts Code §7701(b) to provide, for the first time, a statutory definition of the term "resident."

Under §7701(b), an alien individual is treated as a resident of the United States for a calendar year if such individual satisfies either of the following two tests:

(1) The alien is a lawful permanent resident of the United States under the immigration laws at any time during the calendar year (*i.e.*, the green card test);[44] or

(2) The alien satisfies the substantial presence test.[45]

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Under the substantial presence test, an alien individual is treated as a resident of the United States for a calendar year in either of the following two situations:[46]

(i) The alien is physically present in the United States for 183 days or more during the calendar year; or

(ii) The sum of the days the alien is physically present in the United States during the current calendar year, plus one-third the number of days the alien is physically present in the United States during the first preceding calendar year, plus one-sixth the number of days the alien is physically present in the United States during the second preceding year equals or exceeds 183 days.

Note: The resident or nonresident status of an alien is determined on a calendar year basis.

For purposes of the "substantial presence" test, an alien individual's presence in the United States in the following capacities is disregarded:

(i) As a foreign government-related individual (A-visa and G-visa holders);[47]

(ii) As a teacher or trainee (but only up to a maximum of 2 years);[48]

(iii) As a student (but only up to a maximum of 5 years);[49]

(iv) By reason of a medical condition which arose while the alien was present in the U.S.;[50] and

(v) As a commuter from Mexico or Canada.[51]

There are two exceptions to the "substantial presence" test:

(1) An alien individual is not treated as a resident of the United States under the substantial presence test if such individual is present in the United States for 30 days or less during the calendar year in question;[52] or

(2) An alien individual is not treated as a resident of the United States under the "substantial presence" test if such individual was present in the United States for less than 183 days during the calendar year in question and can establish that he/she has closer connections with and a tax home in a foreign country.[53]

Finally, §7701(b) does not override U.S. tax treaties. Consequently, if an alien individual is treated as a resident of a foreign country under the tie-breaking rules of a U.S. tax treaty, such individual is a nonresident alien of the United States under §7701(b) but only for purposes of applying the treaty provisions.

New Code §7701(b) is generally effective for taxable years beginning after December 31, 1984.[54]

III. Detailed Analysis

Section 138 of the Tax Reform Act, at the very least, achieves one indisputable distinction: for the first time in the history of the Internal Revenue Code it provides a statutory definition of the terms "nonresident alien" and "resident alien." While §7701(b)(1)(A) (as added by §138 of the Act) defines the term "resident alien" in a positive manner, the term "nonresident alien" is defined in a negative and indirect way. Section 7701(b)(1)(B) provides that an individual is a nonresident alien of the United States if such individual is: (i) not a citizen of the United States, and (ii) not a resident alien of the United States. Thus, an alien individual satisfies the definition of a "nonresident alien" if such individual does not fit the definition of a "resident alien."

A. Definition of a "Resident Alien"

The definition of a "resident alien" as provided in §7701(b) is significantly different from the prior definition of this term as provided under Regs. §1.871-2(b) and the case law. An individual who qualified as a "resident alien" under the prior law may not qualify as a resident alien under §7701(b). Conversely, an alien individual who would be a nonresident under the prior law may fit the definition of a "resident alien" provided in §7701(b). It is important to note, therefore, that the scope of the definition of a "resident alien" in §7701(b) is not all-embracing. The purposes for which the new definition is valid are limited expressly by the statute and the legislative history. The old definition of this term continues to have some vitality.

1. The Scope

The new definition of a "resident alien" in §7701(b) applies only for purposes of determining the U.S. income tax liability of individuals who are not citizens of the United States. As discussed below, the statute and the legislative history pinpoint three situations in which the §7701(b) definition does not apply.

a. Section 7701(b) Does Not Apply for Estate and Gift Tax Purposes

The estate and gift tax rules that apply to nonresident aliens (nondomiciliaries to be more exact) are significantly different from the rules that apply to citizens and resident aliens (domiciliaries to be more exact).[55] The concept of "residence" (or domicile to be more exact) is equally important for purposes of estate and gift taxation of the alien individuals.

The regulations provide and the courts agree that, for estate and gift tax purposes, a resident is one who at the time of his/her death (or at the time of making the gift) has his/her domicile in the United States.[56] The concept of "domicile" is the same as the concept of "residence" under pre-TRA 1984 rules except that "domicile" requires more permanence than "residence." For example, an individual physically present in the United States can be considered a resident if his/her purpose in coming to the United States required an extended stay.[57] By contrast, an individual cannot be considered to have his/her domicile in the United States unless he/she intends to reside in the United States permanently. For purposes of determining the "issue of domicile" it is not a fleeting, casual, or sporadic intention which controls, but a serious conception of home."[58] Thus, the basic distinction between the concepts of "residence" and "domicile" is that an intention to make a temporary home in the United States was considered enough for the former, while the latter required an intent to make a permanent home in the United States.

Nevertheless, since the estate and gift tax provisions in the statute use the terms "resident" and "nonresident

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alien", rather than "domiciliary" and "nondomiciliary," the definition of the term "resident" in §7701(b) would, in the absence of an express exception, override the concept of "domicile" in the estate and gift tax area. This problem is, however, resolved by §7701(b)(1), which states specifically that the definition of the terms "resident alien" and "nonresident alien" as provided therein do not apply for purposes of Subtitle B (which contains the estate and gift tax provisions of the Code). Consequently, the concept of domicile continues to apply for purposes of determining the estate and gift tax liability of alien individuals.

b. Section 7701(b) Does Not Apply for §911 Purposes

U.S. citizens and resident aliens are entitled to certain exclusions from gross income with respect to their foreign source earned income.[59] However, in order to claim these exclusions, the taxpayer must establish either: (i) that he/she was physically present in the foreign country (countries) on 330 days in any consecutive 12-month period;[60] or (ii) that he/she is a bona fide resident of a foreign country (or countries) for an uninterrupted period that includes an entire taxable year.[61]

The regulations under §911 (and §913) have traditionally provided that §871 principles apply in determining whether a U.S. citizen is a bona fide resident of a foreign country. The courts have generally applied Regs. §1.871-2(b) and the criteria developed in the domestic area for purposes of determining whether a U.S. citizen qualifies as a bona fide resident of a foreign country.[62]

If the §7701(b) definition of a "resident" is applied in the §911 context, it would render meaningless the physical presence test of §911(d)(1)(B) because a U.S. citizen who is present in a foreign country (or countries) for 183 days in calendar year will qualify as a bona fide resident under the substantial presence test of Code §7701(b)(3).

The definition of the term "resident alien" in §7701(b) does not, by its own terms, apply for §911 purposes. Section 7701(b) provides a definition of when an alien qualifies as a resident alien of the United States. It does not attempt to define when a citizen would be considered a bona fide resident of a foreign country. While in the past, the rules governing the definition of a resident alien of the United States have been borrowed for purposes of determining when a U.S. citizen qualified as a bona fide resident of a foreign country, the House Ways and Means Committee Report explicitly states that the new definition of a resident alien of the United States in §7701(b) is not applicable for purposes of determining when a U.S. citizen qualifies as a bona fide resident of a foreign country under §911(d)(1)(A).[63]

Thus, Regs. §1.871-2(b) and the case law which governed the determination of resident status of alien individuals prior to the enactment of §7701(b) will continue to apply for purposes of determining the resident status of U.S. citizens in foreign countries under §911(d)(1)(A).

c. Section 7701(b) Does Not Apply to Estates and Trusts

The Conference Committee Report (accompanying H.R. 4170) clarifies that the definition of a "resident alien" in §7701(b) does not in any way affect the determination whether a trust (or estate) is a U.S. or a foreign trust (or estate) except insofar as that determination itself turns on the resident or nonresident status of an alien individual.[64]

2. The Term "Resident Alien" Defined

Under §7701(b), an alien individual qualifies as a resident alien of the United States if he/she satisfies either one of the following two tests:[65]

(i) The Lawful Permanent Resident Test; or

(ii) The Substantial Presence Test.

These two tests are discussed in detail below.

a. The Lawful Permanent Resident Test

Section 7701(b)(1)(A)(i) provides that an alien individual is treated as a resident alien of the United States for a calendar year if at any time during the calendar year such individual is a lawful permanent resident of the United States. An alien individual qualifies as a lawful permanent resident of the United States at any given time if: (i) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws; and (ii) such status has not been revoked and has not been administratively or judicially determined to have been abandoned.[66]

It is apparent, therefore, that resident status under this test is totally divorced from the length of physical presence in the United States. An alien individual who is issued a "green card" under the immigration laws becomes a resident alien of the United States for U.S. income tax purposes on the first day he/she is physically present in the United States as a lawful permanent resident regardless of whether he/she is so present in the United States for one day or 100 days.[67] Similarly, a "green card" holder who comes to the United States for only a few days in each calendar year just to keep his/her "permanent resident" status alive is a resident alien for income tax purposes. This sweeping rule is justified by the Ways and Means Committee Report as follows:

> "The committee believes that aliens who have entered the United States as permanent residents and who have not officially lost or surrendered the right to permanent U.S. residence should be taxable as U.S. residents. These persons have rights that are similar to those afforded citizens (including the right to enter the United States at will); equity demands that they contribute to the cost of running the government as much as citizens." [68]

Once an alien acquires resident status under this test, such status continues until such time as: (i) the alien surrenders his/her "green card;" (ii) the "green card" is revoked by the immigration authorities; or (iii) it is administratively or judicially determined that the alien has abandoned his/her lawful permanent resident status under the immigration laws. Thus, resident status for tax purposes continues until such time as "permanent resident alien" status under immigration laws is officially lost or abandoned. It is not enough to establish that the individual comes to the United States so infrequently that, upon close scrutiny, he/she is no longer entitled to a permanent resident status. There must be an actual surrender of the green

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card, or an official revocation of the green card, or an actual administrative or judicial determination of an abandonment of such status for the loss of resident status to be effective.

Comment: The lawful permanent resident test represents a significant change from the prior law. Under the prior law, admission to the United States for permanent residence pursuant to the Immigration and Nationality Act did not *per se* establish residence for Federal income tax purposes.[69] If such individual's stay in the United States resembled that of a nonresident alien, he/she was treated as a nonresident alien.[70] In *Jellinek v. Comr.*,[71] and *Adams v. Comr.*,[72] for example, the taxpayers, who were "green card" holders, were held to be nonresident aliens for Federal income tax purposes. Under the new law, the taxpayers in both *Jellinek* and *Adams* would qualify as resident aliens for Federal income tax purposes.

b. The Substantial Presence Test

An alien individual not lawfully admitted as a permanent resident under the immigration laws may, nevertheless, qualify as a resident alien of the United States for Federal income tax purposes if such individual meets the substantial presence test of §7701(b)(3).

Comment: An alien individual who is lawfully admitted as a permanent resident under the immigration laws of the United States may or may not also qualify under the substantial presence test as a resident alien of the United States for Federal income tax purposes. If an individual qualifies as a resident alien for a calendar year under both tests, his/her residency starting date is the earlier of (i) the first day he/she was present in the United States as a lawful permanent resident, or (ii) his/her residency starting date under the "substantial presence" test.[73]

The substantial presence test is essentially a numerical test. It is satisfied if the alien individual is physically present in the United States for a certain number of days either in the current calendar year or over a three-year look-back period. This test is described in the House Ways and Means Committee Report:

> "It is just as clearly appropriate to treat as residents individuals who spend significant time in the United States. While there is no single system that is perfect, the committee believes that a regime that depends on length of stay meets the criteria of objectivity and establishing nexus to the United States and is appropriate. Almost all individuals present in the United States for more than half a year should be taxable as U.S. residents. Moreover, individuals who repeatedly spend significant amounts of time in the United States should have to note their presence with the Internal Revenue Service; if they do not have a closer connection with a foreign country than with the United States and a tax home in that foreign country, they, too, should be taxable as U.S. residents. The committee believes that an average of 122 days of presence over a three year period is significant amount of time for the purposes of imposing U.S. tax in such circumstances, but that an individual who is present for fewer than 31 days in a year should not be subject to this rule for that year." [74]

According to §7701(b)(3), an alien individual qualifies as a resident alien of the United States for a calendar year under the substantial presence test in either of the following two situations:

> (i) If the alien is physically present in the United States for 183 days or more during the calendar year; or
>
> (ii) If the sum of the days the alien is physically present in the United States during the current calendar year, plus one-third the number of days the alien is physically present in the United States during the first preceding calendar year, plus one-sixth the number of days the alien is physically present in the United States during the second preceding calendar year, equals or exceeds 183 days.

Comment: Both parts of the substantial presence test, as described above, are far from satisfactory. One hundred and eighty-three days in a single calendar year is too short a stay in the United States to make an alien individual a resident of the United States. Too many unsuspecting tourists and casual visitors (*i.e.*, aliens who come to visit their relatives in the United States) are likely to fall within the clutches of this test. One can anticipate the reactions of a foreigner who, in a single calendar year, makes two 3-month visits to the United States as a tourist, for example, when he/she finds out that the penalty for enriching the U.S. economy [75] is a U.S. tax at graduated rates on his/her worldwide income. The second part of the substantial presence test, which is designed to effectuate "an average of 122 days of presence over a three year period" rule expressed in the committee report, also fails to achieve its objective. It would seem that the test would achieve the purpose behind the 122-day rule if it results in bringing any alien who spends 366 days (122 x 3) in the United States over a three-year look-back period within the substantial presence test net. The structure of this test does not produce this result, however. An alien can spend as many as 455 days in the United States over a three-year period and still avoid the substantial presence test. For example, an alien who is present in the United States for 182 days in the second preceding year, 182 days in the first preceding year, and 91 days in the current year does not meet the substantial presence test. Another defect in the three-year lookback test is that it treats the alien as a resident only in the current calendar year even though he/she spent significant amounts of time in the U.S. in the prior two calendar years. Consider the example of an alien who is present in the United States for 182 days in the second preceding year, 182 days in the first preceding year, and 360 days in the current year. Although this individual has spent in the United States 724 out of a maximum of 1095 days in the three-year look-back period, he/she is treated as a resident only in the current calendar year. A superior structure for the substantial presence test would treat an alien individual as a resident of the United States for a calendar year if the alien is present in the United States for 270 days during such year. Under this alternative structure, an alien individual who is present in the United States for a total of 550 days over a three-calendar year period would also be treated as a resident of the United States for all three calendar years.

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Since the substantial presence test turns upon the number of days an alien individual is physically present in the United States, the rules governing the numerical day-count are extremely important. These rules are discussed in detail immediately below.

(1) The Rules Governing the Day-Count

Section 7701(b)(6) provides that an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day. Thus, the day of arrival in the United States as well as the day of departure from the United States will count.

Observation: Contrast this rule with the day-count rule for §911 purposes, which provides that a full day's presence in a foreign country is a continuous period of twenty-four hours beginning with midnight and ending the following midnight.[76] The day of departure often does not count as a full day under this rule.

For purposes of the substantial presence test, if an alien individual is present in the United States in certain capacities, the days present in such capacities do not count. For example, if an alien is present in the United States as an "exempt individual," or if an alien's presence in the United States is prolonged due to a medical condition, such presence is not taken into account when counting the number of days for the "substantial presence test" purposes. The following paragraphs discuss in detail the situations in which physical presence in the United States is disregarded.

(a) Exempt Individuals

An alien individual who is actually physically present in the United States is treated as not being present in the United States on any day if on such day he/she is treated as an "exempt individual."[77] Basically, there are three categories of individuals who are treated as "exempt individuals":[78]

Foreign government related individuals,

Teachers or trainees; and

Students.

(i) Foreign Government-Related Individuals

Foreign government related individuals include the following:

(i) An individual holding a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status (*i.e.*, generally, the A-visa holders);[79]

(ii) An individual who is a full-time employee of an international organization (*i.e.*, generally G-4 visa holders);[80] and

(iii) An individual who is a member of the immediate family (*e.g.*, spouse or child) of an individual described in (i) and (ii) above (*i.e.*, generally A and G-4 visa holders).[81]

Comment: The A and G visa holders are entitled under immigration laws to bring domestic servants from foreign countries into the United States. For example, a G-4 visa holder may bring a nonresident alien domestic servant into the United States on a G-5 visa. From the apparent language of the statute, domestic servants do not appear to be included in the category of exempt individuals.

The House Ways and Means Committee Report, in describing the exemption for foreign government-related individuals, assumes that such individuals' presence in the United States is temporary.[82] As a matter of fact, such individuals may be present in the United States for as little as one year or for as many as 20 years or more. A majority of the employees working for international organizations are career employees and, consequently, the length of their stay in the United States can hardly be described as temporary. Nonetheless, the statutory language and the committee reports are clear and unambiguous on this point. An alien individual present in the United States as a foreign government-related individual is always a nonresident alien regardless of whether he is present in the United States for 20 years or more.

Comment: Section 7701(b) changes the result reached in *Escobar v. Comr.* and PLRs 7740001 and 7740002, where the Tax Court and the Service ruled that the taxpayers, who held G-4 visas, were resident aliens of the United States.[83] Under §7701(b), these taxpayers will no longer be considered as resident aliens of the United States.

Although there is no doubt as to the impact of the §7701(b) on those foreign government-related individuals who are nonresident aliens under the old law, it is not clear whether those foreign government-related individuals who have filed their U.S. tax returns as resident aliens for past years would suddenly be required to switch and henceforth file their returns as nonresident aliens. The statute is silent on this point and a clarification, perhaps in the forthcoming regulations, is in order.

Comment: The exemption of foreign government-related individuals from the substantial presence test is by no means a grace measure. On the contrary, the tax impact of this measure is largely negative from the standpoint of the taxpayers involved. Although the salaries of these individuals are exempt from U.S. tax under §894 (provided they are not U.S. citizens), other income earned by these individuals as well as their spouses is subject to U.S. tax. As was illustrated in *Escobar*, if such individuals are treated as residents they are entitled to file joint returns and, thus, lower taxes are applied to them. Since, in a typical situation, these individuals (and their spouses) have minimal foreign source income and substantial non-exempt U.S. source income, §7701(b) implies higher U.S. tax liabilities for these individuals.

Comment: The exemption from U.S. presence applies for purposes of the substantial presence test only. Consequently, those foreign government-related individuals who have applied for and have been accorded lawful permanent resident status will be treated as resident aliens of the United States. Although their own salaries remain tax-exempt under §894, they will be able to file joint returns with their spouses and continue to enjoy the benefits of income-splitting for their non-salary income and the income of their spouses.

(ii) Teachers and Trainees

The term "teacher or trainee" means any individual who is temporarily present in the United States under

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subparagraph (J) of section 101(15) of the Immigration and Nationality Act (other than as a student) and who substantially complies with the requirements for being so present (*i.e.*, the J-visa holders).[84]

Section 101(15)(J) of the Immigration and Nationality Act as in effect on July 18, 1984, defines a J-visa holder as:

> ". . an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist or leader in a field of specialized knowledge or skill, or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing, lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training, and who, if he is coming to the United States to participate in a program under which he will receive graduate medical education or training also meets the requirements of §1182 of this title, and the alien spouse and minor children of any such alien if accompanying him or following to join him."

A J-visa holder's presence in the United States is disregarded for the substantial presence test purposes only under the following conditions:

> (i) A J-visa holder must establish that he/she has substantially complied with the visa requirements. For this purpose it will not be enough to merely show that the visa has not been revoked. For tax purposes, an independent redetermination as to substantial compliance with the visa terms is required. Thus, if a J-visa holder accepts employment in violation of the visa terms, such individual will be regarded as a resident alien of the United States, assuming he/she otherwise satisfies the substantial presence test.
>
> (ii) A J-visa holder ceases to be an exempt individual after he/she has claimed exemption for any 2 calendar years during the preceding 6 calendar years as a teacher, trainee, or a student.[85]

The net effect of the exemption of J-visa holders from the substantial presence test is that such individuals will be treated as nonresident aliens for 2 calendar years in any 6 calendar year period. In the third year, however, they will be treated as resident aliens provided they spend at least 183 days in the United States.

Comment: The new law changes the result reached in Rev. Rul. 67-159, where the Service ruled that a J-visa holder, who was present in the United States for a continuous period of 2 years, was a resident alien of the United States.

(iii) Students

The term "student" means any individual who is temporarily present in the United States under subparagraph (F) of §101(15) of the Immigration and Nationality Act or as a student under §101(15)(J) of such Act, and who substantially complies with the requirements of being so present.[86]

Section 101(15)(F) of the Immigration and Nationality Act, as in effect on July 18, 1983, defines a student as:

> "an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student qualified to pursue a full course of study and who seeks to enter the United States temporarily and solely for the purpose of pursuing such a course of study at a college, university, seminary, conservatory, academic high school, elementary school, or other academic institution or in a language training program in the United States particularly designated by him and approved by the Attorney General after consultation with the Secretary of Education, which institution or place of study shall have agreed to report to the Attorney General the termination of attendance of each nonimmigrant student, and if any such institution of learning or place of study fails to make reports promptly the approval shall be withdrawn . . ."

Exemption from the substantial presence test for students applies only under the following conditions:

> (i) Like a J-visa holder, an F-visa holder must also establish that he/she has substantially complied with the terms of his/her visa.[87] It is not enough to show that the visa has not been revoked. An independent redetermination as to substantial compliance with the visa terms is required for tax purposes. Consequently, a student who holds a valid visa but who, upon scrutiny, is found to have accepted unauthorized employment, for example, would be regarded as a resident alien, provided he/she otherwise satisfies the substantial presence test.
>
> (ii) Generally, a student who has claimed exemption from the substantial presence test as a teacher, trainee, or student for five calendar years will be treated as a resident alien in the sixth calendar year (assuming he/she otherwise satisfies the substantial presence test) unless he can establish to the Commissioner's satisfaction that: (a) he has substantially complied with the term of his visa; and (b) he does not intend to reside permanently in the United States.[88] On the question of intent, perhaps the rules developed prior to the enactment of §7701(b) would govern.[89]

Comment: For an F-visa holder who does not earn any income, it is immaterial whether he/she is treated as a resident or a nonresident. But if an F-visa holder has any foreign source income, it is crucial that such individual substantially comply with the terms of his/her visa in order to avoid resident status. If an F-visa holder has U.S. source income, however, it may be to his/her advantage to be treated as a resident by violating the terms of his visa, but this may create problems with immigration authorities.

(b) Individuals with Medical Conditions

An individual is not treated as present in the United States on any day if such individual was unable to leave the United States on such day due to a medical condition which arose while the individual was present in the United States.[90] For example, suppose A comes to the United States on January 1, 1985, on business and is scheduled to leave the United States on March 30, 1985. However, on March 25, 1985, he suffers an accident and is hospitalized until July 15, 1985. Under the 183-day test, A would normally be considered a resident for 1985. However, he would not be treated as present in the United States from

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March 25, 1985 through July 15, 1985 because of the medical condition exemption. Thus, if A leaves the United States immediately after July 15, 1985, he would not qualify as a resident under the substantial presence test.

Note that the medical condition must have arisen while the alien individual was present in the United States for this exemption to apply. Thus, an alien who comes to the United States for medical treatment and stays here long enough to satisfy the substantial presence test would be treated as a resident alien of the United States. Neither the statute nor the legislative history, however, provides any guidance as to pre-existing medical conditions which the aliens are not aware of until they are physically present in the United States. Would such a medical condition be considered to arise when the alien is first afflicted by it or would it be considered to arise when the alien first discovers it. The answer to this question could mean the difference between resident and nonresident status for the alien individual.

Penalizing nonresident aliens, who come and stay in the United States for long periods of time for medical treatment, with resident status is justified by the House Ways and Means Committee Report thus:

> "The Committee also believes, however, that the Federal Government has contributed to the creation of medical facilities in the United States that are second to none in the world, and that aliens who come to the United States for medical treatment and stay for extended periods of time should be subjected to the bill's regular rules." [91]

Comment: Contrast this rationale with the committee's rationale for justifying the exemption of teachers, trainees, and students from the substantial presence test: "Exceptions to the general rules for some students, teachers, and trainees will allow the United States to maintain its paramount position in the field of education." [92] One might question why foreign students, teachers, and trainees need U.S. tax incentives to avail themselves of the opportunities in this country. Particularly what is the correlation between tax incentives for foreign students, teachers, and trainees and the United States' paramount position in the field of education? On the other hand, if there is a class of foreigners who deserve U.S. benevolence, it is the foreign sick, if for no other reason, than on grounds of fairness.[93] At any rate, there is more behind the exemption for students, teachers, trainees, and the non-exemption for the foreign sick than the stated rationale. The real reason for these rules is that they are advantageous from the standpoint of the U.S. Treasury. Foreign students, teachers, and trainees earn small incomes in the United States. Since the U.S. Treasury can collect more taxes by taxing such individuals as nonresidents than by taxing them as residents, such individuals are exempt from the substantial presence test. As for the foreign sick, U.S. Treasury will collect no income taxes by treating them as nonresident aliens; hence, the non-exemption for such individuals from the substantial presence test.

Comment: The U.S. Congress, by imposing a potential U.S. income tax liability on the worldwide income of the foreign sick who choose to come to the United States for medical treatment, may have created an opportunity for a new type of offshore commercial enterprise; *i.e.*, offshore medical facilities.

(c) Commuters from Canada and Mexico

An individual who regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico is not treated as being present in the United States on any day on which he/she so commutes for purposes of the substantial presence test.[94]

In order for this exemption to apply, the alien must have a place of residence in Canada or Mexico and he/she must regularly commute to a place of employment (or self-employment) in the United States.

Comment: Whether this provision is harmful or beneficial to commuters will depend upon the circumstances of each individual. If the alien commuter has no non-U.S. income, this provision may be harmful. On the other hand, if the alien commuter has substantial non-U.S. income, U.S. taxation as a nonresident alien is beneficial.

(d) Days in Transit

If an alien individual is in transit between two points outside the United States, his physical presence in the United States for less than 24 hours shall be disregarded for purposes of the substantial presence test.[95]

(2) Exceptions

An alien individual falling within the four corners of the substantial presence test is nevertheless treated as a nonresident alien in two situations. These two exceptions are discussed below.

(a) The 31-Day Exception

An alien individual who is present in the United States for less than 31 days in any calendar year is not treated as a resident alien of the United States for such calendar year under the substantial presence test.[96] For example, suppose A is present in the United States for 30 days during the current calendar year, for 330 days during the first preceding calendar year, and for 300 days in the second preceding calendar year. Under the substantial presence test, A would normally be a resident alien of the United States for the current calendar year (30 + 330/3 + 300/6 = 190). However, since A is present in the United States for less than 31 days, he is not treated as a resident in the current calendar year under the 31-day exception.

Comment: Although an alien individual may escape classification as a resident alien under the 31-day exception, such individual may still be subject to U.S. tax under §877(b) by virtue of the anti-avoidance rule discussed at C, 3, The Anti-Avoidance Rule, *infra*.

(b) The Closer Connection/Tax Home Exception

An alien individual who is not present in the United States for 183 days in the current calendar year but who qualifies as a resident alien under the substantial presence test, is, nevertheless, treated as a nonresident alien for the current calendar year provided the following conditions are met:[97]

> (i) The alien individual establishes that, for the current calendar year, he/she has a tax home in a

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foreign country and has closer connection with such foreign country than with the United States, and

(ii) The alien individual neither had an application pending for adjustment of status nor took other steps to apply for status as a lawful permanent resident of the United States at any time during the current calendar year.[98]

(i) Tax Home/Closer Connection Requirement

The term "tax home," for purposes of this exception, has the same meaning as it has in §911(d)(3) without regard to the second sentence thereof.[99] Section 911(d)(3) provides that:

"The term 'tax home' means, with respect to any individual, such individual's home for purposes of §162(a)(2) (relating to traveling expenses while away from home). An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States."

Thus, for purposes of the tax home/closer connection exception, an alien individual will be considered to have a tax home in a foreign country if his/her home is in the foreign country for purposes of the §162(a)(2) deduction, even though such individual has a house or an apartment in the United States.

Under §162(a)(2), an individual can deduct business-related travel expenses if three conditions are met: (i) the expenses are incurred while away from home; (ii) the expenses are incurred in pursuit of a trade or business; and (iii) the expenses are necessary and reasonable in amount. The concept of "home" for purposes of this deduction has been highly controversial. The Service, with the Tax Court's support, has consistently taken the position that the taxpayer's principal place of business is his "tax home."[100] Several courts of appeals, however, including the Second, Fifth, Sixth, Eighth, and Ninth Circuits, have either rejected or limited the vocational interpretation of the term "tax home" and instead given it the conventional meanings of abode or residence.[101] Normally, however, a taxpayer is expected to live in the vicinity of his principal place of business or employment; therefore, it generally makes little difference whether "tax home" is defined in terms of "abode" or "principal place of business."

Consequently, an alien individual may establish that his/her tax home is in a foreign country by showing that his/her principal place of business and "abode" are located in such foreign country. If the alien has no principal place of business because of the nature of his/her trade or business, such individual may be able to establish a "tax home" in a foreign country by showing that his/her permanent abode is located in such foreign country (where his/her family resides, for example).

Comment: Because of a lack of agreement among various courts and the Service as to what constitutes a "tax home" and because of the difficulties inherent in applying this test to certain categories of individuals (*e.g.*, jet-setters, entertainers, and athletes, who frequently travel to and spend substantial amounts of time in the United States), the application of this test is likely to be a problematic area.

Proving a "tax home" in a foreign country, of course, is only one-half of the story. In order to come within the exception, the alien individual must also establish that he/she has a closer connection with the country of his/her tax home than with the United States. Neither the statute nor the legislative history provides any guidance as to how or what factors will be taken into account to show a closer connection with a foreign country. In the absence of any specific provisions, one can speculate that all those factors which were taken into account in determining an alien's intentions as to the length and nature of his/her stay in the United States under the prior law (*e.g.*, the purpose and character of alien's visits to the United States, whether the taxpayer relocates his/her family to the United States, whether the taxpayer buys a home in the United States, the taxpayer's business and investment ties with the United States as compared to his/her business and investment ties with the foreign country, the taxpayer's social and cultural ties with the United States as compared to such ties with the foreign country, taxpayer's bank accounts in the United States as compared to such accounts in the foreign country, and whether the taxpayer files tax returns with the foreign country as a resident)[102] may be considered. If this approach is adopted, assigning the degree of importance and the balancing of various factors will be required for a closer connection determination.

Regardless of what approach is used for a closer connection determination, this inquiry, by its own nature, is likely to remain a factual inquiry and, thus, a source of uncertainty and controversy.

(ii) Lack of Adjustment of Status Request

The closer connection/tax home exception is not available to an alien individual who either: (i) has an application for adjustment of status to a permanent resident alien pending during the current calendar year, or (ii) has taken other steps during the calendar year to apply for status as a lawful permanent resident.

Under the immigration laws, a relative of the alien may apply for the alien to become a lawful permanent resident of the United States. Such application is disregarded for purposes of the closer connection/tax home exception. This exception becomes unavailable only when the alien individual takes an affirmative step to seek permanent resident alien status. When another individual has begun the immigration procedure on behalf of the alien individual, the filing of a Biographic Information form (*i.e.*, Form G-325A) will, for example, constitute an affirmative step.

(iii) Annual Statement Requirement

Section 7701(b)(7) authorizes the Secretary to issue regulations requiring those alien individuals claiming an exemption or an exception from the substantial presence test in the following situations to file annual statements setting forth the bases on which such exemption or exception is claimed:

(i) Alien individuals who claim an exception from the substantial presence test by establishing a closer connection/tax home in a foreign country;[103]

(ii) Alien individuals who claim to be "exempt indi-

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viduals" (foreign government-related individuals, teachers, trainees, and students);[104] and

(iii) Alien individuals who claim exemption from the substantial presence test on account of a medical condition.[105]

B. Rules for Determining the Beginning and Ending Dates of Residency Period

An alien individual acquiring U.S. residency may not necessarily do so on the first day of the calendar year. If such an individual acquires U.S. residency sometime after the first day of the calendar year and was not a resident in the prior years, he/she will be a dual status alien for such calendar year.[106] This, in effect, means that the alien will be a nonresident alien (and, thus, will generally be taxable on U.S. source income only) for that portion of the year which falls before the residency starting date, and a resident alien (and, thus, subject to U.S. tax on worldwide income) for that portion of the calendar year which falls before the residency terminating date. Similarly, an alien individual abandoning U.S. residence may do so before the last day of the calendar year. If so, the alien will be considered a resident alien for that portion of the year which falls before the residency abandoning date, and a nonresident alien for the balance of the year. The residency starting date and the residency ending date, therefore, can mean a significant difference in the alien's U.S. tax liability.

The rules pertaining to a determination of the residency starting date and the residency ending date are summarized below.

1. Residency Starting Date

Different rules apply to alien individuals depending upon whether they acquire U.S. residency under the substantial presence test or under the lawful permanent residence (green card) test.

a. Substantial Presence Test

An alien who acquires U.S. residency under the substantial presence test, but who was not a U.S. resident in the prior year,[107] begins his/her U.S. residency on the first day during the calendar year when he/she was physically present in the United States.[108] There is, however, an exception to this general rule. If the alien satisfies the following conditions, nominal presence in the United States is disregarded for purposes of determining the residency starting date:

(i) The alien meets only the substantial presence test during the calendar year; and

(ii) The alien can establish that, during the time of this nominal presence in the United States, he/she had a closer connection with a foreign country than with the United States.[109]

"Nominal presence" is defined as a period of presence not exceeding 10 days.[110]

The purpose behind the nominal presence exception is to permit brief visits to the United States prior to the commencement of actual residence for either business or house-hunting.

Example 1: A, a Chile citizen and resident, has never been a resident of the United States for tax purposes. On February 10, 1985, A comes to the United States for a business meeting. He leaves the United States on February 19, 1985. On May 10, 1985, A comes back to the United States on business and stays here until November 1, 1985, on which date he departs for Chile. Since A is present in the United States for more than 182 days during the calendar year 1985, he is a resident alien of the United States for 1985. However, his residency starting date is May 10, 1985. A's presence in the month of February is disregarded under the nominal presence exception because he establishes that during the period of February 10 — February 19 he had a closer connection with Chile than with the United States. Consequently, non-U.S. source income earned by A prior to May 10, 1985, is not subject to U.S. income tax.

Example 2: A, a citizen and resident of Mexico, has never been a resident of the United States for tax purposes. On January 1, 1985, A comes to the United States as a tourist and stays here until January 20, 1985. A comes back to the United States on business on June 1, 1985, and stays here until November 11, 1985, on which date he departs for his native Mexico. Since A is present in the United States for more than 182 days during the calendar year 1985, A is a resident alien of the United States for 1985. A's residency starting date is January 1, 1985, because his presence in the United States as a tourist is not excepted under the nominal presence exception on account of the 10-day limitation. Thus, income earned by A from U.S. as well as non-U.S. sources during the entire calendar year 1985 will be subject to U.S. income tax.

b. Lawful Permanent Resident Test

An alien, who acquires U.S. residency under the lawful permanent resident (green card) test but who was not a U.S. resident in the prior calendar year, begins his/her U.S. residency on the first day during the calendar year when he was physically present in the United States as a lawful permanent resident of the United States.[111] The nominal presence exception does not apply to an alien individual who acquires U.S. residency under this test.

If an alien individual satisfies both the substantial presence and the green card test in a calendar year, his/her residency starting date is the earlier of: (i) the first day he/she was present in the United States as a lawful permanent resident, or (ii) his/her residency starting date under the substantial presence test. These rules are illustrated by the following examples:

Example 1: A, a citizen and resident of Brazil, has never been a resident of the United States for tax purposes. He comes to the United States as a tourist on January 10, 1985, and stays here until January 19, 1985, when he departs for Brazil. A returns to the United States on June 15, 1985, as a lawful permanent resident of the United States. On August 20, 1985, A returns to his native Brazil and does not come back to the United States in 1985. A is a resident alien of the United States for tax purposes under the green card test for the calendar year 1985. His residency starting date is June 15, 1985, when he was first present in the United States as a lawful permanent resident.

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Example 2: Assume the same facts as above except that A, instead of returning to Brazil on August 20, 1985, stays on in the United States for the balance of the calendar year 1985. A qualifies as a resident alien of the United States under both the green card and the substantial presence test for calendar year 1985. However, the residency starting date under both tests is June 15, 1985, because A's presence in the U.S. from January 10 — January 19 is disregarded for purposes of the substantial presence test under the nominal presence exception as A is able to establish closer connections with Brazil.

Example 3: A, a citizen and resident of Singapore, has never been a resident of the United States for tax purposes. He comes to the United States on January 10, 1985, as a tourist and leaves on January 30, 1985. A comes back to the United States on July 1, 1985, as a lawful permanent resident and stays in the United States until the end of 1985. A satisfies both the green card and the substantial presence test for the calendar year 1985. A's residency starting date under the green card test is July 1, 1985. However, his residency starting date under the substantial presence test is January 10, 1985. Consequently, A's residency starting date is January 10, 1985.

2. *Residency Ending Date*

Just like the rules pertaining to the residency starting date, the rules governing the residency ending date differ depending upon whether the alien qualified as a resident under the substantial presence test or the lawful permanent resident test.

a. *The Substantial Presence Test*

An alien individual, who qualified as a resident alien of the United States for tax purposes in the current calendar year under the substantial presence test but who does not qualify as a resident alien of the United States for tax purposes in the following calendar year, terminates his U.S. residency on that day of the current calendar year when he/she was last physically present in the United States.[112] For purposes of determining the residency terminating date, nominal presence in the United States after the residency terminating date is disregarded provided the alien individual can establish that during this nominal presence period he/she had a closer connection with a foreign country than with the United States.[113] The purpose behind this nominal presence exception is to allow brief presence in the United States (for example, for business or for sale of a U.S. residence) without extending U.S. resident status. The nominal presence exception, however, does not apply if the U.S. presence exceeds 10 days.[114]

Example: A, a citizen and resident of Colombia, is physically present in the United States from January 15, 1985, to August 30, 1985, on which date he leaves for his native Colombia. A returns for a business meeting in the United States on December 5, 1985, and leaves on December 12, 1985. A qualifies as a resident alien of the United States for the calendar year 1985. Since A establishes that for the period of December 5, 1985, through December 12, 1985, he had a closer connection with Colombia than with the United States, A's U.S. residency terminating date is August 30, 1985, because his presence in the month of December is disregarded under the nominal presence exception.[115]

b. *The Lawful Permanent Resident Test*

An alien, who is a U.S. resident for tax purposes during the current calendar year under the green card test but who is not a U.S. resident in the following calendar year, terminates U.S. residency on the first day during the calendar year on which he/she ceases to be a lawful permanent resident.[116]

An alien individual who is not a U.S. resident in the following calendar year but who satisfies both the green card and the substantial presence test in the current calendar year terminates his U.S. residency on the later of: (i) the first day he/she ceases to be a lawful permanent resident, or (ii) the last day he/she was a resident alien of the United States under the substantial presence test.

Example 1: A, a citizen and resident of Venezuela comes to the United States on January 15, 1985, on business but does not return to his country. On February 20, 1985, he is accorded the status of a lawful permanent resident of the United States. On June 15, 1985, A's green card is revoked and he is deported to Venezuela. A's residency in the United States begins on February 20, 1985 and ends on June 15, 1985.

Example 2: A, a citizen and resident of Kuwait, comes to the United States for the first time on January 5, 1985. He is accorded the status of a lawful permanent resident on February 15, 1985. A surrenders his green card on August 10, 1985, and leaves the United States on that date. A returns to the United States on December 2, 1985. A establishes that for the period of December 2, 1985, through December 9, 1985, he had a closer connection with Kuwait than with the United States. A qualifies as a resident alien of the United States for the calendar year 1985 under both the green card and the substantial presence test. Under the green card test, A's residency in the United States terminates on August 10, 1985, the day he surrenders his green card. Also, since A's physical presence in the United States in December is disregarded under the nominal presence exception, A's residency in the United States under the substantial presence test also terminates on August 10, 1985. Thus, A's U.S. residency terminates on August 10, 1985.

Example 3: Assume the same facts as in Example 2 above except that after surrendering his green card on August 10, 1985, A stays on in the United States until August 20, 1985. In this case A's residency under the green card test ends on August 10, 1985, but his U.S. residency under the substantial presence test ends on August 20, 1985. Thus, A's residency in the U.S. would be considered to have terminated on August 20, 1985.

Example 4: Assume the same facts as in Example 2 above except that A is not able to establish that, for the period of December 2, 1985, through December 9, 1985, he had a closer connection with Kuwait than with the United States. In this case, A's residency in the United States during the calendar year 1985 terminates on August 10th under the green card test but on December 9th under the substantial presence test.

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Thus, A's residency in the United States in 1985 would be considered to have terminated on December 9, 1985.

3. Lapse of U.S. Residency

In the case of an alien individual, who qualifies as a resident alien of the United States for a portion of the current calendar year which begins after January 1 under the residency starting date rules discussed above, the residency starting date is deemed to be January 1 provided the alien also qualified as a resident alien of the United States in the preceding calendar year.[117]

Example 1: A, an alien individual who is a citizen and resident of Panama, first comes to the United States on July 1, 1985, and leaves for Panama on December 31, 1985. A comes back to the United States on May 15, 1986, and stays on until November 16, 1986, when he again leaves for his native Panama. Under the normal residency starting date rules, A begins his residency in the calendar year 1986 on May 15. However, since A qualified as a U.S. resident for the calendar year 1985, A's residency starting date for the calendar year 1986 is January 1, 1986.

Similarly, in the case of an alien individual, who qualifies as a resident alien of the United States for tax purposes only for a portion of the current calendar year which ends before December 31st under the general residency ending date rules discussed above, the U.S. residency date is deemed to be December 31st if the alien individual again qualifies as a U.S. resident alien in the following calendar year.[118]

Example 2: A, an alien individual who is a citizen and resident of Saudi Arabia, comes to the United States for the first time on January 15, 1985, and leaves for his native Saudi Arabia on July 18, 1985. A returns to the United States on February 1, 1986, as a lawful permanent resident of the United States. For the calendar year 1985, A's residency in the United States would end on July 18, 1985, under the general residency ending date rules. However, since A qualifies as a U.S. resident in the calendar year 1986, A's residency in the United States for calendar year 1985 is deemed to end on December 31, 1985.

Thus, if an alien individual qualifies as a U.S. resident for only portions of two consecutive calendar years, his/her U.S. residency does not lapse but continues through both years.

Example 3: Assume the same facts as in Example 2 and assume further that A's permanent resident status remains intact through the end of 1986, when he surrenders his green card and returns to his native Saudi Arabia. A's U.S. residency in calendar year 1985 is deemed to end on December 31, 1985, because he is a U.S. resident for the following calendar year. In the calendar year 1986, A's U.S. residency is deemed to begin on January 1 (even though he first entered the United States as a lawful permanent resident on February 1) because he qualified as a U.S. resident in the preceding calendar year. Provided A does not qualify as a resident alien in calendar year 1987, A's U.S. residency in 1986 is deemed to end on December 31, the day he surrenders his green card and leaves the United States. Thus, A's U.S. residency period in the U.S. begins on January 15, 1985, and ends on December 31, 1986.

For purposes of the residency lapse rules, it is immaterial whether an individual qualifies as a U.S. resident under the substantial presence test or the green card test.

C. The Anti-Avoidance Rule

Spurred by a concern that long-time U.S. residents may interrupt their U.S. residency briefly to avoid U.S. tax, the Congress included §7701(b)(9), which provides a limited anti-avoidance rule. Under §7701(b)(9), if an alien individual satisfying the "initial residency period" requirement interrupts his/her U.S. residency for less than three calendar years, such individual is subject to U.S. tax during his/her period of nonresidency under §877(b) provided the tax imposed by §877(b) is greater than the tax imposed by §871. Thus, taxation under §877(b) ensues only if the following conditions are satisfied:

(i) The alien individual satisfies the "initial residency period" requirement;

(ii) The alien individual ceases to be a U.S. resident after satisfying the "initial residency period" requirement;

(iii) The alien individual resumes U.S. residency within the prescribed time limit; and

(iv) The tax imposed by §877(b) is greater than the tax imposed by §871.

The period for which taxation under §877(b) is imposed is that period which begins after the close of the "initial residency period" and which ends on the day before the alien individual resumes his/her U.S. residency.

1. Initial Residency Period

An alien individual satisfies the initial residency period requirement if such individual is a U.S. resident for tax purposes for a period of time which includes at least three consecutive calendar years.[119] Thus, the anti-avoidance rule of §7701(b)(9) is not triggered if the alien individual at no time qualified as a resident alien for a period of time which includes at least three consecutive calendar years.

Example 1: A, a citizen and resident of Syria, first comes to the United States on January 1, 1985. He leaves for his native Syria on October 5, 1985. On January 15, 1986, A returns to the United States as a lawful permanent resident alien. On March 15, 1986, A goes back to Syria. On December 31, 1987, A surrenders his green card. Under the rules discussed in the foregoing sections, A begins his U.S. residency on January 1, 1985, and ends it on December 31, 1987. Since A's period of U.S. residency includes at least three consecutive calendar years, he meets the "initial residency period" requirement.

Example 2: A, a citizen and resident of Hong Kong, first enters the United States as a lawful permanent resident on February 1, 1985. He leaves the United States on March 15, 1985 and surrenders his green card on November 10, 1986. A comes back to the United States on June 5, 1988 and returns to Hong

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Kong on December 5, 1988. A, therefore, qualifies as a U.S. resident for the period beginning on February 1, 1985, and ending on November 10, 1986, and for the period June 5, 1988, through December 5, 1988. In this case, although A qualifies as a U.S. resident for three calendar years (1985, 1986, and 1988), A does not meet the "initial residency period" requirement since the calendar years are not consecutive.

It should be emphasized that all that is necessary is that the residency period include three consecutive calendar years. It is not necessary that the residency period extend over 36 months. An alien individual may be a U.S. resident for as few as 14 months and still satisfy the three consecutive calendar years requirement.

Example 3: A, a citizen and resident of Nigeria, enters the United States on December 1, 1985, as a lawful permanent resident of the United States. On January 31, 1987, he surrenders his green card and departs from the United States. A qualifies as a resident alien of the United States for the period beginning on December 1, 1985, and ending on January 31, 1987. Since A's period of residence in the United States includes three consecutive calendar years (*i.e.*, 1985, 1986, and 1987), he meets the "initial residency period" requirement even though his U.S. residency period spanned only 14 months.

2. Time Limit for Resumption of U.S. Residency

For the anti-avoidance rule to apply, the alien individual (who satisfies the initial residency period requirement as discussed above) must resume his/her U.S. residency before the close of the third calendar year beginning after the close of the initial residency period.[120]

Example 1: A, a citizen and resident of Hong Kong, first enters the United States on January 20, 1985, as a lawful permanent resident of the United States. He departs the United States on January 30, 1985. On November 30, 1987, his green card is revoked. A returns to the United States on June 2, 1990, and stays here through December 2, 1990. A qualifies as a U.S. resident for the period beginning on January 20, 1985, and ending on November 30, 1987, thus satisfying the initial residency period requirement. A again qualifies as a U.S. resident for the period beginning on June 2, 1990, and ending on December 2, 1990. Since A became a resident of the United States again before the close of the third calendar year (*i.e.*, 1990) beginning after the close of the initial residency period (*i.e.*, November 30, 1987), he is subject to tax under §877(b) for the intervening period of nonresidency (*i.e.*, December 1, 1987 through June 1, 1990).

Example 2: Assume the same facts as in Example 1 above except that A returns to the United States on July 2, 1990. In this case, A does not qualify as a resident of the United States in 1990 because he is present in the United States for only 182 days. Consequently, A will escape taxation under §877(b).

3. Taxation Under §877(b)

Section 877(a) provides that if a U.S. citizen renounces his/her U.S. citizenship and one of the principal purposes of such renunciation is to avoid U.S. Federal income or estate and gift taxes, then for a period of up to 10 years such expatriate is subject to tax under §877(b). Tax determined under §877(b), however, applies only if it exceeds the amount of tax that would be payable under §871.[121]

Section 877(b) assigns expatriates to a hybrid category: (i) it treats them like resident aliens in that they can neither take advantage of the 30 percent tax rate on U.S. source investment type income nor benefit from the 183-day rule prescribed in §871(a)(2) for U.S. source capital gains;[122] and (ii) at the same time it treats them like nonresident aliens in that they are subject to tax only on U.S. source noneffectively connected income and income effectively connected with a U.S. trade or business.[123] Section 877(b) is complimented by §877(c), which provides special source rules for purposes of determining the tax under §877(b). Under §877(c), gain derived from the sale of: (i) property (other than stock or debt obligations) located in the United States; (ii) stock of a domestic corporation, and (iii) debt obligations issued by U.S. persons or federal, state, or local governments are U.S. source income regardless of the property source of income rules prescribed in §§861(a)(6) and 862(a)(6).

The impact of §877(b), therefore, is to tax the expatriates on their U.S. source investment income and gain derived from U.S. assets (as described in §877(c)) at the graduated rates regardless of the 183-day rule of §871(a)(2) and the source of income rules prescribed in §§861(a)(6) and 862(a)(6).

Example 1: A, a citizen of the United States and a calendar year basis taxpayer, owns stock in a U.S. corporation. With a view to avoid U.S. tax, A migrates to France on April 5, 1985. On April 10, 1985, A formally renounces his U.S. citizenship. On April 30, 1985, A disposes of his stock in the U.S. corporation. A's gain from the disposition of the stock is not subject to U.S. tax under §871 because during the taxable year in question (*i.e.*, calendar year 1985) A was not present in the United States for 183 days or more.[124] However, since one of A's principal purposes in renouncing his citizenship was the avoidance of federal income tax, his gain from the disposition of stock is subject to U.S. tax at graduated rates under §877(b).

Example 2: A, a citizen of the United States and a calendar year basis taxpayer, owns some extremely valuable paintings for which he has received an offer from the London Museum of Art. With a view to avoid U.S. federal income tax on the gain which A would derive from a sale of the paintings, he leaves the United States on July 2, 1985. On July 10, 1985, he formally renounces his U.S. citizenship. On July 25, 1985, A consummates the sale of the paintings but stipulates in the contract of sale that the title to the paintings passes to the London Museum of Art in London. A's gain is not exempt from U.S. tax under §871(a)(2) because he was present in the United States for 183 days or more during the year of the sale. But since the title passes outside the United State, A's gain is exempt from U.S. tax under §871 as foreign source income. However, since one of A's principal purposes in renouncing his U.S. citizenship was the avoidance of U.S. federal income tax, his gain is subject to U.S. tax by virtue of §§877(b) and (c).

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4. Application of §877(b) to Nonresident Aliens

Section 877(b) applies to an expatriate only if one of the principal purposes of the renunciation of U.S. citizenship was the avoidance of federal income or estate and gift taxes. The element of tax avoidance, however, is not required for purposes of applying the anti-avoidance rule of §7701(b)(9). Thus, if an alien individual satisfies the initial residency period requirement, ceases to be a U.S. resident, and again becomes a U.S. resident within the prescribed time limit, he/she is subject to U.S. tax under §877(b) on income earned during the intervening period of nonresidency regardless of any tax avoidance motive.

The net effect of the anti-avoidance rule is to treat the alien individual as a resident for the intervening period of nonresidency, but only for the limited purpose of taxing U.S. source investment income and the gain derived from: (i) the sale of property located in the United States, and (ii) the sale of stock in U.S. corporations and certain securities.

Comment: The true penalty imposed by the anti-avoidance rule is to prevent an alien from reacquiring U.S. residency within the time limit prescribed in §7710(b)(9)(B). In any case where an alien individual would owe substantial U.S. taxes under the rule of §7701(b)(9), it probably would be advisable for such individual to wait until the period prescribed in §7701(b)(9)(B) has elapsed before reacquiring U.S. residency.

Comment: The anti-avoidance rule of §7701(b)(9) has a limited anti-avoidance effect. It only prevents an alien individual from avoiding U.S. income tax on U.S. source investment income or income derived from property and certain U.S. stock or securities. An alien individual may go in and out of U.S. resident status with impunity to avoid potential U.S. income tax on foreign source income or income derived from property located in a foreign country.

D. The Taxable Year of an Alien

Section 7701(b)(8) provides that an alien individual who is not already on a fiscal year basis must adopt as a taxable year the calendar year. This rule makes sense because the resident or nonresident status of aliens is determined on a calendar year basis and the adoption of a fiscal year would provide the alien individual with the undesirable ability to reduce U.S. taxes by shifting income from one taxable year to another.

An alien individual, who is already on a fiscal year basis and who qualifies as a resident alien of the United States for a calendar year, shall be treated as a resident of the United States with respect to any portion of his/her taxable year which falls within such calendar year.[125]

Example: A, a citizen and resident of Mexico, is engaged in a U.S. trade or business since 1983. For U.S. tax purposes, he is on a September 30th fiscal year basis. A comes to the United States on May 10, 1985, and stays here until November 10, 1985, on which date he leaves for his native Mexico. Assuming that A does not become a resident of the United States in 1986, he qualifies as a U.S. resident for the period beginning on May 10, 1985, and ending on November 10, 1985. Consequently, for his fiscal year ending on September 30, 1985, A will be taxed as a U.S. resident for the period which begins on May 10, 1985, and ends on September 30, 1985. For his fiscal year which ends on September 30, 1986, A will be taxed as a U.S. resident for the period which begins on October 1, 1985, and ends on November 10, 1985.

E. Section 7701(b) Does Not Override U.S. Tax Treaties

Because of the conflicting internal laws of various tax jurisdictions an individual may qualify as a resident of more than one jurisdiction. In such a situation, the question arises: which jurisdiction has the right to tax such individual. If the jurisdictions involved do not have a tax treaty in effect, the individual may be out of luck because he/she may be taxed by both jurisdictions as a resident. In certain cases, however, where there is an income tax treaty in effect, the jurisdictions involved may resolve the issue of taxing jurisdiction by applying the so-called "tie-breaker" rules in the treaty. The recently negotiated U.S. tax treaties, for example, provide such "tie-breaker" rules.[126] These "tie-breaker" rules, which are patterned after Article 4 of the United States Model Income Tax Treaty, basically provide that where an individual is a resident of both Contracting States according to the internal laws of those States, then his status shall be determined as follows:

(i) He shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (*i.e.*, center of vital interests);

(ii) If the States in which he has his center of vital interest cannot be determined, he shall be deemed to be a resident of that State in which he has his habitual abode;

(iii) If the individual has an habitual abode in both States, or in neither of them, he shall be deemed to be a resident of that State of which he is a national; and

(iv) If he is a national of both States or of neither of them, the competent authorities of the two contracting states shall settle the question by mutual agreement.

The legislative history of Code §7701(b) makes it clear that where an individual, who is a resident of the United States under §7701(b), qualifies as a resident of the treaty partner under the tie-breaker rules, such individual shall be treated as a resident of the treaty partner. However, the treaty provisions override the Code provisions only for the limited purpose of taxation under the treaty. For purposes of internal U.S. taxation, such individual will continue to be treated as a U.S. resident.

The House Ways and Means Committee Report, in pertinent part, provides that:

"The definition of resident alien contained in the bill could conflict with existing treaty obligations of the United States. That is, the definition in the bill could cause an alien to be a U.S. resident, while "tie-breaker" rules in an income tax treaty could indicate that the alien is a resident of the treaty partner (*see, e.g.*, Article 4 of the U.S. Model Income Tax Treaty, and Article 4(2) of the U.S.–United Kingdom Income Tax Treaty). The committee does not intend to override treaties on this point; therefore, in such a case, the

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treaty definition will prevail, and such an alien will not be taxable as a resident of the United States." [127]

The Conference Committee Report, in pertinent part, provides that:

> "The conferees do not intend that the conference agreement override treaty obligations of the United States. For example, an alien who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under a United States income tax treaty will be eligible for the benefits that the treaty extends to residents of the treaty partner. However, notwithstanding the treatment of the alien as a resident of the other country for treaty purposes, the conference agreement will treat the alien as a U.S. resident for purposes of the internal tax laws of the United States. For example, if the alien owns more than 50 percent of the voting power of a foreign corporation, the foreign corporation will be a controlled foreign corporation §957)." [128]

F. *The Effective Date and Transitional Rules*

Section 138(b) of the Tax Reform Act of 1984 provides that, generally, the provisions of §7701(b) are applicable to tax years beginning after December 31, 1984. Thus, if an alien individual is present in the United States for 183 days in the calendar year 1984, such individual will not qualify as a resident alien of the United States. Similarly, except as discussed below, an alien individual's U.S. presence in the calendar year 1984 and earlier years will not count for purposes of the 3-year look-back part of the substantial presence test.

For purposes of applying the "substantial presence" and the "green card" tests, §138(b) of the Act also provides two transitional rules:

> (i) For purposes of applying the 3-year look-back part of the substantial presence test, an alien individual's presence in the United States during the calendar year 1984 will count if the alien qualified as a U.S. resident at the close of calendar year 1984 under the law then in effect. If the alien qualified as a U.S. resident under the law then in effect for both 1983 and 1984, his/her presence in both years will be taken into account.[129]
>
> (ii) For purposes of applying the lawful permanent resident test to calendar year 1985, an alien individual will be considered to start his U.S. residency on January 1, 1985, if such individual was: (i) a lawful permanent resident of the United States throughout the calendar year 1984 regardless of whether he/she was physically present in the United States; or (ii) physically present in the United States at any time during the calendar year 1984 while he/she was a lawful permanent resident of the United States.[130]

G. *Planning Considerations*

Because of the significant U.S. income tax consequences that flow from an acquisition or termination of U.S. resident status, careful planning is required each time an alien either acquires or abandons U.S. residency. The following discussion attempts to illustrate some of the planning opportunities available under the new §7701(b)(9).

1. *Pros and Cons of Resident Alien Status*

The tax regime that applies to resident aliens of the United States is radically different from that which applies to nonresident aliens. Upon classification as a resident alien of the United States, some of the U.S. tax consequences that will follow include:

> (i) The alien individual will be subject to U.S. income tax on his/her worldwide income;
>
> (ii) If the alien individual owns stock in a U.S. corporation, such corporation may be classified as a personal holding company with its attendant U.S. tax consequences;
>
> (iii) If the alien individual owns stock in a foreign corporation, such corporation may be classified as a foreign personal holding company, a foreign investment company, or a controlled foreign corporation with the attendant U.S. tax consequences (including reporting obligations) to U.S. shareholders;
>
> (iv) The application of §§367 and 1491 where the alien individual makes a property transfer to a foreign entity after the residency starting date;
>
> (v) If the alien individual is a settlor of a foreign trust which qualifies as a grantor trust, the alien individual becomes subject to U.S. tax on the trust income; and
>
> (vi) If the alien individual is a beneficiary of a foreign trust settled by a U.S. grantor, the grantor becomes subject to U.S. income tax on the trust income attributable to property transferred to the trust by such grantor (§679).

On the other hand, an alien individual, who is classified as a U.S. resident, enjoys certain advantages over a nonresident alien. For example:

> (i) A resident alien may deduct foreign source losses against U.S. source income;
>
> (ii) A resident alien may file a joint return (a §6013(g) or (h) election may be necessary for this purpose), and is entitled to other deductions, exclusions, and credits unavailable to a nonresident alien; and
>
> (iii) A resident alien may avoid altogether or minimize foreign taxes on his/her foreign source income under the extensive U.S. tax treaty network.

Considering the pros and cons of the resident alien status (some of which are described above), a nonresident alien, who expects to qualify as a resident alien for the calendar year in question either under the "green card" test or the substantial presence test, may take certain planning steps before entering the United States. These steps may include, among others, the following:

> (i) The alien individual may accelerate foreign source income that he/she expects to receive after acquiring U.S. residency;
>
> (ii) If the alien owns appreciated property, he/she may sell it (avoiding carefully, however, the 183-day

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rule of §871(a)(2) if the capital gain is U.S. source income) and acquire new property;

(iii) The alien may complete all transfers of property to foreign entities before acquiring U.S. residency in order to avoid §§367 and 1491; and

(iv) The alien may consider reducing his/her ownership in U.S. and foreign corporations to avoid the potentially adverse consequences under the PHC, the FPHC, the FIC, and the CFC provisions of the Code.

2. Planning Opportunities Under the New §7701(b)

Along with its flaws and weaknesses, §7701(b) has one overriding merit: it lends certainty to an area where certainty was badly needed. Section 7701(b) provides alien individuals with a remarkable ability to obtain the best possible U.S. tax results by simple planning in the following two areas:

(i) Control of the resident or the nonresident status in a given calendar year; and

(ii) Control of the residency beginning and the residency terminating dates.

In a given calendar year, for example, a nonresident alien may be better off as a resident for U.S. tax purposes. Conversely, a resident alien of the United States may be able to obtain better U.S. tax results in a given year by terminating U.S. tax residency. Similarly, it may be crucial for a prospective or current U.S. resident to plan his/her residency beginning date and residency terminating date (as the case may be) carefully to minimize U.S. tax burden in the relevant calendar year.

a. Control of the Resident or Nonresident Status

An alien individual has very little control over the acquisition of resident alien status under the "green card" test because such alien's eligibility to apply for a lawful permanent resident alien status and the amount of time required for the processing and approval of the application depend largely upon the immigration laws and regulations. Once an alien individual has been accorded the resident status, however, he/she can control the calendar year in which he/she desires U.S. residency for tax purposes by simply controlling the date on which he/she first enters the United States as a lawful permanent resident. Termination of the resident alien status under the "green card" test, on the other hand, is easy. It simply requires the surrendering of the "green card" and leaving the United States.[131]

The fact that the acquisition of resident alien status under the "green card" test is beyond the control of an alien individual is not of much consequence because the alien can always utlilize the substantial presence test to achieve the resident alien status. Thus, if the alien individual determines that it would be to his/her advantage to be taxed as a resident alien in a particular calendar year, all that is required is that the alien spend a maximum of 183 days [132] in the United States during such calendar year. Conversely, where an alien, who has been a long-time resident alien of the United States, determines that it would be to his/her advantage to be taxed in the United States as a nonresident alien in a particular year, he/she may achieve that status by simply limiting his/her presence in the United States to the required number of days in the relevant calendar year.

Comment: The substantial presence test provides an alien individual great flexibility in the sense that such individual may change his/her status from nonresident alien to resident alien and back to nonresident alien on a year to year basis. The only limitations on this are the alien's own ability, willingness, and desire to spend a certain required number of days in the United States, and the anti-avoidance rule of §7701(b)(9). This flexibility, however, is not available under the "green card" test.

The following examples illustrate some of the planning opportunities offered by §7701(b):

Example 1: A, a citizen and resident of country B, owns two businesses X and Y. A conducts X business in France and Y business in the United States. In 1985, A starts business Z in country C. For the calendar year 1985, A has a taxable income of $500,000 from business X, a taxable income of $2.5 million from business Y, and a net loss of $1.5 million from business Z. If, for the calendar year 1985, A is taxed as a nonresident alien, he will owe U.S. income tax on $2.5 million taxable income. If, on the other hand, A is taxed as a resident alien, he will be subject to U.S. income tax on $1.5 (.5 + 2.5 - 1.5) million taxable income. It would, therefore, be advantageous for A to qualify as a U.S. resident alien in the calendar year 1985.

Example 2: A, a citizen and resident of foreign country B, is engaged in a U.S. trade or business. In the calendar year 1985, A has no foreign source taxable income, $800,000 in U.S. source royalty, interest and dividend income which is not effectively connected with A's U.S. business, and a $800,000 loss from the U.S. business. If, for the calendar year 1985, A is taxed as a nonresident alien, he will owe $240,000 in U.S. withholding tax (*i.e.*, 30% of $800,000). However, A may eliminate this U.S. tax liability by becoming a resident of the United States in the calendar year 1985.

Example 3: A, a citizen of foreign country B, qualifies as a resident alien of the United States for the calendar year 1985 under the substantial presence test. A owns valuable paintings in which his basis is $500,000. A foreign art museum offers to buy these paintings from A for $2.5 million. A may avoid U.S. tax on the $2 million of gain by delaying the sale until 1986 and then becoming a nonresident alien in the calendar year 1986.

b. Control of the Residency Starting Date and Residency Ending Date

The residency starting date and the residency terminating date rules make it clear that it is totally within the alien individual's power to determine the date on which his/her residency starts and the date on which it ends. It involves nothing more than the simple mechanics of fixing the date of entry into the United States and the date of departure from the United States.[133]

Careful planning with respect to the residency starting date and the residency ending date can translate into significant U.S. tax savings.

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Example 1: A, a citizen and resident of foreign country B, sold an office building located in B for $10 million on an installment basis in 1981. The fifth and final installment of $2 million is due on March 20, 1985. A plans to become a U.S. resident in 1985. He would be well-advised to arrive in the United States after March 20, 1985, and after receiving the last installment.

Example 2: A, a citizen of the foreign country B, owns valuable paintings in which he has a basis equal to $500,000. A comes to the United States for the first time on January 15, 1985. On July 15, 1985, a foreign museum offers to buy the paintings from A for $2.5 million. If A sells the paintings immediately, he would be subject to U.S. tax on his $2 million gain. However, if A departs from the United States and then sells the paintings, his gain would not be subject to U.S. tax provided, of course, he does not again become a U.S. resident in calendar year 1986.

c. Other Planning Pointers

(1) How to Avoid Resident Status When Prolonged U.S. Presence Is Necessary

If, for any reason, an alien individual must remain in the United States for a period of more than 182 consecutive days, such individual should attempt to spread this presence over a two-calendar year period in order to avoid resident alien status.

Example: A, a wealthy and distinguished citizen of an oil-rich state, suffers from a chronic ailment. He is advised by a U.S. hospital on May 30, 1985, that he requires surgery and post-surgery care by the hospital's medical staff for a period extending over 7 months. During the calendar year 1985, A expects an income of $10 million from non-U.S. sources. If A stays on in the United States and enters the hospital for surgery and post-surgery care, he would qualify as a resident alien for the calendar year 1985. He would, therefore, owe U.S. income tax on his $10 million income. However, if A returns to his country and comes back to the United States on July 30, 1985,[134] undergoes medical treatment, and again returns to his country on March 1, 1986, he will not qualify as a U.S. resident either for 1985 or for 1986. His $10 million income would, thus, avoid U.S. income tax.

Comment: An alien individual may spend 364 consecutive days in the United States without qualifying as a U.S. resident provided this period of presence in the United States is equally spread over two consecutive calendar years.

(2) Planning for Foreign Government-Related Individuals

Treatment of foreign government-related individuals as nonresident aliens holds two adverse U.S. tax consequences:

(i) Such individual's U.S. source investment income (*e.g.*, dividends and capital gains) becomes subject to a flat 30 percent withholding tax; and

(ii) Such individuals cannot file joint returns with their working spouses.

These individuals may consider the following steps in order to minimize the adverse U.S. tax impact:

(i) Apply for a permanent resident alien status;

(ii) Consider switching from U.S. investments to foreign investments; and

(iii) Consider earning the types of U.S. source interest income which is exempt from U.S. withholding tax in the hands of nonresident aliens.

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[1] §871(a)(1) of the Code. Unless otherwise indicated, all references herein are to the Internal Revenue Code of 1954, as amended.
[2] §1441(a).
[3] §871(a)(1)(A).
[4] §§871(a)(1)(B), (C), and (D). The capial gains of a nonresident alien individual (other than gains derived from the disposition of a U.S. real property interest) not engaged in a U.S. trade or business are exempt from U.S. tax, provided the alien is not present in the United States for 183 days or more during the taxable year (§871(a)(2)). Capital gains derived from the disposition of a United States real property interest are taxed as effectively connected income. See §897.
[5] §§871(b), 864(c)(1), (2), and (3).
[6] Such income remains subject to the withholding tax at a rate of 30 percent (or the lower treaty rate) unless exempt under the Code or an applicable treaty.
[7] §864(c)(4).
[8] In addition, the resident status of an individual attracts certain other U.S. tax consequences, *e.g.*, the toll charge and the excise tax provisions of §§367 and 1491, the Subpart F provisions of §§951-964 and §1248, the Personal Holding Company provisions of §§541-547, the Foreign Personal Holding Company provisions of §§551-558, and the Foreign Investment Company provisions of §1246, etc. *See* the discussion under III, G, *infra*.
[9] Regs. §1.871-4.
[10] O.D. 197, C.B. 1, 164 (1919); Rev. Rul. 64-285, 1964-2 C.B. 184.
[11] *El-Sabban v. Comr.*, 30 T.C.M. 453 (1971); *Rynowiekl v. Comr.*, 27 T.C.M. 151 (1968); and *Adams v. Comr.*, 46 T.C. 352 (1966).
[12] *Chapman v. Comr.*, 9 T.C. 619 (1947); *Goldring v. Comr.*, 36 B.T.A. 779 (1937); and *Stallforth v. Comr.*, 30 B.T.A. 546 (1934), aff'd, 77 F.2d 548 (D.C. Cir. 1935). Compare, however, *Toor v. Comr.*, 36 T.C.M. 1617 (1977), where the taxpayer came to the United States on a visitor's visa for medical treatment and died after nine months. The Tax Court ruled that the presumption of nonresidence was not rebutted in the absence of a definite intention to stay in the United States.
[13] 79 T.C. 252 (1982).
[14] Rev. Rul. 64-285, 1964-2 C.B. 184.
[15] *Nubar v. Comr.*, 185 F.2d 584 (4th Cir. 1950); *Jamvold v. Comr.*, 11 T.C. 122 (1948); and *Constantinescu v. Comr.*, 11 T.C. 27 (1948).
[16] 31 T.C. 1031 (1959), aff'd, 272 F.2d 709 (5th Cir. 1959).
[17] This language was quoted with approval by the Tax Court again in *Jellinek v. Comr.*, 36 T.C. 836 (1961).
[18] 46 T.C. 352 (1966), acq., 1967-2 C.B. 1.
[19] *See Heinzelman v. Comr.*, 41 T.C.M. 1423 (1982), where the Tax Court observed that intent was the primary factor to be considered in determining residence.
[20] Regs. §1.871-2(b).
[21] *Id.*

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[32] *Toor v. Comr.*, 36 T.C.M. 1617 (1977); and *Siddiqi v. Comr.*, 70 T.C. 553 (1978).

[33] In *Barocas v. Comr.*, 34 T.C.M. 755 (1975), the court found a failure of the taxpayer's wife to join him as negating bona fide residency. In *Fugit v. Comr.*, 34 T.C.M. 647 (1975), the court similarly found that the taxpayer's failure to relocate his family was sufficient evidence that he was not a bona fide resident. Compare, however, *Maclean v. Comr.*, 73 T.C. 1045 (1980), where the Tax Court held that the taxpayer's failure to relocate his family did not establish conclusively that he was a nonresident alien.

[34] *Park v. Comr.*, 79 T.C. 252 (1982); *Escobar v. Comr.*, 68 T.C. 304 (1977); *Adams v. Comr.*, 46 T.C. 352 (1966); *Chapman v. Comr.*, 9 T.C. 619 (1947); and *Stallforth v. Comr.*, 30 B.T.A. 546 (1934), aff'd, 77 F.2d 548 (D.C. Cir. 1935).

[35] *Schoneberger v. Comr.*, 74 T.C. 1016 (1980); *Croyle v. Comr.*, 41 T.C.M. 339 (1980); *Escobar v. Comr.*, 68 T.C. 304 (1977); *Adams v. Comr.*, 46 T.C. 352 (1966); and *Begassiere v. Comr.*, 31 T.C. 1031 (1959).

[36] *Park v. Comr.*, 79 T.C. 252 (1982).

[37] *Hoskins v. Comr.*, T.C. Memo 1983-508; *Croyle v. Comr.*, 41 T.C.M. 339 (1980); *Escobar v. Comr.*, 68 T.C. 304 (1977); and *Adams v. Comr.*, 46 T.C. 352 (1966).

[38] *Croyle v. Comr.*, 41 T.C.M. 339 (1980); *Escobar v. Comr.*, 68 T.C. 304 (1977).

[39] 1964-2 C.B. 184.

[40] 1967-1 C.B. 280.

[41] 70 T.C. 553 (1978); *see also Budhwani v. Comr.*, 70 T.C. 287 (1978).

[42] *Patino v. Comr.*, 186 F.2d 962 (4th Cir. 1951); *Cooper v. Comr.*, 15 T.C. 757 (1950); and *Chapman v. Comr.*, 9 T.C. 619 (1947).

[43] 68 T.C. 304 (1977); *see also* PLRs 7740001 and 7740002.

[44] Rev. Rul. 76-82, 1976-1 C.B. 192.

[45] Rev. Rul. 72-297, 1972-2 C.B. 212. *See also* Rev. Rul. 76-82, 1976-1 C.B. 192.

[46] 36 T.C. 826 (1961).

[47] 46 T.C. 352 (1966).

[48] Rev. Rul. 60-129, 1960-1 C.B. 272; *Friedman v. Comr.*, 37 T.C. 539 (1961); and *Baer v. Comr.*, 6 T.C. 1195 (1946).

[49] Rev. Rul. 60-129, 1960-1 C.B. 272.

[50] *Dillin v. Comr.*, 56 T.C. 228 (1971); and *Goldring v. Comr.*, 36 B.T.A. 779 (1937).

[51] 35 T.C.M. 870 (1976).

[52] 68 T.C. 68 (1977). *See also Hoskins v. Comr.*, T.C. Memo 1983-508.

[53] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. p. 1523 (1984).

[54] Code §7701(b)(1)(A)(i).

[55] Code §7701(b)(1)(A)(ii).

[56] Code §7701(b)(3)(A).

[57] Code §§7701(b)(3)(D) and 7701(b)(4)(A)(i).

[58] Code §§7701(b)(3)(D); 7701(b)(4)(A)(ii); and 7701(b)(4)(E)(i).

[59] Code §§7701(b)(3)(D); 7701(b)(4)(A)(iii); and 7701(b)(4)(E)(ii).

[60] Code §7701(b)(3)(D)(ii).

[61] Code §7701(b)(6)(B).

[62] Code §7701(b)(3)(A)(i).

[63] Code §7701(b)(3)(B).

[64] Section 138(b) of The Tax Reform Act of 1984 (P.L. 98-369).

[65] *E.g.*, the gross estate of a nondomiciliary includes only that propery which has its situs in the United States; §2032A is not available to nondomiciliaries; certain deductions are not available to the estates of nondomiciliaries (*e.g.*, bequests to foreign corporate charities and the marital deduction); and the estate of a nondomiciliary is allowed a unified credit in the amount of $3,600 only.

[66] Regs. §§20.0-1(b)(1) and 25.2501-1(b); *Farmers Loan & Trust Co. v. U.S.*, 60 F.2d 618 (S.D. N.Y. 1932); *Rodiek v. Comr.*, 33 B.T.A. 1020 (1936), aff'd, 87 F.2d 328 (2nd Cir. 1937).

[67] An alien individual may have every intention of returning home, but if his purpose requires a lengthy stay in the United States and he makes his home temporarily in the United States, such individual would be considered a resident alien of the United States under pre-TRA 1984 rules (*see* Regs. §1.871-2(b)).

[68] *Rodiek v. Comr.*, 33 B.T.A. 1020, at 1033 (1936).

[69] §911(a).

[70] §911(d)(1)(B).

[71] §911(d)(1)(A).

[72] *See, e.g., Van Yost v. Comr.*, T.C. Memo 1982-516; *Schoneberger v. Comr.*, 74 T.C. 1016 (1980); *Croyle v. Comr.*, 41 T.C.M. 339 (1980); *Barocas v. Comr.*, 34 T.C.M. 755 (1975); and *Fugit v. Comr.*, 34 T.C.M. 647 (1975).

[73] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1528 (1984).

[74] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 967 (1984).

[75] §7701(b)(1)(A).

[76] §7701(b)(5).

[77] §7701(b)(2)(A)(ii).

[78] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1524 (1984).

[79] Rev. Rul. 72-297, 1972-2 C.B. 212.

[80] Rev. Rul. 76-82, 1976-1 C.B. 192.

[81] *Supra*, footnote 36.

[82] *Supra*, footnote 37.

[83] *See* the discussion under III, B, 1, b, *infra*.

[84] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1524 (1984).

[85] Foreign tourists make an obviously important contribution to the U.S. economy.

[86] Prop. Regs. §1.911-2(d)(2).

[87] §7701(b)(3)(D)(i).

[88] §7701(b)(4)(A).

[89] §7701(b)(4)(B)(i).

[90] §7701(b)(4)(B)(ii). An international organization is an organization which is entitled to the benefits of the International Immunities Act.

[91] §7701(b)(4)(B)(iii).

[92] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1526 (1984).

[93] *Supra*, footnote 33.

[94] §7701(b)(4)(C).

[95] §7701(b)(4)(E)(i).

[96] §7701(b)(4)(D).

[97] §7701(b)(4)(D)(ii).

[98] §7701(b)(4)(E)(ii).

[99] *See* generally, the discussion under I, Introduction, *supra*.

[100] §7701(b)(3)(D)(ii).

[101] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1525 (1984).

[102] *Id.* at 1524.

[103] Commentators have criticized the fact that a foreigner should be required to pay U.S. income tax on his/her worldwide income when the foreigner stays in the United States soley for medical reasons.

[104] §7701(b)(6)(B).

[105] §7701(b)(6)(C).

[106] §7701(b)(3)(A)(i).

[107] §7701(b)(3)(B).

[108] §7701(b)(3)(C).

[109] §7701(b)(3)(B)(ii).

[110] T.M. 400, *Travel and Transporation Expenses*, at p. A-4.

[111] *Id.* at p. A-6.

[112] *See* the discussion under III, A, 2, b, (2), (b), *supra*.

[113] *See* the discussion under III, A, 2, b, (1), (a), *supra*.

[114] *See* the discussion under III, A, 2, b, (1), (b), *supra*.

[115] §7701(b)(2)(A)(i).

[116] If the alien was a U.S. resident in the prior calendar year, the residency does not lapse. For a further discussion of lapse of U.S. residency, *see infra*.

[117] §7701(b)(2)(A)(iii).

[118] §7701(b)(2)(C)(i).

[119] §7701(b)(2)(A)(ii). The closer connection standard is probably the same as in §7701(b)(3)(B).

[120] §7701(b)(2)(C)(ii).

[121] If the alien individual qualifies as a resident alien in the following calendar year, his/her residence in the United States will not lapse in the current year. *See* the discussion at III, B, 3, *infra*.

[122] §7701(b)(2)(B).

[123] §7701(b)(2)(C).

[124] §7701(b)(2)(C)(ii).

[125] It is assumed, of course, that A does not become a resident of the United States in calendar year 1986.

[126] §7701(b)(2)(B).

[127] §7701(b)(2)(A)(i).

[128] §7701(b)(2)(B).

[129] §7701(b)(9)(A).

[130] §7701(b)(9)(B).

[131] §877(a).

[132] The expatriates are taxable in accordance with §1 under §877(b).

[133] §872(b)(1).

[134] §871(a)(2).

[135] §7701(b)(8)(B).

[136] Article 4(2) of the United States–United Kingdom tax treaty; Article 4(2) of the United States–Malta tax treaty; Article 3(2) of the United States–Morocco tax treaty; Article 4(2) of the United States–Poland tax treaty; Article 4(2) of the United States–New Zealand tax treaty; Article 3(2) of the United States–Norway tax treaty; and Article 3(2) of the United States–Romania tax treaty.

[137] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1528 (1984).

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[128] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 967 (1984).
[129] §138(b)(2)(B) of the Act.
[130] §138(b)(3) of the Act.
[131] *See* the discussion under III, B, 2, b, *supra*.
[132] If the alien was present in the United States in prior two calendar years, the required presence in the calendar years would be less than 183 days.
[133] In the case of a lawful permanent resident a surrender of green card would also be necessary.
[134] It is assumed that on his initial visit to the United States in 1985, A was present in the United States for less than 10 days.

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CHAPTER 62

THE 30 PERCENT U.S. WITHHOLDING TAX ON PORTFOLIO INTEREST REPEALED

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I. Introduction

A. The Applicable Rules of Law [1]

The United States imposes a flat 30-percent tax (subject to reduction under an applicable tax treaty provision) on the gross amount of U.S. source fixed or determinable, annual or periodical income (*e.g.*, dividends, interest, rent, and royalties) and certain other income (*e.g.*, OID, gains described in §§402(a)(2) and 403(a)(2)) derived by a nonresident alien individual or a foreign corporation provided such income is not effectively connected with the U.S. trade or business of such individual or corporation.[2] This 30-percent tax is generally collected by withholding at source by the person making the payment (*i.e.*, the withholding agent) and therefore, is referred to as the "30-percent withholding tax." [3]

If, however, the types of income described above are effectively connected with the recipient's U.S. trade or business of the foreign investor, such income is not subject to the 30-percent withholding tax, but instead is taxed at the regular graduated rates of U.S. tax on a net basis.[4]

Various Code provisions exempt from the 30-percent withholding tax certain categories of interest income, which under the general source of income rules [5] would be considered U.S. source income. The categories of exempt interest include the following:

(i) Interest derived by nonresident aliens and foreign corporations from deposits in U.S. banks and similar institutions, provided such interest is not effectively connected with a U.S. trade or business;[6]

(ii) Original issue discount income of nonresident aliens and foreign corporations on obligations maturing in six months or less;[7]

(iii) Interest paid to nonresident aliens and foreign corporations by a domestic corporation which earns less than 20 percent of its gross income over a 3-year base period from U.S. sources (the so-called "80/20 company");[8]

(iv) Interest paid to nonresident aliens and foreign corporations on certain debt obligations which were part of an issue with respect to which an election had been made for purposes of the expired Interest Equalization Tax;[9]

(v) Interest income (other than interest derived from commercial activities in the United States) derived by a foreign government from investments in the U.S. securities.[10]

In addition to the statutory exemptions, U.S. source interest income derived by a nonresident alien individual or a foreign corporation may be either exempt or subject to a reduced rate of withholding tax under an income tax treaty signed by the United States with the nonresident alien's or the foreign corporation's country of residence. For example, under the U.S. income tax treaties with Austria, Denmark, Finland, West Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands and the Netherlands Antilles, Norway, Poland, Sweden, the U.S.S.R., and the U.K., the U.S. source interest income is exempt from withholding tax. Under the income tax treaties with Belgium, Canada, Egypt, Morocco, and the Philippines, the withholding tax rate on interest is reduced to 15 percent; and it is reduced to 10 percent under the income tax treaties with France, Japan, and Romania. It should be noted, however, that the exemption or the reduced withholding rate of tax is available under an income tax treaty only with respect to that interest income which is not effectively connected with a U.S. trade or business conducted through a permanent establishment.

In order to secure a treaty exemption or reduction from U.S. withholding tax on U.S. source interest income, a foreign resident is required to file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). This Form requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the Form 1001 must be presented to the payor by or on behalf of the foreign owner with each coupon.

The Code imposes an information reporting obligation on any person who makes payments of interest (including original issue discount) aggregating $10 or more during any calendar year.[11] This requirement to file an information return is also imposed on any person who collects interest as a nominee and makes payments out of the interest income so collected aggregating $10 or more.[12] Interest, for purposes of the information reporting requirement, is defined to include interest on any obligation issued in registered form, or of a type offered to the public (other than an obligation with maturity of less than one-year and held by a corporation).[13] It also includes interest paid on bank deposits, CD's, and similar obligations of banks and savings institutions; interest on amounts held by insurance companies, investment companies, and brokers; and interest on any

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other amounts designated by the Secretary unless specifically excluded by §6049(b)(2).[14]

Reportable interest, however, does not include interest on an obligation of a natural person or an obligation the interest on which is exempt under §103 or any other provision of law (without regard to the identity of the recipient).[15] Also excluded from reporting requirement are the following types of interest payments:

(i) Any amount subject to withholding under §§1441 or 1442;

(ii) Any amount which would be subject to withholding under these sections by the payor but for the fact that: (a) such amount is income from foreign sources; (b) the payor is exempt from the application of §1441(a) by reason of §1441(c) or a tax treaty; or (c) such amount is original issue discount.[16]

Reportable interest also does not include (except to the extent provided by the regulations) any amount which is income from sources outside the United States or is paid by:[17]

(i) A foreign government or international organization or any agency or instrumentality thereof;

(ii) A foreign central bank of issue;

(iii) A foreign corporation not engaged in a U.S. trade or business;

(iv) A foreign corporation less than 50 percent of whose gross income from all sources over a 3-year base period is effectively connected with a U.S. trade or business; and

(v) A partnership not engaged in a U.S. trade or business and composed wholly of nonresident alien individuals or persons listed in (i)–(iii) above.

An information return is also required under §6041 with respect to payment of interest (but only if the aggregate amount of the payment is $600 or more) which does not meet the definition of the term "interest" in §6049.

In 1982, in response to the Service's concern regarding poor compliance with the reporting requirements pertaining to interest and dividends, the U.S. Congress enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Code §§3451-3456, which require a 10-percent withholding tax on all dividend and interest payments. These withholding provisions, however, provoked considerable opposition primarily by banks and other financial institutions. Consequently, the Interest and Dividend Compliance Act of 1983 (P.L. 98-67) repealed §§3451-3456 and enacted §3406, which imposes a back-up withholding requirement on two types of reportable payments: (i) reportable interest and dividend payments; and (ii) certain other reportable payments. Under §3406, if the payee fails to furnish his/her Taxpayer Identification Number (TIN) to the payor in the manner required, or where the Service informs the payor that the TIN furnished by a payee is incorrect, the payor of reportable interest (or other payments) is required to withhold and remit to the Treasury 20 percent of such payment.

TEFRA also enacted provisions requiring registration of certain obligations issued by corporations and governmental agencies or instrumentalities. Section 310 of TEFRA amended the Second Liberty Bond Act to provide that all long-term obligations (*i.e.*, obligations with a maturity of more than one year from the date of issue) of a type offered to the public issued by a corporation or a governmental unit must be in registered form. Obligations of natural persons and privately-placed corporate notes are not required to be in registered form. Also exempt from the registration requirement is an obligation (i) which is issued under arrangements reasonably designed to ensure that it will be sold (or resold in connection with original issue) only to persons who are not U.S. persons, (ii) the interest on such obligation is payable only outside the United States and its possessions, and (iii) there appears on the face of the obligation a statement that any United States person who holds such obligation will be subject to limitations under the U.S. income tax laws.

Any registration-required obligation that is not in registered form attracts certain penalties: (i) §4701 imposes an excise tax on the issuer of the obligation; (ii) the exemption under §103 is unavailable for interest on such an obligation; (iii) a loss deduction is denied under §165 for such an obligation; (iv) a deduction under §163 for interest paid on such obligation is denied; (v) an earnings and profits adjustment is denied for interest paid on such obligations; and (vi) the gain upon the disposition of such an obligation is ordinary income.

B. Background

The repeal of the 30-percent withholding tax on portfolio interest was spurred by a congressional desire to provide U.S. corporations with direct access to foreign capital markets on a tax-free basis without the necessity of having to set-up a complex structure involving an intermediary finance company in a tax treaty jurisdiction, such as, the Netherlands Antilles. The need to create an international finance subsidiary was dictated to U.S. corporations by the realities of the Eurobond market.

First, in all Eurobond issues, the issuer typically pays interest, premiums, and principal net of any tax which might be withheld at source. Since not all investors in these bonds could claim an exemption from the U.S. withholding tax on interest under an applicable treaty,[18] the U.S. issuer would be required to shoulder the burden of the U.S. withholding tax on any direct borrowing.

Comment: In all Eurobond issues floated by U.S. companies through international finance subsidiaries, the issuer reserved the right to call the bonds in the event that a withholding tax was imposed on interest or principal. This was a precautionary step against the eventuality that, through a change either in the law or an administrative interpretation of the law, the tax consequences of the transaction were different from those anticipated.

Second, the U.S. companies' competitors in the Eurobond market generally do not have a withholding tax concern. Borrowers from foreign countries avoid the withholding tax at source either through extraterritorial finance subsidiaries (*e.g.*, West German borrowers), through specific statutory exemptions (*e.g.*, the Netherlands and Sweden), or by reason of issuing bonds denominated in foreign currencies (*e.g.*, Japan). A U.S. company desiring to borrow directly in the Eurobond market, therefore, would be at

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a severe competitive disadvantage because of the U.S. withholding tax.

Finally, given the interest rate differential between the domestic market and the Eurobond market, the withholding tax cost made the total cost of borrowing in the Eurobond market commercially and economically unfeasible.

For U.S. companies seeking access to the cheaper Eurobond market, it was necessary, therefore, to find a solution to the U.S. withholding tax on interest. Such a solution was typically found in the shape of a finance subsidiary in the Netherlands Antilles.[19]

The Netherlands Antilles finance subsidiary arrangement worked as follows: The U.S. company would set up a wholly-owned subsidiary in the Netherlands Antilles by contributing generally one-third of the amount it intended to borrow in the Eurodollar market to the equity capital of such subsidiary. The Antilles subsidiary would then float a bond issue for the desired amount in the Eurobond market through an established network of underwriters and financial institutions. The underwriters and financial institutions then sold the bonds to individuals, banks, investment companies, insurance companies, and pension funds. Since the finance subsidiary had no established creditworthiness, the U.S. parent company usually guaranteed the subsidiary's obligations in order to make them saleable. The finance subsidiary then lent the proceeds of the bond issue (and sometimes also the equity capital) back to the parent at an interest rate which typically was one percentage point higher than the interest rate paid by the subsidiary on its obligations.

The tax consequences that the U.S. parent hoped to achieve by this arrangement were as follows:

(i) Under Article VIII of the U.S.-Netherlands Antilles treaty, an exemption was claimed from U.S. withholding tax on interest paid by the U.S. parent company to the Antilles finance subsidiary;

(ii) Under the internal laws of the Netherlands Antilles, interest paid by the Antilles finance subsidiary to the foreign lenders was free of any withholding tax;

(iii) The Netherlands Antilles finance subsidiary usually obtained a ruling from the Antilles revenue authorities that it was entitled to a deduction for the interest paid to foreign lenders, so that it paid the Antilles income tax at the normal rates (28% - 30%) only on the "spread" (*i.e.*, the difference between the interest charged to the U.S. parent and affiliates and interest paid to foreign lenders, which was usually one percentage point);

(iv) The "spread" was currently taxable to the U.S. parent as Subpart F income, but this income was more than offset by the sizeable interest deduction which the U.S. parent claimed for interest paid to the Antilles finance subsidiary. As a result, the Antilles income tax attributable to the Subpart F inclusion, which was claimed as a deemed paid foreign tax credit, absorbed the U.S. parent's excess foreign tax credits.[20]

(v) Since the Antilles finance subsidiary was not considered to be engaged in a U.S. trade or business, interest paid by it to foreign lenders was not subject to the second-tier U.S. withholding tax.[21]

(vi) The foreign lenders were also not subject to any U.S. or Antilles estate, gift, or inheritance tax with respect to the securities of the Antilles finance subsidiary.

C. *Reasons for Repeal*

The Senate Finance Committee Report summarizes the reasons for the repeal of the 30-percent withholding tax on U.S. source portfolio interest paid to nonresident alien individuals and foreign corporations as follows:[22]

"The committee believes it important that U.S. businesses have access to the Eurobond market as a source of capital. The Committee believes that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons may impair the ability of U.S. corporations to raise capital in the Eurobond market. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. By contrast, U.S. bond issues generally are not exempt from U.S. withholding tax, although as indicated above there is a patchwork of statutory exceptions to the withholding tax and the tax is frequently reduced or eliminated by treaty.

"As explained above, to avoid the withholding tax, U.S. corporations seeking access to the Eurobond market generally establish international finance subsidiaries that issue Eurobonds, almost all of which are incorporated in the Netherlands Antilles. Exemption from withholding tax is claimed under the U.S. income tax treaty with the Netherlands, as extended to the Netherland Antilles.

"The committee believes that if tax-free access to the Eurobond market is important, such access should be direct. In the committee's view, the current practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, is neither economical nor indicative of sound tax policy. The committee is informed that the current practice imposes additional cost burdens on the issuing corporations and, in many cases, provides incomplete access to the Eurobond market. The cost of Eurobond borrowing to U.S. corporations would probably be lower were Eurobonds issued directly from the United States, utilizing existing U.S. office resources and personnel.

"At the same time, the risk that U.S. withholding tax could be imposed on interest paid on Eurobonds issued by U.S. corporations sometimes makes it difficult to trade U.S. obligations in international bond markets since holders of international obligations desire assurance that there will be no withholding tax on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. corporate borrowers, as explained above, typically indemnify the foreign bondholders against all U.S. withholding tax should the IRS successfully attack the claimed exemption or the Netherlands Antilles tax treaty be changed to eliminate the basis for the claimed exemption. This also raises the

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cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

"For these reasons, the committee believes that the 30-percent withholding tax on interest paid to foreign corporations and non-resident alien individuals by a U.S. borrower on portfolio debt investments generally should be repealed. This will allow U.S. corporations direct access to the Eurobond market.

"The committee is concerned, however, that repeal of the withholding tax, without a transitional period, may have a substantial negative impact on the economy of the Netherlands Antilles. Because repeal of the withholding requirement will make it unnecessary for U.S. corporations to route borrowings through the Antilles, the use of the Antilles as a financial center is likely to be substantially reduced. The committee is informed that offshore financing activities currently generate a large portion of the Antilles budget. The committee believes that while tax treaties should not be used as a basis for establishing conduits whose existence results in a transfer of revenues from the U.S. Treasury, the Antilles should have some time to adjust to tax law changes that will affect its economy."

II. Overview

Section 127 of the Tax Reform Act of 1984 (P.L. 98-369) amends §§871, 881, 864(c)(2), 1441, 1442, and 2105. Under these amendments, portfolio interest received by nonresident aliens and foreign corporation from U.S. sources on obligations issued after July 18, 1984, is not subject to the 30-percent U.S. withholding tax. The term "portfolio interest" means interest (including original issue discount) paid on two types of obligations: (i) bearer obligations which are described in §163(f)(2)(B); and (ii) registered obligations with respect to which the United States person, who would otherwise be required to withhold tax (hereinafter referred to as the "withholding agent"), has received a statement that the beneficial owner of the obligation is not a United States person. Interest paid on obligations incurred before July 18, 1984, and assumed by a U.S. person is not exempt from the 30-percent U.S. withholding tax. Additionally, portfolio interest paid to nonresident aliens or foreign corporations is not exempt from the 30-percent withholding tax in the following cases:

(i) Portfolio interest received by a 10-percent shareholder in the payor corporation;

(ii) Portfolio interest received by a partner who owns 10-percent or more of the capital or profits interest in the payor partnership;

(iii) Portfolio interest (other than interest paid on an obligation of the United States) received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of business;

(iv) Portfolio interest received by a controlled foreign corporation from a person who is a "related person" within the meanings of §864(d)(4); and

(v) Portfolio interest which is effectively connected with the recipient's U.S. trade or business.

Finally, any obligation, the interest on which would be free from the 30-percent withholding tax if received by the decedent at the time of his death, is not property located within the United States within the meaning of §2105 and, thus, is free from U.S. estate tax liability.

III. Detailed Analysis

A. The General Rule

Portfolio interest (including original issue discount) from U.S. sources received by a foreign corporation [23] or a nonresident alien individual [24] after July 18, 1984, on obligations issued after July 18, 1984,[25] in taxable years ending after July 18, 1984, is free of any United States tax and, therefore, not subject to the 30-percent withholding tax.[26] Portfolio interest paid on obligations issued prior to July 18, 1984, however, is not exempt from U.S. tax. Consequently, if a U.S. person assumes the obligations issued by a foreign corporation prior to July 18, 1984, the interest paid on such obligations will be subject to U.S. withholding tax.

Comment: This provision was probably included as a concession to the Netherlands Antilles. If the U.S. companies had been allowed to assume the existing obligations of their finance subsidiaries, there would have been a mass exodus of the finance companies from the Antilles precipitating a financial crisis in that country.

B. "Portfolio Interest" Defined

The term "portfolio interest" means interest paid on the following two types of obligations: (i) bearer obligations which are described in §163(f)(2)(B), and (ii) registered obligations with respect to which the U.S. withholding agent has received a statement to the effect that the beneficial owner is not a United States person.[27]

1. Bearer Obligations

Interest paid on an obligation which is not in registered form qualifies as "portfolio interest" (and for exemption from the 30-percent U.S. withholding tax) only if the obligation is described in §163(f)(2)(B). A "registration-required" obligation is defined by §163(f)(2)(A) as an obligation other than an obligation which:

(i) Is issued by a natural person;

(ii) Is not of a type issued to the public;

(iii) Has a maturity (at issue) of not more than one year; or

(iv) Is described in §163(f)(2)(B).

A bearer obligation meets the requirements of §163(f)(2))B) if:

(i) There are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person;

(ii) Interest on the obligation is payable only outside the United States and its possessions; and

(iii) On the face of the obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

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Thus, interest paid on a foreign-targeted bearer obligation (as described above) qualifies as "portfolio interest" if the obligation is not issued by a natural person, is of the type offered to the public, and has a maturity of more than one year.[28]

Temp. Regs. §1.163-5(c) provides detailed guidance as to when an obligation is considered to be described in §163(f)(2)(B).

a. Obligations Described in §163(f)(2)(B)

The determination whether an obligation meets the requirements of §163(f)(2)(B) is required to be made on an obligation-by-obligation basis.[29] An obligation that is initially issued to a named payee but may later be converted into bearer form will not be considered to be issued pursuant to arrangements reasonably designed to ensure sale to non-U.S. persons.[30] Also, an obligation in bearer form issued directly by, or guaranteed by a U.S. Government-owned agency or a U.S. Government-sponsored agency (*e.g.*, Federal National Mortgage Association, Federal Home Loan Banks, the Federal Loan Mortgage Corporation, the Farm Credit Administration, and the Student Loan Marketing Association) is not considered to meet the requirements of §163(f)(2)(B).[31]

(1) Obligations Designed for Sale to Non-U.S. Persons

An obligation will be considered to have been issued under arrangements reasonably designed to ensure its sale to non-U.S. persons only if the conditions of one of the following paragraphs are met:

(i) In connection with the original issuance of the obligation, the obligation is offered for sale or resale only outside the United States and its possessions, is delivered only outside the United States and its possessions, and is not required to be registered under the Securities Act of 1933 because it is intended for distribution to persons who are not United States persons.[32] The issuer, however, prior to the issuance of the obligations, must have made a good faith determination backed by a written opinion of counsel that the obligations are not required to be registered under the Securities Act of 1933 because they are intended for distribution to non-U.S. persons.

(ii) The obligation is registered under the Securities Act of 1933, or the obligation is exempted from registration by reasons of section 3 or 4 of such Act, or the obligation does not qualify as a security under the Securities Act of 1933 and all of the following conditions are met:[33] (a) in connection with the original issuance, the obligation is offered for sale or resale only outside the United States and its possessions and is delivered outside the United States and its possessions;[34] (b) the issuer, each underwriter and each member of the selling group covenants that it will not, in connection with the original issuance of the obligation, offer to sell or resell the obligation in bearer form to a United States person other than certain financial institutions;[35] (c) in connection with its sale or resale during the original issuance of the obligations, each underwriter and each member of the selling group (or the issuer) sends a confirmation to the purchaser of the bearer obligation that the purchaser represents that it is not a United States person (other than certain financial institutions;)[36] (d) in connection with the original issuance of the obligation, the obligation is released in definitive form to the person entitled to physical delivery thereof only upon presentation of a certificate signed by such person stating that such obligation is not being acquired by or on behalf of, or for offer to resell or for resale to a United States person (other than certain financial institutions);[37] and (e) the issuer, underwriter, or member of the selling group does not have actual knowledge that the certificate referred to in (d) above is false.[38]

(iii) The obligation is issued only outside the United States and its possessions by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such obligation either directly or through its agent, an underwriter, or a member of the selling group.[39] Where the issuer is a U.S. person, it will meet this requirement only if: (a) it is engaged through a branch in active banking business abroad; (b) the obligation is issued outside the United States by the branch in connection with that trade or business; (c) the obligation that is so issued is sold directly to the public; and (d) the issuer maintains documentary evidence that demonstrates that the purchaser is not a U.S. person.[40]

(2) Interest Payable Outside the United States

Interest will be considered to be payable only outside the United States and its possessions if payment of such interest can be made only upon presentation of a coupon, or upon making demand for payment, outside of the United States and its possessions to the issuer or a paying agent.[41] The fact that the interest payment may be made by a draft drawn on a United States bank account or by wire or other electronic transfer from a United States bank account does not affect this result.[42]

Interest payments will not be considered to be made outside the United States if the interest is paid to a person (other than certain financial institutions) by a transfer of funds into an account maintained by the payee in the United States, or mailed to an address in the United States, provided the interest is paid on an obligation issued by a U.S. person, a controlled foreign corporation (as defined in §957(a)), or a foreign corporation 50 percent or more of whose worldwide gross income over a three-year base period is effectively connected with a U.S. trade or business.[43] Also, interest will be considered to be paid in the United States if a coupon is presented, or demand for payment is made, to the issuer or its paying agent in the United States or its possessions even if the funds are paid into an account, maintained by the payee outside the United States or its possessions.[44]

However, if interest becomes payable at the office of the issuer or its U.S. paying agent because the full amount of interest payment at the offices of the foreign paying agents becomes illegal or is effectively precluded due to the imposition of exchange controls, the interest will be considered to be payable outside the United States and its possessions, provided the issuer has appointed paying agents located outside the United States and its possessions with the reasonable expectation that such paying agents will be able to pay the interest in United States dollars.[45]

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(3) The Legend on the Face of the Obligation

A bearer obligation must have the following legend in English on the face of the obligation and on any interest coupons which may be detached therefrom: "Any United States persón who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in §165(j) and 1287(a) of the Internal Revenue Code.[46]

b. Secretary May Exclude An Obligation from Section 163(f)(2)(B)

Prior to 1984, §163(f)(2)(C) empowered the Secretary to require by regulations that an obligation be registered even if it met the requirements of §163(f)(2)(B) provided the obligation was of a type used frequently in avoiding federal taxes.

Section 127(f) of P.L. 98-369 amends §163(f)(2)(C) to provide the Secretary with even broader powers to require registration. Under amended §163(f)(2)(C)(i), the Secretary may specify, by regulations, the types of registration-required obligations meeting the requirements of §163(f)(2)(B) which must be issued in registered form regardless of whether or not such obligations are of a type frequently used in avoiding federal taxes.

The first hint of the use of this power by the Secretary came on September 7, 1984. On that date, consistent with the U.S. Treasury's earlier decision not to issue its securities in bearer form, Secretary Regan announced that bearer securities that are backed by U.S. government securities (including any obligations issued by a federal agency) will not be permitted. To implement this decision, the Treasury is expected to issue regulations under §163(f)(2)(C)(i) to provide that §163(f)(2)(B) will not apply to: (i) pass-through or participation certificates backed by U.S. government securities; (ii) interests in fixed investments or grantor trusts or custodial arrangements funded with U.S. government securities; (iii) debt obligations collateralized with U.S. government securities; (iv) securities backed by securities guaranteed as to interest or principal by the U.S. government; or (v) other similar instruments or interests. The types of securities referred to (i) through (v) above, therefore, will be required to be issued in registered form.

2. Registered Obligations

The term "portfolio interest" also includes interest paid on an obligation:

(i) which is in registered form, and

(ii) with respect to which the United States withholding agent has received a statement that the beneficial owner of the obligation is not a United States person.

a. The Term "Registered Form" Defined

The term "registered form" has the same meanings as given such term by §163(f).[47] An obligation is in registered form if:[48] (i) the obligation is registered as to both principal and any stated interest and any transfer of the obligation may be accomplished only through the surrender of the old instrument and the reissuance by the issuer of the old instrument to the new holder or the issuance of a new instrument to the new holder by the issuer; or (ii) the right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system.

An obligation is considered transferrable only through a book-entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.[49]

b. The Statement Requirement

As stated earlier, interest paid on a registered obligation qualifies as "portfolio interest" only if the U.S. withholding agent receives a statement that the beneficial owner is not a U.S. person. Such statement may be made either by the beneficial owner of the obligation or by a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business.[50]

If the initial purchaser of a registered obligation is a person other than an individual (*e.g.*, a financial institution), the statement requirement is satisfied if the withholding agent receives a statement made under penalties of perjury by the beneficial owner certifying that the owner is not a U.S. person.[51] If, however, the initial purchaser is an individual, the required statement must be signed by the beneficial owner under penalties of perjury, certify that the beneficial owner is neither a citizen nor resident of the United States, and provide the name and address of the beneficial owner.[52] The statement may be made, at the option of the withholding agent, on Form W-8 or on a substitute form that is substantially similar to Form W-8.[53] The statement must be received by the withholding agent in the calendar year in which the payment of interest is made or collected or in either of the two preceding calendar years. The withholding agent, however, may require the statement from the payee each time it makes a payment to, or collects an amount on behalf of, the payee. The withholding agent is required to retain the statement for at least four years following the end of the last calendar year during which the payment was made or an amount was collected.[54]

If the information provided on the statement changes, the beneficial owner must so inform the withholding agent within thirty days of such change.[55]

If the initial purchaser of a registered obligation is a custodian (*i.e.*, a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business), the statement must be signed under penalties of perjury by an authorized representative of the custodian institution and must state: (i) that the institution has received from the beneficial owner a Form W-8 or a substitute form stating that such owner is not a U.S. person; or (ii) that it has received from another financial institution a similar statement that it, or another financial institution acting on behalf of the beneficial owner, has received the Form W-8 or substitute form from the beneficial owner.[56]

In the case of multiple financial institutions between the beneficial owner and the withholding agent, the certificate must be given by each financial institution to the one above it in the chain. Although no particular form is

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required for the certificate, it must provide the name and address of the beneficial owner and a copy of the Form W-8 provided by the beneficial owner must be attached to it. If the information on the form W-8 changes, the beneficial owner is required to inform the financial institution within thirty days of the change and the financial institution must promptly so inform the withholding agent. The financial institution is also obligated to notify the withholding agent if it has actual knowledge that the information has changed but has not been notified of such change by the beneficial owner.[57]

The withholding agent receiving the certificate is required to make an information return on Form 1042S of the payment with respect to which the certificate is required for the calendar year. Also, the withholding agent is required to attach the certificate with Form 1042S.[58]

If the withholding agent does not receive the certificate described in the foregoing paragraphs, it is required to withhold tax under §§1441(a) and 1442(a) even if the interest otherwise qualifies as "portfolio interest."[59]

Certification requirements are slightly different for registered obligations targeted to foreign markets,[60] interest on which is paid to a registered owner at a foreign address provided the registered owner is a financial institution described in §871(h)(4)(B) (*i.e.*, a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business). In such a case, the U.S. withholding agent may treat the interest as "portfolio interest" (and thus not subject to withholding) if it does not have actual knowledge that the beneficial owner is a U.S. person and if it receives a statement: (i) identifying the obligation with respect to which the statement is given; (ii) stating that the beneficial owner is not a U.S. person; and (iii) identifying and providing the address of the person providing the statement.[61] The statement must be provided with respect to each interest payment within the period beginning 90 days prior to the interest payment.[62] If the statement is provided by a clearing organization, it must be based on a written statement from the member organization to which the interest is paid that the beneficial owner is not a U.S. person. If the information provided in the statement changes, the person providing the statement must so inform the U.S. withholding agent (or the clearing organization) within thirty days of the change. The statement must be retained in the records of the U.S. withholding agent (or the clearing organization) for at least four years from the end of the calendar year in which it was received.[63]

Finally, the Secretary is authorized by statute to declare by written determination published at least one month prior to payment of interest on any obligation that a statement made with respect to such payment of interest by any clearing organization, bank, or financial institution (described in §871(h)(4)(B)) is unacceptable.[64]

3. Exceptions

Interest that is effectively connected with the recipient's U.S. trade or business does not qualify as "portfolio interest." In addition, certain interest, which otherwise qualifies as "portfolio interest," does not qualify as such when received by certain persons. These exceptions to the definition of "portfolio interest" are discussed below.

a. Interest Received by a Ten Percent Shareholder

The term "portfolio interest" does not include interest received by a ten-percent shareholder.[65] In the case of an obligation issued by a corporation, the term ten-percent shareholder means any person who owns ten percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote.[66] In determining whether a recipient owns the requisite ten percent stock, the attribution rules of §318(a) apply with the following two modifications:[67] (i) §318(a)(2)(C) shall be applied without regard to the 50-percent limitation, and (ii) any stock which a person is treated as owning after application of §318(a)(4) shall not, for purposes of applying paragraphs (2) and (3) of §318(a), be treated as actually owned by such person.

In the case of an obligation issued by a partnership, the term ten-percent shareholder means any person who owns ten percent or more of the capital or profits interest in such partnership.[68] For purposes of determining whether a recipient owns the requisite ten percent capital or profits interest in the partnership, the statute directs the Secretary to prescribe attribution rules similar to those that apply in determining ten percent ownership in a corporation.[69]

The Conference Committee Report notes that some taxpayers may attempt to circumvent the ten-percent shareholder exception by entering into a back-to-back loan arrangement. For example, the foreign shareholder may lend money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. In such cases, the Conference Committee directs the IRS to use means at its disposal to determine whether back-to-back loans exist.[70]

b. Interest Received by Foreign Banks

"Portfolio interest" does not include the interest received by foreign banks on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business.[71] This exception, however, does not apply to interest paid on obligations of the United States government. Thus, interest received by foreign banks on U.S. obligations will qualify as "portfolio interest."

The observation made in the previous paragraph dealing with ten-percent shareholders with respect to back-to-back loans also applies to foreign banks.[72] Consequently, a foreign bank will not be able to avoid this exception by entering into a back-to-back loan arrangement.

c. Interest Received by a CFC From a Related Person

"Portfolio interest" does not include interest received by a controlled foreign corporation from a related person as defined in §864(d)(4).[73]

Section 864(d)(4) defines the term "related person" to include: (i) any person who is a related person within the meaning of §267(b); (ii) any United States shareholder within the meanings of §951(b); and (iii) any person who is related to a U.S. shareholder within the meanings of §267(b).

d. Inadequate Exchange of Information Exception

If the Secretary determines that the exchange of information is inadequate between the United States and a

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foreign country to prevent the evasion of United States income tax by U.S. persons, the Secretary may publish a statement in writing providing that, beginning on a specified date, the payments of interest to any person within such foreign country (or payments addressed to, or for the account of, persons within such foreign country) shall not qualify as "portfolio interest." [74] Interest paid before the statement's publication date, however, will qualify as "portfolio interest." [75]

C. *Special Rules for Controlled Foreign Corporations*

A foreign corporation, which is a controlled foreign corporation within the meanings of §957(a), may earn U.S. source interest that qualifies as "portfolio interest" and for exemption from the thirty-percent U.S. withholding tax.

Comment: Note, however, that interest received by a CFC from a related person does not qualify as "portfolio interest" (see the discussion under III, B, 3, c, *supra*).

Section 881(c)(4), however, provides rules which effectively ensure that such interest will be taxed currently in the hands of the CFC's U.S. shareholders. Section 881(c)(4) provides that in the case of "portfolio interest" received by a CFC, the following exceptions to foreign base company income will not apply:

(i) The exception contained in §954(b)(3) (which provides that if the foreign base company income of a CFC is less than ten percent of gross income, no part of the CFC's gross income is treated as foreign base company income);

(ii) The exception contained in §954(b)(4) (which provides that foreign base company income does not include any item of income derived by a CFC which is not formed or availed of for tax avoidance purposes); and

(iii) A number of exceptions to the Subpart F foreign personal holding company income rules provided in §954(c) are also rendered inapplicable. These exceptions include: (a) §954(c)(3)(B) relating to certain income derived in the active conduct of a trade or business; (b) §954(c)(3)(C) relating to certain income derived by an insurance company; and (c) §§954(c)(4)(A) and (B) relating to certain income received from related persons.

The Conference Committee Report makes it clear that the "portfolio interest" received by a CFC from U.S. sources will, upon inclusion in the U.S. shareholders' gross income, retain its U.S. source character under §904(g) without regard to any exception from 904(g) available for other income.[76] Thus, U.S. source "portfolio interest" income of a CFC will not enable its U.S. shareholders to utilize their excess foreign tax credits.

D. *Resolution of the Audit Issue*

The international finance company arrangements of U.S. companies are susceptible to attack on a number of grounds. For example, some have argued that since the foreign lenders look ultimately to the U.S. parent company for payment of the principal and interest, the debt obligations of the finance company are in fact the obligations of the U.S. parent. Thus, interest paid on such obligations is subject to U.S. withholding tax. Alternatively, the creation of a finance company may be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent and, hence, the exemption from withholding does not apply in accordance with §269. In recent years the Service, in fact, has challenged a number of arrangements involving international finance companies organized by U.S. companies in the Netherlands Antilles.[77]

In conjunction with the repeal of the thirty-percent withholding tax on portfolio interest, the U.S. Congress also resolved this audit issue. The rules in §127(g)(3) of the Tax Reform Act of 1984 provide in substance that the obligations of the finance companies will be treated the obligations of such companies. This virtually ensures that the tax results anticipated by U.S. companies when they organized the finance subsidiaries will in fact prevail.

Specifically, §127(g)(3) provides that interest paid by the U.S. parent or other U.S. affiliate to a controlled foreign corporation shall be treated as payment of interest to a resident of the country in which the CFC is organized, provided the following conditions are met:

(i) The CFC was in existence on or before June 22, 1984;[78]

(ii) The principal purpose of the CFC on the date of interest payment was issuing its obligations, holding short-term obligations and lending proceeds of such obligations to affiliates (*i.e.*, persons related to it within the meaning of §482);[79]

(iii) The interest payments must be made on an obligation of a person which is related to the CFC within the meanings of 482;[80]

(iv) The interest must be paid on an obligation of related U.S. person issued before June 22, 1984;[81] and

(v) The CFC meets the conditions of Rev. Ruls. 69-377, 69-501, 70-645, and 73-110 on the date of interest payment.[82] These four rulings were issued during the period when the Interest Equalization Tax (IET) was in effect, and the rulings were repealed by Rev. Rul. 74-464 when the IET expired. Basically, the Service sanctioned the existence of international finance companies in these four rulings based on the fulfillment of certain conditions.

Revenue Ruling 69-377 held that the interest paid on debt obligations of a domestic subsidiary with a 5:1 debt-equity ratio, convertible into stock of its U.S. parent and guaranteed by such parent, was deductible under §163 as long as the obligations were held by a person other than the parent or its affiliates.

Revenue Ruling 69-501 involved facts identical to Rev. Rul 69-377, except that the finance subsidiary was a foreign company. The Service accepted the 5:1 debt-equity ratio.

Revenue Ruling 70-645 cited Rev. Rul. 69-377 as authority for the proposition that solely for purposes of the IET and certain income tax purposes, debt obligations issued by wholly-owned financing subsidiaries of domestic parent corporations will be deemed to be indebtedness of such subsidiaries if the amount borrowed by the financing subsidiary does not exceed five times its equity capital.

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In Rev. Rul. 73-110, the Service held that, for IET exclusion purposes, a domestic parent corporation must recompute the debt-equity ratio of its wholly-owned foreign financing subsidiary at the current exchange rate whenever it withdraws equity capital or the subsidiary issues foreign debt obligations.

E. Information Reporting and Backup Withholding

In T.D. 7967 (49 Fed. Reg. 33239) and T.D. 7972 (49 Fed. Reg. 34340), the Service issued temporary regulations in questions and answers form relating to the repeal of 30 percent withholding tax and to the application of information reporting and backup withholding to certain obligations held by foreign persons in light of the repeal. The following discussion summarizes the information reporting and backup withholding requirements as they pertain to bearer obligations, foreign targeted registered obligations, and foreign-non-targeted registered obligations.

1. Information Reporting and Backup Withholding on Bearer Obligations

a. Portfolio Interest Paid by an Issuer or its Agent

Unless the issuer or its agent has actual knowledge that the recipient of portfolio interest ("payee") is a United States person, there are no reporting or backup withholding requirements with respect to payments of U.S. source portfolio interest made outside the United States.[83] Whether a payment of interest is made outside the United States shall be determined in accordance with Q & A 37 of Temp. Regs. §35a.9999-3.[84] Notwithstanding the provisions of Q & A 37, however, payment shall not be considered to be made outside the United States if the interest is paid to a United States address whether by mail or electronic transfer.[85]

b. Foreign Source Interest Paid by a U.S. Person or a CFC

Interest paid by a foreign finance subsidiary or (*i.e.*, a CFC) or a U.S. person who derives 20 percent or less of its gross income over a three-year base period from U.S. sources (*e.g.*, a Netherlands Antilles finance company) is considered foreign source interest.

Unless the issuer or its agent has actual knowledge that the recipient is a United States person, there are no reporting or backup withholding requirements with respect to payments of foreign source interest by a CFC or a U.S. person made outside the United States.[86] In determining whether interest payment is made outside the United States, the provisions of Q & A 37 of Temp. Regs. §35a.9999-3 apply. However, for interest paid after November 20, 1984, on obligations issued after September 21, 1984, payment shall not be considered made outside the United States if interest is paid to a United States address, Q & A 37 notwithstanding.[87]

c. Foreign or U.S. Source Interest Paid by Custodians, Nominees, or Agents

Payment or collection of interest described in (a) and (b) above, outside the United States by a person acting in its capacity as a custodian, nominee, or other agent of the payee with respect to such payment or collection is generally not subject to the reporting and back-up withholding requirements.[88] However, the payment or collection of interest outside the United States by a custodian, nominee, or other agent of the payee may be subject to the information reporting requirements under §6049 if the agent falls in one of the following three categories:[89] (i) a United States person (*e.g.*, a foreign branch of a U.S. bank); (ii) a controlled foreign corporation as defined in §957(a); or (iii) a foreign corporation 50 percent or more of whose worldwide gross income over a three-year base period is effectively connected with a U.S. trade or business.

A U.S. person, a CFC, or a foreign corporation acting as an agent of the payee is nonetheless exempt from information reporting requirements if the payee is an exempt recipient (within the meanings of Regs. §1.6049-4(c)(1)(ii)) or it has documentary evidence that the payee is not a citizen or resident of the United States.[90] Such evidence may include a written indication from the payee (*e.g.*, appearing on an account application form) that the payee is neither a citizen nor a resident of the United States. The mere fact, however, that the payee has provided an address outside the United States is insufficient evidence to establish for this purpose that the payee is neither a citizen nor a resident of the United States. For payments made before November 20, 1984, on accounts opened on or before August 22, 1984, an affidavit by an employee of the agent stating that the employee knows, or the payee has represented orally, that the payee is not a U.S. person will be sufficient evidence of such foreign status. For all other payments, an affidavit of an employee will be sufficient to establish the foreign status of the payee only if the affidavit states that the employee has a reasonable basis founded on documentary evidence for believing that the payee is neither a citizen nor a resident of the United States.[91]

If the payment or collection of interest by an agent is not subject to information reporting under §6049 as described above, it is also exempt from reporting requirements under 6041.[92]

Finally, even if the payment or collection of interest outside the United States by an agent of the payee is subject to information reporting under §6049 (*e.g.*, where the payee is a U.S. person), the agent is not subject to the backup withholding requirements.[93] The backup withholding issue, however, is under study and the Service may at some future time subject the agent of the payee to backup withholding requirements in the case described above.

2. Information Reporting and Backup Withholding on Registered Obligations

a. Non-Targeted Registered Obligations

As discussed under III, B, 2, b, *supra*, payments on registered obligations that have not been targeted to foreign markets are exempt from the 30-percent withholding tax only if the beneficial owner is identified by either a Form W-8 or by a certificate from a financial institution to the effect that it has received a Form W-8.[94] The 30-percent withholding under §§1441 and 1442, however, does not apply (regardless of whether Form W-8 is received) if the interest is paid, or collected on behalf of, an exempt recipient at an address within the United States, or if the interest is paid to a non-exempt recipient at an address within the United States and backup withholding under §3406 applies.[95]

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In the case of "portfolio interest" paid on a non-targeted registered obligation, the information reporting under §§6041 and 6049 and backup withholding under §3406 does not apply if the payee has furnished Form W-8 (or substitute form), and if the payor does not have actual knowledge that the payee is a United States person.[96]

b. Foreign-Targeted Registered Obligations

As discussed under III, B, 2, b, *supra*, Form W-8 is not required to avoid thirty-percent withholding tax with respect to interest paid on certain registered obligations that have been targeted to foreign markets. However, a substitute certificate that merely states that the beneficial owner is not a United States person is required with respect to interest paid by a U.S. person on those obligations to a registered owner outside the United States, provided the registered owner is a financial institution that holds customers' securities in the ordinary course of trade or business.[97] The substitute certificate must: (i) identify the obligation with respect to which it is given; (ii) state that the beneficial owner is not a United States person; and (iii) identify and provide the address of the person providing the certificate.[98]

In the case of "portfolio interest" paid on a foreign-targeted registered obligation, neither the reporting requirements of §§6041 and 6049 nor the backup withholding requirements of §3406 apply if the certificate referred to above is provided to the payor, and if the payor does not have actual knowledge that the beneficial owner is a United States person.[99] However, collection outside the United States of portfolio interest on a registered obligation by a person acting as a custodian, nominee, or other agent is subject to information reporting under §6049 if the custodian, nominee, or other agent falls in one of the following three categories: (i) a U.S. person (*e.g.*, a foreign branch of a U.S. bank); (ii) a controlled foreign corporation as defined in §957(a); or (iii) a foreign corporation 50 percent or more of whose worldwide gross income over a three-year base period was effectively connected with a U.S. trade or business.[100]

The U.S. person, the CFC, or the foreign corporation that collects interest on a registered obligation outside the United States in its capacity as a custodian, nominee, or other agent may nevertheless avoid the reporting requirements of §6049 if: (i) the payee is an exempt recipient under Regs. §1.60459-4(c)(1)(ii); or (ii) the agent has documentary evidence in its files that the payee is not a citizen or resident of the United States.[101] In this regard, the same evidentiary standards that apply to bearer obligations in similar situations are applicable here.[102]

F. Exemption from Estate Tax

In conjunction with the repeal of the 30-percent withholding tax on portfolio interest, §127 of the Tax Reform Act of 1984 also eliminates any potential U.S. estate tax liability of nonresident alien individuals for obligations the income from which, if received by the decedent at the time of his death, would be exempt from the withholding tax. Since U.S. estate tax liability applies only to that portion of a nonresident alien's estate which is located in the United States, §127 of the Act achieves this result by providing that the obligations, the interest on which is exempt from the thirty percent withholding tax, are considered property located outside the United States.

Specifically, §127(d) of the Act amends Code §2105(b) to provide that the following assets shall not be deemed property within the United States:

> (i) Amounts described in §861(c), if any interest thereon would be treated under §861(a)(1)(A) as foreign source income were such interest received by the decedent at the time of his/her death;[103]
>
> (ii) Deposits with a foreign branch of a domestic corporation or domestic partnership if such branch is engaged in commercial banking business;[104] and
>
> (iii) Debt obligations, if, without regard to whether a statement meeting the requirements of §871(h)(4) has been received, any interest thereon would be eligible for exemption from tax under §871(h)(1) were such interest received by the decedent at the time of his/her death.

The amendments to §2105(b) are effective for obligations issued after July 18, 1984, with respect to the estates of decedents dying after July 18, 1984.[105]

G. Effective Date

The exemption from the thirty-percent withholding tax on U.S. source "portfolio interest" received by nonresident aliens and foreign corporations applies only to interest received after July 18, 1984, on obligations issued after July 18, 1984, in taxable years ending after such date.[106]

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[1] The discussion under this subsection does not take into account the changes made by the Tax Reform Act of 1984 (P.L. 98-369).
[2] §§871(a) and 881(a). Unless otherwise indicated, all references herein are to the Internal Revenue Code of 1954, as amended.
[3] §§1441 and 1442.
[4] §§871(b) and 882(a).
[5] Under the general rule of §861(a)(1), interest paid by an obligor who is a resident of the United States is U.S. source income.
[6] §§861(a)(1)(A) and 861(c).
[7] §§871(a)(1)(C) and 881(a)(3).
[8] §861(a)(1)(B).
[9] §§861(a)(1)(G) and 4912(c).
[10] §892.
[11] §6049(a)(1).
[12] §6049(a)(2).
[13] §6049(b)(1).
[14] *Id.*
[15] §6049(b)(2)(A) and (B).
[16] §§6049(b)(2)(C) and 6049(b)(5).
[17] §6049(b)(2)(D).
[18] A statutory withholding tax exemption is also not available generally to a foreign investor in long-term U.S. corporate obligations.
[19] It should be pointed out that a Netherlands Antilles subsidiary was utilized only in those cases where the loan proceeds were intended for utilizaton by the U.S. parent itself or its U.S. affiliates. Where the loan proceeds were intended for use solely by the foreign affiliates, the U.S. parent would simply set up a finance subsidiary in the United States. Since such a company qualified as an 80-20 company, interest paid by it to foreign lenders was free of U.S. tax as foreign source income.
[20] A companion provision in the Tax Reform Act of 1984 (*i.e.*, section 121 of P.L. 98-369, which adds a subsection (g) to §904 of the Code) would preserve the U.S. source attribute of the Antilles finance subsid-

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iary's income when such income is taxed to the U.S. parent as Subpart F income. Consequently, no foreign tax credit will be available to the U.S. parent for Antilles income tax paid with respect to such income.

[21] *See* §861(a)(1)(C) which provides that interest paid by a foreign corporation, less than 50 percent of whose worldwide gross income over a three-year base period is effectively connected with a U.S. trade or business, is foreign source income.

[22] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess., pp. 419-421 (1984).

[23] §881(c) added by §127(b) of P.L. 98-369.

[24] §871(h) added by section 127(a) of P.L. 98-369.

[25] §127(g)(1) of P.L. 98-369.

[26] §1441(a)(9) as added by section 127(e)(1) of P.L. 98-369; and §1442(a) as amended by section 127(e)(2) of P.L. 98-369.

[27] §§871(h)(2) and 881(c)(2).

[28] Temp. Regs. §35a.999-5(a), Q & A 1.

[29] Temp. Regs. §1.163-5(c)T(1).

[30] *Id.*

[31] *Id.*

[32] Temp. Regs. §1.163-5(c)T(2)(i)(A).

[33] Temp. Regs. §1.163-5(c)T(2)(i)(B).

[34] Temp. Regs. §1.163-5(c)T(2)(i)(B)(1).

[35] Temp. Regs. §1.163-5(c)T(2)(i)(B)(2).

[36] Temp. Regs. §1.163-5(c)T(2)(i)(B)(3).

[37] Temp. Regs. §1.163-5(c)T(2)(i)(B)(4).

[38] Temp. Regs. §1.163-5(c)T(2)(i)(B)(5).

[39] Temp. Regs. §1.163-5(c)T(2)(i)(C)

[40] *Id.*

[41] Temp. Regs. §1.163-5(c)T(2)(v).

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] Temp. Regs. §1.163-5(c)T(1)(ii)(B).

[47] §§871(h)(6) and 881(c)(6).

[48] Regs. §5f.163-1(a); Regs. §5f. 103-1(c).

[49] Regs. §5f.103-1(c)(2).

[50] §871(i)(4).

[51] Temp. Regs. §35a.9999-5(b), Q & A 9.

[52] *Id.*

[53] Temp. Regs. §35a.9999-5(b), Q & A 9; Regs. §1.6049-5(b)(2)(iv).

[54] *Id.*

[55] Temp. Regs. §35a.9999-5(b), Q & A 9.

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] Temp. Regs. §35a.9999-5(b), Q & A 10. The withholding agent, however, is not required to withhold if: (i) the interest is paid to, or collected on behalf of, an exempt recipient at an address within the United States, or (ii) the interest is paid to a person at an address within the United States and backup withholding is required with respect to that interest under §3406.

[60] An obligation is targeted at foreign markets if it is sold (or resold in connection with its original issuance) only to foreign persons (or to foreign branches of U.S. financial insitutions described in §871(h)(4)(B)) in accordance with procedures similar to those described in Regs. §1.163-5(c)(2)(i)(A) or (B) with certain modifications (*see* Temp. Regs. §35a.9999-5(b), Q & A 13).

[61] Temp. Regs. §35a.9999-5(b), Q & A 12 and 14.

[62] Temp. Regs. §35a.9999-5(b), Q & A 15.

[63] *Id.*

[64] §871(h)(4).

[65] §§871(h)(3)(A) and 881(C)(3)(B).

[66] §871(h)(3)(B)(i).

[67] §871(h)(3)(C).

[68] §871(h)(3)(B)(ii).

[69] §871(h)(3)(C).

[70] H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 937, 938 (1984).

[71] §881(c)(3)(A).

[72] H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 937, 938 (1984).

[73] §881(c)(3)(C).

[74] §§871(h)(5) and 881(c)(5).

[75] §871(h)(5)(B).

[76] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 937 (1984).

[77] According to one source, there have been challenges to at least 25 of these arrangements. *See* 46 Taxes Int'l. 13 (August 1983). Also, Texas International Airlines has disclosed such an audit in a proxy statement.

[78] Section 127(g)(3)(A) of P.L. 98-369.

[79] Section 127(g)(3)(C) of P.L. 98-369.

[80] Sections 127(g)(3)(A) and 127(g)(3)(C)(ii) of P.L. 98-369.

[81] *Id.*

[82] Section 127(g)(3)(B) of P.L. 98-369.

[83] Temp. Regs. §35a.9999-5T(a), Q & A 2.

[84] *See* the discussion under III, B, 1, a, (2), *supra.*

[85] Temp. Regs. §35a.9999-5(a), Q & A 2.

[86] Temp. Regs. §35a.9999-5(a), Q & A 3.

[87] *Id.*

[88] Temp. Regs. §35a.9999-5(a), Q & A's 1 and 2; Temp. Regs. §35a.9999-4T, Q & A 5.

[89] Temp. Regs. §35a.9999-4T, Q & A 5.

[90] Temp. Regs. §35a.9999-5(a), Q & A's 1 and 2.

[91] Temp. Regs. §35a.9999-4T, Q & A 5.

[92] *Id.*

[93] *Id.*

[94] Temp. Regs. §35a.9999-5(b), Q & A 9.

[95] Temp. Regs. §35a.9999-5(b), Q & A 10.

[96] Temp. Regs. §35a.9999-5(b), Q & A 11.

[97] Temp. Regs. §35a.9999-5(b), Q & A 12.

[98] Temp. Regs. §35a.9999-5(b), Q & A 14.

[99] Temp. Regs. §35a.9999-5(b), Q & A 16.

[100] Temp. Regs. §35a.9999-4T(b), Q & A 5; Temp. Regs. §35a.9999-5(b), Q & A 16.

[101] *Id.*

[102] *See* the text at footnote 91, *supra.*

[103] Note that interest on such amounts is exempt from the thirty-percent withholding tax under §861(a)(1)(A) and not under §871(h)(1).

[104] Note that interest on such deposits is exempt from thirty percent withholding tax under §861(a)(1)(F)(i) and not under §871(h)(1).

[105] Section 127(g)(2) of P.L. 98-369.

[106] Section 127(g)(1) of P.L. 98-369.

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Chapter 63

FIRPTA WITHHOLDING PROVISIONS

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I. Introduction

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") generally taxes the gains realized by nonresident aliens and foreign corporations upon the disposition of United States real property interests. Prior to the enactment of FIRPTA, tax on the disposition of a United States real property interest would have been imposed only if the gain were effectively connected with a United States trade or business or, in the case of nonresident alien individuals, the seller were present in the United States for 183 days or more during a taxable year. As enacted, FIRPTA envisioned relying on information reporting requirements to enforce its provisions.

Gains and losses of foreign investors on the disposition of United States real property interests generally are treated as if they were effectively connected with a United States trade or business of the foreign investor.[1] Thus, under FIRPTA, net gains are generally taxable to foreign investors at the same graduated capital gains rates that apply to United States taxpayers.[2] In the case of individual investors, tax is imposed at a minimum rate of 20 percent of net gains or 20 percent of alternative minimum taxable income, whichever is less.[3]

FIRPTA taxes gains on the disposition of interests in real property (including interests in mines, wells, or other natural deposits) located in the United States or the Virgin Islands.[4] The term "interest in real property" includes fee ownership and co-ownership of land or improvements, easements, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.[5] Moreover, the term includes such interests as life estates, remainders, and reversions.[6] Proposed Treasury Regulations provide that the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, United States real property.[7] Moveable walls, furnishings, and other personal property associated with the use of real property are considered real property for purposes of FIRPTA.[8]

United States real property interests also include certain holdings in United States real property holding corporations, as defined in §897(c)(2).[9] A United States real property holding corporation is any corporation (whether foreign or domestic) the fair market value of whose United States real property interests is at least 50 percent of the sum of the fair market value of its United States real property interests, its interests in foreign real property, and any other assets used in a trade or business during the taxable year.[10] Any interest in a domestic corporation, other than an interest solely as a creditor, is treated as a United States real property interest unless the taxpayer establishes that the corporation was at no time a United States real property holding corporation during the period after June 18, 1980, during which the taxpayer held the interest, or the five-year period preceding the disposition of the interest, whichever is shorter.[11]

In determining whether a corporation is a United States real property holding corporation, a corporation that is a partner in a partnership takes into account its proportionate share of all assets of the partnership. The same rules apply to trusts and estates in which a corporation has an interest and to a chain of partnerships, trusts, or estates in which a corporation has an interest.[12] Constructive ownership rules also apply to a controlling interest held by a corporation in another corporation with respect to assets held by the controlled corporation.[13] A "controlling interest" is defined as 50 percent or more of the fair market value of all classes of stock of a corporation.[14]

In general, gains from the disposition of an interest in a United States real property holding corporation are subject to tax. However, no tax is imposed on the sale of publicly traded corporate stock by an investor who, throughout the test period defined in §897(c)(1)(A)(ii), owned five percent or less of the class of stock sold.[15]

FIRPTA does not tax gains on the disposition of stock in a foreign corporation. Instead, §897(d) taxes foreign corporations on distributions to prior shareholders (whether or not in liquidation) of appreciated United States real property interests, or on the sale of appreciated United States real property interests in connection with liquidation of the corporation. Tax is imposed notwithstanding any nonrecognition provisions of the Code unless the distributee who receives appreciated property from a foreign corporation takes a carryover basis in the property and, viewed at the time of receipt of the property, would be subject to tax on a subsequent distribution of the property. FIRPTA also authorizes the issuance of regulations providing to what extent the nonrecognition provisions of the Code will apply.[16] Such regulations have not yet been issued.

Except to the extent otherwise provided in regulations, gain is recognized by a foreign investor under FIRPTA on the transfer of a United States real property interest to a foreign corporation if the transfer is made as paid in surplus or as a contribution to capital. The gain equals the fair market value of the property transferred over the

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adjusted basis of the property and any other gain recognized by the transferor.[17]

If a foreign corporation holds a United States real property interest, and under any treaty obligation of the United States is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect to be treated as a United States corporation for purposes of FIRPTA.[18] All of the shareholders must consent to the election and consent to taxation on any gain from the disposition of the interest under FIRPTA even if a treaty to which the United States is a party would not permit such taxation.[19] If a class of stock in a foreign corporation is traded on an established securities market, then only a person who holds more than five percent of that class of stock need affirmatively consent to the election.[20] The election may not be revoked without the consent of the IRS.[21]

FIRPTA provides United States shareholders of a foreign corporation holding United States real property interests that adopts a plan of liquidation with a credit against any tax imposed on the surrender of their stock.[22] The credit is available to United States shareholders who acquired their stock before June 18, 1980 (the effective date of FIRPTA) and have held it continuously since then. The United States shareholder is deemed to realize income equal to, and to receive a credit against tax equal to, his proportionate share of the tax imposed on the liquidating foreign corporation on the distribution or liquidating sale of its United States real property interests.[23]

Gain of a foreign investor on the disposition of an interest in a partnership, trust, or estate is subject to tax under FIRPTA to the extent that the gain represents the investor's pro rata share of appreciation in the value of United States real property interests of the entity. This provision contemplates implementation by regulations, but these have not yet been issued.[24]

Distributions to foreign shareholders by a real estate investment trust (REIT) are treated as gains on the sale of a United States real property interest to the extent of the shareholder's pro rata share of the net capital gain of the REIT on the disposition of United States real property interests.[25] In the case of REITs controlled by United States persons, sales of REIT shares by foreign shareholders are not subject to tax.[26]

Since enactment, FIRPTA has provided for enforcement of the tax on foreign investors through a system of information reporting designed to identify foreign owners of United States real property interests. Prior to amendment by the 1984 Act, §6039C required reporting by United States real property holding corporations, foreign or domestic partnerships, foreign or domestic trusts, and foreign or domestic estates in which a foreign investor held an interest. In addition, a foreign investor who directly owned United States real property interests worth $50,000 or more was required to file an information return.

The Internal Revenue Service has had difficulty developing regulations interpreting the information reporting requirements. The information reporting requirements of FIRPTA have been postponed by the Internal Revenue Service for years 1980 through 1983 pending the issuance of final regulations. Since final regulations have not been issued, no information reporting is presently required.[27]

In order to simplify the administration of FIRPTA and to ensure collection of the tax, the Senate version of the 1984 Act required withholding of tax on dispositions of United States real property interests. To the extent that withholding was required on a transaction, the reporting requirements of FIRPTA would be superseded. The withholding obligation would fall on any transferee, transferee's agent, or settlement officer with respect to an acquisition of a United States real property interest from a foreign person. The withholding tax would be equal to the smallest of: (i) 28 percent of the amount realized (sales price) in the case of a corporate transferor, or 20 percent of the amount realized in the case of an individual transferor; (ii) the fair market value of the portion of the transferee's consideration that was within the withholding agent's control at any time; or (iii) the transferor's maximum tax liability, defined to include tax under §871(b)(1) or §882(a)(1) by reason of the disposition, plus any unsatisfied withholding liability caused by prior foreign ownership of such interest.[28]

As to any given payment, the Senate bill did not require withholding unless the transferee, transferee's agent, or the settlement officer received notice or knew that the transferor was a foreign person. The transferor's agent was required to furnish such notice and was obligated to make reasonable inquiry into whether the transferor was a foreign person. A transferor's agent would have been entitled to rely in good faith on a written statement of the transferor that the transferor was not a foreign person. In the event that the transferor's agent failed to notify the transferee, liability for withholding fell upon the transferor's agent instead of the transferee.

The Senate bill would not require withholding where the transferor furnished to the transferee a "qualifying statement" from the IRS that the transferor was exempt from tax or provided adequate security for the transferor's tax liability. The Senate bill also contained exceptions from withholding in the case of any acquisition of real property for $200,000 or less to use as the principal residence of the transferee, or for any transfer of stock of a corporation on an established securities market.

In order to implement the provision that withholding should not exceed the maximum tax liability of the transferor, the Senate bill contained a procedure for establishing the maximum tax liability. Upon request, the Internal Revenue Service would have been required to furnish a computation of the maximum tax liability of the transferor within 30 days.

The Senate bill provided that the fair market value of property as well as cash was subject to withholding. The withholding obligation also applied to the amount of any indebtedness assumed by the transferee, or subject to which the transferee took the property, but only if such indebtedness was incurred within two years of the transaction.

The Senate bill provided that, pursuant to regulations, a domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate was required to withhold tax from amounts in its custody which were attributable to the disposition of a United States real property interest, and were either: (i) includable in the distributive share of a

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partner of the partnership who was a nonresident alien individual or a foreign corporation, partnership, trust, or estate; or (ii) includable in the income of a beneficiary of the trust or estate who was a nonresident alien individual or a foreign corporation, partnership, trust, or estate; or (iii) includable in the income of a nonresident alien individual or a foreign corporation, partnership, trust, or estate under the grantor trust rules of §671.

The Senate bill provided for withholding in the case of any transaction involving a United States real property interest on which gain was recognized under §897(d) or §897(e), relating to distributions (including liquidating distributions) by foreign corporations. The bill required the foreign corporation to withhold 28 percent of the net gain deemed realized on the transaction.

The Senate bill would have applied to the disposition of any United States real property interests acquired more than 30 days after the date of enactment.

The Conference Committee substantially modified the Senate bill. The modifications made by the Conference Committee will be discussed in the explanation of the 1984 Act below.

II. Overview

A. FIRPTA Withholding Requirements

Except as otherwise provided, new §1445 of the Code requires any transferee to withhold tax on the disposition of a United States real property interest (as defined in §897(c)) by a foreign person. The normal withholding rate will be ten percent of the amount realized on the disposition.

No withholding is required if one of five exemptions applies to a transaction under §1445(b). First, a transferee will be relieved of any withholding obligation if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, that the transferor is not a foreign person and the transferor's United States taxpayer identification number ("non-foreign affidavit"). The Internal Revenue Service is authorized to prescribe regulations requiring a transferee to furnish to the Service a copy of any nonforeign affidavit upon which the transferee intends to rely. Second, no withholding will be required upon the disposition of an interest in a domestic corporation if the domestic corporation furnishes to the transferee an affidavit stating, under penalty of perjury, that the domestic corporation is not and has not been a United States real property holding corporation (as defined in §897(c)(2)) during the test period specified in §897(c)(1)(A)(ii). Third, a transaction is exempt from withholding if the transferee of a United States real property interest receives a "qualifying statement" satisfying regulations to be prescribed by the Internal Revenue Service. A "qualifying statement" is a statement by the Internal Revenue Service that either the transferor is exempt from tax under FIRPTA, the transferor or the transferee has provided adequate security for payment of the tax, or the transferor or the transferee has made other arrangements for the payment of the tax. The Service will prescribe regulations establishing procedural rules for requests for qualifying statements. The statute requires the Service to take action on a request for a qualifying statement within 90 days of receipt of the request. Fourth, a transferee who acquires property for use by him as a residence will not be required to withhold FIRPTA tax if the total purchase price for the property does not exceed $300,000. Fifth, no withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market.

The obligation to withhold tax will not exceed the amount that the Internal Revenue Service determines to be the transferor's maximum tax liability. Either the transferor or the transferee may request a determination of the transferor's maximum tax liability from the Service. In the event of overwithholding, a transferor may seek an early refund of any amount withheld in excess of the transferor's maximum tax liability. The amount overwithheld, however, will not bear interest. As in the case of requests for qualifying statements under §1445(b)(4), the Service will have 90 days in which to respond to a request for a determination of the transferor's maximum tax liability.

At the request of either the transferor or the transferee, the Service may prescribe a reduced amount of withholding if the Service determines that reduced withholding will not jeopardize the ultimate collection of the tax. This provision is similar to the §1445(b)(4) qualifying statement exemption, which permits either the transferor or the transferee to provide security in lieu of withholding. The period within which the Service will be required to respond to a request for reduced withholding is also 90 days after receipt of the request.

A transferor's agent or a transferee's agent who has actual knowledge that a nonforeign affidavit or an affidavit that a domestic corporation is not a United States real property holding corporation is false, but fails to notify the transferee that the affidavit is false, may become liable for withholding to the extent of the agent's compensation derived from the transaction. In the case of a transferor's agent whose principal is a foreign corporation, the agent will be liable to the extent of his compensation for failure to notify the transferee that the transferor's affidavit is false, even in absence of proof of actual knowledge on the part of the agent.

The Act provides several special rules relating to corporations, partnerships, trusts, or estates. A domestic or foreign partnership, trust, or estate must withhold tax equal to ten percent of the fair market value of any United States real property interest distributed to a foreign partner or beneficiary if the distribution is subject to FIRPTA tax under the regulations to be prescribed under §897(g). As regulations have not yet been promulgated under §897(g), the scope of the withholding obligation under this provision is uncertain. Also to the extent provided in regulations, the transferee of an interest in a partnership, trust, or estate may be required to withhold tax equal to ten percent of the amount realized by the transferor on the disposition of the interest in the partnership, trust, or estate. A domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate must withhold tax equal to ten percent of any amount in its custody that is attributable to the disposition of a United States real property interest and is includable in the income of a foreign partner or beneficiary. A foreign corporation is required to withhold tax equal to 28 percent of the amount of net gain recognized on a

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distribution to shareholders under §897(d) or §897(e). If a domestic corporation that is or has been a United States real property holding corporation during the test period specified in §897(c)(1)(A)(ii) redeems stock from a foreign shareholder in a transaction taxable under §302 or makes a liquidating distribution to a foreign shareholder, the corporation must withhold tax equal to ten percent of the amount realized by the foreign shareholder.

Section 1445 contains no exemption from withholding corresponding to the election under §897(i) for a corporation to be treated as a domestic corporation. However, the Conference Report directs the Internal Revenue Service to prescribe regulations allowing foreign shareholders in a foreign corporation electing §897(i) treatment to credit against their FIRPTA tax liability on a liquidating distribution any tax withheld on a qualifying §337 liquidation-related sale of a United States real property interest.

The Act generally repeals the information reporting requirements of FIRPTA. However, the act amends §6039C to authorize the Internal Revenue Service to prescribe regulations requiring reporting by foreign persons holding direct investments in United States real property interests. A foreign person will be treated as holding direct investment in United States real property interests if the foreign person did not engage in a trade or business in the United States at any time during the calendar year and the foreign person directly held, at any time during the calendar year, United States real property interests with a fair market value at least equal to $50,000.

B. Effective Date

The withholding rules will apply to dispositions of United States real property interests that occur on or after January 1, 1985, regardless of the date on which a foreign transferor originally acquired the United States real property interest. The changes in the information reporting requirements are effective retroactively to calendar year 1980.[29]

III. Detailed Analysis

A. Withholding of Tax on Dispositions of United States Real Property Interests

1. General Rule

Except as otherwise provided, new §1445 of the Code requires any transferee to withhold tax on the disposition of a United States real property interest (as defined in §897(c)) by a foreign person. The normal withholding rate will be 10 percent of the amount realized on the disposition.[30]

The structure of the withholding scheme required by §1445, as well as the required rate of withholding, differs substantially from the provision in the Senate bill. The Conference Report states that:

> "The Conference Agreement differs from the Senate amendment in requiring withholding *unless* one of five exemptions applies. The Senate amendment generally would have required withholding only if the would-be withholding agent had actual knowledge or had received formal notice that the seller was foreign. The Senate amendment would have imposed a general requirement on the transferor to notify the transferee (as well as any transferee's agent or settlement officer) if the transferor was a foreign person. It would also have imposed a general requirement on any transferor's agent to make a reasonable inquiry concerning the transferor's status and to notify the transferee if the agent had reason to believe that the transferor might be a foreign person. The conference agreement eliminates these two general requirements." [31]

By imposing a general duty of withholding and providing clear exemptions, while removing the uncertainties of the duty of investigation which would have been imposed under the Senate bill, the conference agreement appears to have created a simpler, more workable mechanism for FIRPTA withholding.

2. Exemptions from Withholding

a. Transferor Furnishes Non-foreign Affidavit

A transferee will be relieved of any withholding obligation if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, that the transferor is not a foreign person and the transferor's United States taxpayer identification number.[32] The transferee will not be relieved of its withholding obligation if the transferee has actual knowledge that the nonforeign affidavit is false, or if the transferee receives notice from an agent of either the transferor or the transferee that the nonforeign affidavit is false.[33]

The Internal Revenue Service is authorized to prescribe regulations requiring a transferee to furnish to the Service a copy of any non-foreign affidavit upon which the transferee intends to rely. If the Service prescribes such regulations and a transferee fails to furnish a copy of a non-foreign affidavit in the time and manner required by the regulations, then the transferee will lose the benefit of the non-foreign affidavit exemption and the withholding obligation will remain.[34]

b. Domestic Corporation Furnishes Affidavit That It Is Not a United States Real Property Holding Corporation

No withholding will be required upon the disposition of an interest in a domestic corporation if the domestic corporation furnishes to the transferee an affidavit by the domestic corporation stating, under penalty of perjury, that the domestic corporation is not and has not been a United States real property holding corporation (as defined in §897(c)(2)) during the test period specified in §897(c)(1)(A)(ii).[35] As in the case of a non-foreign affidavit, an affidavit that a domestic corporation is not a United States real property holding corporation will not protect the transferee if the transferee has actual knowledge that the affidavit is false or the transferee receives notice from an agent of the transferor or the transferee that the affidavit is false.[36] A purchaser of stock will also lose the protection of an affidavit that a domestic corporation is not a United States real property holding corporation if the Internal Revenue Service requires transferees to furnish a copy of such an affidavit to the Service and the purchaser fails to furnish a copy of the affidavit as required.[37]

The prudent purchaser of a United States real property interest, including an interest in a domestic corporation

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which may be a United States real property holding corporation, will obtain from the seller a non-foreign affidavit or an affidavit that the seller is not a United States real property holding corporation. The Conference Report warns of the consequences of failure to obtain either of the two affidavits:

> "Under the Conference Agreement and the provisions of FIRPTA, a purchaser of non-publicly traded stock in a domestic corporation is potentially liable for withholding unless he obtains a non-U.S. RPHC affidavit from the corporation or a non-foreign affidavit from the seller. If the purchaser obtains neither, he will be liable for withholding if the seller is in fact a foreign person, the domestic corporation was in fact a U.S. RPHC during the base period specified Code sec. 897(c)(1)(A)(ii), and the purchaser does not receive a qualifying statement." [38]

c. Transferee Receives Qualifying Statement

A transaction is exempt from withholding if the transferee of a United States real property interest receives a qualifying statement satisfying regulations to be prescribed by the Internal Revenue Service.[39] A "qualifying statement" is a statement by the Internal Revenue Service that either the transferor is exempt from tax under FIRPTA, the transferor or the transferee has provided adequate security for payment of the tax, or the transferor or the transferee has made other arrangements for the payment of the tax.[40] A further requirement for issuance of a qualifying statement is that either the transferor or the transferee must pay or provide adequate security for the payment of unsatisfied withholding liability from past transactions as well as from the transaction with respect to which the qualifying statement is sought.[41]

The Conference Report provides an example of a situation where the Service should issue a qualifying statement. Where the consideration paid by the transferee for a United States real property interest is not sufficient to cover the withholding liability for the transaction, a qualifying statement should be requested from and issued by the IRS. This might occur whenever the downpayment is less than ten percent of the total purchase price, since the ten percent withholding liability is computed based on total purchase price rather than on the amount of payments actually made by the transferee. In such a case, a qualifying statement will be issued "if the requirements for such a statement are otherwise satisfied and no abuse is involved." [42] Presumably, the real property which is the subject of the transaction will often be used to provide "adequate security" in cases where the downpayment is insufficient to cover the withholding liability.

The Service will prescribe regulations establishing procedural rules for requests for qualifying statements. The statute requires the Service to take action on a request for a qualifying statement within 90 days after receipt of the request.[43] The conferees substituted the 90-day deadline for the 30-day deadline in the Senate bill after the Internal Revenue Service pleaded insufficient resources to meet the 30-day deadline.[44] Whatever the merits of the Service's position, the longer deadline will reduce the utility of the qualifying statement if only those who are farsighted enough to make a request at least 90 days before closing a transaction can safely rely on the exemption.

d. Acquisition of Residence for Not More Than $300,000

A transferee who acquires property for use by him as a residence will not be required to withhold FIRPTA tax if the total purchase price for the property does not exceed $300,000.[45] The conference agreement liberalized a similar exemption in the Senate bill by increasing the limitation on the purchase price from $200,000 to $300,000, and by eliminating the requirement that the property be used by the transferee as his *principal* residence.

e. Publicly Traded Stock

No withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market.[46] The securities market on which the stock is traded need not be located in the United States.[47] The exemption from withholding is more liberal than the exemption from FIRPTA tax under §897(c)(3). Although a shareholder who owns more than five percent of a class of publicly-traded stock at any time during the test period defined in §897(c)(1)(A)(ii) may be liable for tax under FIRPTA on gain from the disposition of his stock, the transferee will not be liable for withholding as long as the stock is publicly traded.

3. Limitations on Amount Required To Be Withheld

a. Maximum Tax Liability of Transferor

The obligation to withhold tax will not exceed the amount that the Service determines to be the transferor's maximum tax liability.[48] The Senate Finance Committe described the method of computing the transferor's maximum tax liability as follows:

> "The transferor's maximum tax liability consists of two elements: first, the maximum amount that the Treasury (upon request of the transferor or the withholding agent) determines that the transferor could owe on his gain on the sale, discussed below, and second, any unsatisfied prior withholding tax liabilities caused by prior foreign ownership with respect to the transferred property that, under the bill, were previously required to be withheld but were not withheld. The first element, the maximum tax that the transferor could owe on the sale, is to be calculated on a transaction by transaction basis at the highest possible tax rate for that transaction. For example, if a nonresident alien purchased unimproved land on January 1, 1985, for $100,000 and sold the land on September 1, 1985, for $110,000, his maximum tax liability would be $2,000, *i.e.*, 20 percent, the highest marginal tax rate for long-term capital gains of an individual, times $10,000, his net gain. Neither offsetting transactions (completed or anticipated) nor the presumed absence of other income during the taxable year would enter into the calculation of the maximum tax that the transferor could owe on the sale." [49]

Either the transferor or the transferee may request a determination of the transferor's maximum tax liability from the Internal Revenue Service.[50] The Conference Report, however, contains language restricting requests by

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transferees for determination of the transferor's maximum tax liability: "However, transferees may request a maximum tax liability determination only to cure over-withholding errors. The procedure is not intended to be utilized to relieve transferees from withholding responsibility *before* a transaction occurs." [51] The Conference Report then proceeds to cast doubt on this apparently clear warning by stating that "Transferees may request a determination of maximum tax liability before or after a disposition." [52] The Conference Report does not make it clear why a transferee should seek a determination of the transferor's maximum tax liability before a disposition, if the determination cannot relieve the transferee from withholding responsibility. One may hope that the regulations will shed some light on the rather obscure explanation in the Conference Report.

A transferor may seek an early refund of any amount withheld in excess of the transferor's maximum tax liability.[53] This provision is intended to allow a transferor to seek a refund of overwithholding prior to the time that the transferor could otherwise file a Federal income tax return. The amount overwithheld, however, will not bear interest.[54]

Regulations are to be prescribed governing requests for determinations of a transferor's maximum tax liability and requests for early refunds of amounts overwithheld.[55] As in the case of requests for qualifying statements under §1445(b)(4), the Service will have 90 days in which to respond to a request for a determination of the transferor's maximum tax liability.[56]

b. Discretionary Reduction of Amount of Withholding Required

At the request of either the transferor or the transferee, the Service may prescribe a reduced amount of withholding if the Service determines that reduced withholding will not jeopardize the ultimate collection of the tax.[57] This provision is similar to the §1445(b)(4) qualifying statement exemption, which permits either the transferor or the transferee to provide security in lieu of withholding. It is conceivable that if a foreign transferor possesses substantial assets in the United States, the Service would not require the posting of a bond or other security and would utilize the authority of §1445(c)(2) to reduce the amount of withholding required.

The statute contemplates regulations governing requests for reductions in the amount of withholding required.[58] As in the case of requests for qualifying statements under §1445(b)(4) and requests for determinations of a transferor's maximum tax liability under §1445(c)(1), the Service will be required to respond to a request for reduced withholding within 90 days after receipt of the request.[59]

4. Liability of Transferor's or Transferee's Agents

A transferor's agent or a transferee's agent who has actual knowledge that a non-foreign affidavit or an affidavit that a domestic corporation is not a United States real property holding corporation is false, but fails to notify the transferee that the affidavit is false, may become liable for withholding to the extent of the agent's compensation. The liability of an agent for withholding in case of a failure to give notice is in addition to any penalties imposed under other provisions of the Code or other laws (civil and criminal).[60]

In the case of a transferor's agent whose principal is a foreign corporation, the agent will be liable to the extent of his compensation for failure to notify the transferee that the transferor's affidavit is false, even in the absence of proof of actual knowledge on the part of the agent. The Conference Report states: "The conferees believe that any agent deriving compensation from a foreign corporate principal in a real estate transaction will know that his or her principal is in fact foreign. The chances of ignorance in such a case are so remote that the Conference Agreement precludes a claim of ignorance." [61]

A "transferor's agent" is any person who represents the transferor in any negotiation related to the transaction with the transferee or any transferee's agent, or in settling the transaction.[62] A "transferee's agent" is any person who represents the transferee in any negotiation related to the transaction with the transferor or any transferor's agent, or in settling the transaction.[63] A settlement officer will not be treated as a transferor's agent or a transferee's agent merely because he receives or disburses any portion of the consideration for the transaction or records any document in connection with the transaction.[64]

5. Special Rules Relating to Corporations, Partnerships, Trusts, or Estates

a. Distributions by Domestic or Foreign Partnerships, Trusts, or Estates

A domestic or foreign partnership, trust, or estate must withhold tax equal to ten percent of the fair market value of any United States real property interest distributed to a foreign partner or beneficiary if the distribution is subject to FIRPTA tax under the regulations to be prescribed under §897(g).[65] As noted above, regulations have not yet been promulgated under §897(g), so the scope of the withholding obligation of a partnership, trust, or estate under this provision is uncertain. The Conference Report notes that, while most distributions by partnerships, trusts, and estates are not generally taxable, such distributions may be taxable for purposes of FIRPTA under the §897(g) regulations.[66]

b. Dispositions of Interests in Partnerships, Trusts, or Estates

To the extent provided in regulations, the transferee of an interest in a partnership, trust, or estate may be required to withhold tax equal to ten percent of the amount realized by the transferor on the disposition of the interest in the partnership, trust, or estate.[67] Unlike §1445(e)(4), this provision makes no reference to regulations under §897(g), but will presumably complement §1445(e)(4) and coordinate with the regulations to be prescribed under §897(g).

c. Disposition of United States Real Property Interests by Partnerships, Trusts, and Estates

A domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate must withhold tax equal to ten percent of any amount in its custody that is attributable to the disposition of a United States real property interest (other than a disposition covered by §1445(e)(4) or (e)(5)), and is either (1) includable in the

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distributive share of a partner of a partnership who is a foreign person, or (2) includable in the income of a beneficiary of the trust or estate who is a foreign person, or (3) includable in the income of a foreign person by reason of the grantor trust rules of §671.[68] Aside from the reduction in the rate of withholding, this provision is essentially unchanged from the version in the Senate bill.

d. Distributions by Foreign Corporations

A foreign corporation is required to withhold tax equal to 28 percent of the amount of net gain recognized on a distribution to shareholders under §897(d) or §897(e).[69]

e. Distributions by United States Real Property Holding Corporations to Foreign Shareholders

If a domestic corporation that is or has been a United States real property holding corporation during the test period specified in §897(c)(1)(A)(ii) redeems stock from a foreign shareholder in a transaction taxable under §302 or makes a liquidating distribution to a foreign shareholder, the corporation must withhold tax equal to ten percent of the amount realized by the foreign shareholder.[70] The FIRPTA withholding provisions impose no independent withholding obligation on dividend distributions from United States real property holding corporations to foreign shareholders, which are already subject to the general provisions requiring withholding of tax from dividend distributions.[71] The Conference Report notes that withholding by a domestic corporation from distributions to foreign shareholders is necessary because dispositions of United States real property interests by the corporation would not have been taxed under FIRPTA. A disposition by a domestic corporation would not be subject to FIRPTA tax because, by definition, a domestic corporation is not a "foreign person," even if all of the shareholders are foreign persons.[72]

The Conference Report notes that if all gain from the disposition of United States real property interests by a corporation was recognized at the corporate level, an interest in the corporation would not be a United States real property interest subject to tax upon disposition under FIRPTA.[73] This might occur, for example, where a corporation chose not to elect §337 nonrecognition treatment for gain realized in the course of liquidation. In such a case, a qualifying statement granting exemption from withholding should be available.[74]

f. Corporations Making the §897(i) Election

Section 1445 contains no exemption from withholding corresponding to the election under §897(i) for a corporation to be treated as a domestic corporation. Consequently, a sale of a United States real property interest by a foreign corporation in the course of a complete liquidation may be subject to withholding despite the election by the corporation to be treated as a domestic corporation for purposes of FIRPTA. Since the corporation is still treated as a domestic corporation for purposes of the substantive provisions of FIRPTA, although not for purposes of the withholding provisions, the corporation may elect nonrecognition treatment of a sale in connection with its liquidation under §337. The Conference Report directs the Internal Revenue Service to prescribe regulations allowing foreign shareholders in a foreign corporation electing §897(i) treatment to credit against their FIRPTA tax liability on a liquidating distribution any tax withheld on a qualifying §337 liquidation-related sale of a United States real property interest.[75]

6. Information Reporting Requirements

The 1984 Act generally repeals the information reporting requirements of FIRPTA. However, the Act amends §6039C to authorize the Internal Revenue Service to prescribe regulations requiring reporting by foreign persons holding direct investments in United States real property interests. A foreign person will be treated as holding direct investments in United States real property interests if the foreign person did not engage in a trade or business in the United States at any time during the calendar year, and the foreign person directly held, at any time during the calendar year, United States real property interests with a fair market value at least equal to $50,000.[76]

For purposes of determining whether a foreign person directly holds United States real property interests worth $50,000, constructive ownership rules will apply. United States real property interests held by a partnership, trust, or estate shall be attributed proportionately to the partners or beneficiaries.[77] United States real property interests held by the spouse or minor child of an individual shall be attributed to the individual.[78]

If a foreign person is required to pay tax under FIRPTA or file a return, the return should be filed with the United States in the case of any interest in real property located in the United States or an interest in a United States domestic corporation.[79] In the case of an interest in real property located in the Virgin Islands or an interest in a Virgin Islands domestic corporation, the return should be filed with the Virgin Islands.[80]

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[1] §897(a)(1). Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended.
[2] §§871(b)(1) and 882(a)(1).
[3] §897(a)(2).
[4] §897(c)(1)(A)(i).
[5] §897(c)(6)(A).
[6] Joint Committee Print issued in connection with hearings on S. 1915 before the Senate Finance Committee on June 19, 1984.
[7] Prop. Regs. §1.897(c).
[8] §897(c)(6)(B).
[9] §897(c)(1)(A)(ii).
[10] §897(c)(2).
[11] §897(c)(1)(A)(ii).
[12] §897(c)(4)(B).
[13] §897(c)(5)(A).
[14] §897(c)(5)(B).
[15] §897(c)(3).
[16] §897(e)(2).
[17] §897(j).
[18] §897(i)(1).
[19] §897(i)(3)(A).
[20] §897(i)(3).
[21] §897(i)(2). *See also* Prop. Regs. §§1.897-3 and 1.897-4.
[22] §897(l).

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[23] The inclusion in income and credit of the corporate tax ensures that the U.S. shareholder will be taxed at his individual rate on any gain from the liquidation.
[24] §897(g).
[25] §897(h)(1).
[26] §§897(h)(2) and (4).
[27] Joint Committee Print issued in connection with hearings on S. 1915 before the Senate Finance Committee on June 19, 1984, p. 14.
[28] *See generally* Section 141 of the Senate bill; S. Rep. No. 169 (Vol. II), 98th Cong., 2d Sess., p. 406 (1984).
[29] Act Section 129(c).
[30] §1445(a). The conferees believed that 10 percent withholding would more nearly approximate the actual tax owed by the foreign investor in most cases. Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 942 (1984).
[31] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 941 (1984). Emphasis in the original.
[32] §1445(b)(2).
[33] §1445(b)(7)(A).
[34] §1445(b)(7)(B).
[35] §1445(b)(3).
[36] §1445(b)(7)(A).
[37] §1445(b)(7)(B).
[38] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 944 (1984).
[39] §1445(b)(4)(A).
[40] §1445(b)(4)(B)(i) and (ii).
[41] §§1445(b)(4)(B)(ii) and (f)(4).
[42] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 942-943 (1984).
[43] §1445(c)(3)(B).
[44] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 943, 944-945 (1984).
[45] §1445(b)(5).
[46] §1445(b)(6).
[47] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 945 (1984).
[48] §1445(c)(1)(A).
[49] S. Rep. No. 169 (Vol. I) 98th Cong., 2d Sess., pp. 406-407 (1984).
[50] §1445(c)(1)(B).
[51] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 943 (1984).
[52] *Id.*
[53] §1445(c)(1)(C).
[54] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 943 (1984).
[55] §1445(c)(3)(A)(ii).
[56] §1445(c)(3)(B).
[57] §1445(c)(2).
[58] §1445(c)(3)(A)(iii).
[59] §1445(c)(3)(B).
[60] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 942 (1984).
[61] *Id.*
[62] §1445(d)(3).
[63] §1445(d)(4).
[64] §1445(d)(5).
[65] §1445(e)(4).
[66] Conf. Rep., No. 861, 98th Cong., 2d Sess., 946 (1984).
[67] §1445(e)(5).
[68] §1445(e)(1).
[69] §1445(e)(2).
[70] §1445(e)(3).
[71] §§1441 and 1442.
[72] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 946 (1984).
[73] §897(c)(1)(B).
[74] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 946 (1984).
[75] *Ibid.*, at p. 947.
[76] §6039C(b).
[77] §6039C(c)(3)(A).
[78] §6039C(c)(3)(B).
[79] §6039C(d)(1).
[80] §6039C(d)(2).

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CHAPTER 64

FOREIGN SALES CORPORATIONS

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I. Introduction

A. *Original DISC Legislation*

Title V of the Revenue Act of 1971 [1] authorized the creation of domestic international sales corporations ("DISCs") by adding §§991 through 997 to the Code. A DISC is not taxable on its profits, but its shareholders are taxable on the DISC's profits that are either distributed or deemed distributed. Federal income tax is deferred on that portion of DISC profits that are neither distributed nor deemed distributed. Under the original legislation, one-half of the DISC's income was taxable as a deemed distribution to its shareholders, whether distributed or not, and tax was deferred on the remaining one-half of DISC income until the income was actually distributed, a shareholder disposed of his DISC stock, the DISC was liquidated, the corporation ceased to qualify as a DISC, or the DISC election was terminated or revoked by the shareholder(s).

To qualify for this method of taxing export income, a DISC must be incorporated under the laws of any of the states or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the "gross receipts" and "gross assets tests."

The "gross receipts test" requires that at least 95 percent of the corporation's gross receipts consist of "qualified export receipts." In general, "qualified export receipts" are receipts, including commission receipts, derived from the sale or lease for use outside of the United States of "export property," or from the furnishing of services related or subsidiary to the sale or lease of export property. Dividends on stock of a related foreign export corporation and interest on any obligation which is a qualified export asset are also considered qualified export receipts. "Export property" must be manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. government or exports intended for ultimate use in the United States do not qualify as export property. A DISC may not engage in manufacturing, producing, growing, or extracting export property.

The "gross assets test" requires that at least 95 percent of the corporation's assets be "qualified export assets." "Qualified export assets" include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including commissions receivable), producer's loans, working capital, investments in related foreign export corporations, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association.

A DISC may act as a principal or as an agent with respect to export property. Its activities can be performed for or on behalf of related or unrelated parties. There is no requirement for a DISC to have employees or real operations. Because of the opportunity for tax deferral, the methods for allocating income between a DISC and its related suppliers are an important part of the DISC legislation. The allocation is determined either on an "arm's-length" basis or under one of two special pricing rules. An allocation can be made allowing the DISC to earn taxable income not exceeding the greater of:

(i) taxable income based upon the price actually charged the DISC by its supplier, if that price is justifiable under the §482 transfer pricing regulations (referred to as the §482 or arm's-length method);

(ii) four percent of the qualified export receipts attributable to the sale of export property plus 10 percent of the related export promotion expenses, which are the ordinary and necessary expenses incurred to obtain qualified export receipts (referred to as the 4 percent of gross receipts method); or

(iii) fifty percent of the combined taxable income ("CTI") of the DISC and its related supplier attributable to qualified export receipts plus 10 percent of the related export promotion expenses (referred to as the 50 percent of CTI method).

Neither the four percent of gross receipts method nor the 50 percent of CTI method can be applied to create a loss for the related supplier while the DISC is earning a profit.

B. *Statutory Amendments*

The Tax Reduction Act of 1975 [2] denied DISC benefits to profits arising from exports of products in short domestic supply, as determined by the Commerce Department under the Export Administration Act or by Executive Order of the President. The 1975 Act also removed DISC benefits from exports of natural resource products (*e.g.*, oil, gas, and minerals) subject to a percentage depletion allowance. The Tax Reform Act of 1976 excluded renewable resources, such as timber, from the natural resource products ineligible for DISC benefits.

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The Tax Reform Act of 1976 [3] also included incremental provisions limiting DISC benefits to increases in exports above a certain base period. DISC benefits are limited to the income attributable to export gross receipts in excess of 67 percent of the average export gross receipts over a four-year moving base period. DISCs with adjusted taxable income of $100,000 or less are exempt from the incremental rule; the exemption is phased out as adjusted taxable income increases from $100,000 to $150,000.

In applying the incremental provisions, a DISC's export gross receipts are treated as equal to zero for those base period years in which the DISC did not exist. To prevent a controlling shareholder from gaining an advantage by shifting exports between multiple DISCs, the sales of all DISCs identifiable as part of a controlled group are combined in calculating base period exports.

The 1976 Act also reduced the DISC deferral on sales of military goods to one-half of the amount otherwise allowed. In addition, the Act also lengthened the period for recapture of the deferred tax in the event of disqualification or termination of DISC status to twice the number of years of the DISC's existence, up to a maximum period of 10 years.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) [4] increased the deemed distribution rate from a DISC to a corporate shareholder from 50 percent to 57.5 percent of taxable income. This provision, which reduces DISC benefits for such shareholders by 15 percent, applies for tax years of DISCs beginning after 1982.

C. *Reasons for Change*

For several years, the DISC has been the subject of a dispute between the United States and other signatories of the General Agreement on Tariffs and Trade (GATT), who contend that the DISC provisions amount to an illegal export subsidy which violates the GATT. In 1976, a GATT panel determined that the DISC, as well as certain export tax practices of Belgium, France, and the Netherlands, had some characteristics of an illegal export subsidy. While the United States has not conceded that DISC violates the GATT, the United States agreed to the adoption of the GATT Panel Reports on the DISC and the related tax practices of Belgium, France, and the Netherlands in December 1981. The adoption of all four Panel Reports, however, was subject to an important Understanding.

The Understanding is a formal agreement stating that GATT signatories are not required to tax export income attributable to economic processes located outside their territorial limits. Furthermore, the Understanding states that arm's-length pricing principles should be observed in transactions between exporting enterprises and foreign buyers under common control. Finally, the Understanding states that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

A debate in the GATT Council, the ruling body of the GATT, ensued in early 1982 on the interpretation of the Understanding as it applied to the DISC. The European Community (EC) argued that the DISC was an illegal export subsidy because it allowed indefinite deferral of direct taxes on income from exports earned in the United States. The United States defended the DISC on the grounds that its effect on trade as an incentive for exports approximated the effect of the territorial system of taxation used by our European trading partners and found to be consistent with the GATT in the December 1981 Understanding. The majority of the GATT Council members, however, were persuaded by the arguments against the DISC and urged the United States to bring the DISC clearly into conformity with the GATT. The EC went one step further in requesting authorization from the GATT Council to take retaliatory action against the United States. Specifically, the EC wanted to increase trade restrictions on $2.3 billion in U.S. exports to the EC. Other countries also expressed an interest in receiving compensation for the DISC.

To remove the DISC as a contentious issue and to avoid further disputes over retaliation, the United States made a commitment to the GATT Council on October 1, 1982, to propose legislation that would address the concerns of other GATT members. In March 1983, the Reagan Administration approved the general outlines of a proposal to replace the DISC with a simpler, GATT-legal, territorial-type system of taxation for U.S. exports. Since under GATT rules, a country need not tax income from economic processes occurring outside its territory, the Reagan Administration proposal provided that certain income from economic activities occurring outside the United States is exempt from U.S. tax. The activities related to that income were to be undertaken by a foreign sales corporation located outside the U.S. customs territory. A foreign tax credit would not be available with respect to such income. International double taxation would be avoided by use of the exemption method. The proposal was designed to conform with the letter and spirit of the GATT, while providing benefits to exporters comparable to those of DISC at approximately the same revenue cost to the U.S. Treasury.

The proposal creating the foreign sales corporation (the "FSC") was eventually adopted by Congress as Title VIII of the Tax Reform Act of 1984. With certain transition rules, it is generally effective for taxable years of an FSC beginning on or after January 1, 1985. In general, where FSC provisions are identical to or substantially similar to present law DISC provisions, rules comparable to the rules in regulations issued pursuant to the DISC provisions will be applied to the FSC.

II. Overview

A. *General*

Sections 801-805 of the Tax Reform Act of 1984 adds §§921-927 to the Code, which generally replace the system of DISCs with a new system of FSCs. In the typical case, a U.S. parent will form an FSC for the purpose of making its export sales. Provided it satisfies certain requirements, a portion of an FSC's export income will be exempt from U.S. tax at both the corporate and domestic corporate shareholder levels. By requiring certain sales activities to be performed outside the United States, it is hoped that the FSC will comport with the provision in the GATT Understanding requiring tax exempt income to be derived from economic processes located outside the United States. These activities must be performed outside the U.S. cus-

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toms territory either directly by the FSC, or for it on a contract basis.

To comply with the Understanding, the income of the FSC will be determined using arm's-length prices, either actual prices for sales between unrelated, independent parties, or, for sales between related parties, by using the pricing procedures prescribed under §482 of the Code. Alternatively, one of two allocation rules, designed for administrative convenience to approximate arm's-length pricing, may be used.

Under the Act, the accumulated tax-deferred income of a DISC will be deemed previously taxed income and therefore exempt from taxation. Because certain small exporters may find it difficult to comply with the foreign management and activity requirements, the Act provides two options available only to small businesses.

B. Requirements of Foreign Sales Corporation

An FSC must be formed or organized under the laws of any jurisdiction other than the 50 States, the District of Columbia, and Puerto Rico with which the United States maintains an exchange of information agreement (or a treaty providing for the exchange of information).

The shares in the FSC (other than directors' qualifying shares) must be owned directly by no more than 25 persons. An FSC may issue more than one class of stock but may not issue preferred stock.

The FSC must maintain an office outside the United States territory (the foreign office). The foreign office of the FSC need not be maintained in the country of incorporation or organization of the FSC nor in the country where the FSC conducts its principal business.

The FSC must maintain a summary of its permanent books of account at the foreign office and the records which it is required to keep under §6001 at a location within the United States.

The FSC must have at least one director who is not a resident of the United States (defined by the Act to include Puerto Rico). The director may reside in any jurisdiction outside the United States.

A foreign corporation organized in an eligible possession or other foreign jurisdiction must elect to be treated as an FSC.

The FSC may not be a member, at any time during the taxable year, of any "controlled group of corporations" of which a DISC is a member.

The taxable year of an FSC will be required to be the same year as a majority shareholder (unlike current DISC law).

C. Effect of Qualification as an FSC

Foreign trade income ("FTI") is defined as income (including both profits and commissions) derived in connection with the FSC's "foreign trading gross receipts" ("FTGR"). A portion of the FSC's FTI ("exempt FTI") will not be subject to U.S. direct taxation and will be eligible for distribution to U.S. corporate shareholders on a tax-exempt basis.

Exempt FTI is attributable to FTGR that arise from certain economic activity actually conducted outside the U.S. customs territory. This foreign activity is necessary to meet the GATT requirement that any tax exemption be related to economic processes occuring outside the territorial limits of the exporting country.

If an FSC purchases "export property" from an independent party, or if "export property" is transferred to an FSC from a related party on the basis of §482 transfer pricing rules, 32 percent (or 30 percent in cases involving corporate FSC shareholders) of the FSC's income will be exempt from U.S. tax.

If one of two "special administrative pricing rules" is used by a taxpayer to allocate income to the FSC, tax exempt FTI will be determined under corollary administrative allocation rules to equal either 16 percent (15 percent in cases involving corporate FSC shareholders) of CTI or 1.27 percent (1.19 percent in cases involving corporate FSC shareholders) of FTGR, up to a limit of 32 percent (30 percent in the case of corporate FSC shareholders) of CTI.

D. Export Property

"Export property" generally means property manufactured, produced, grown, or extracted in the United States for direct use, consumption, or disposition outside the United States. Exports of products with respect to which a deduction for depletion is allowable, other than oil and gas and primary products from oil and gas, will be considered "export property" and eligible for FSC benefits.

E. Foreign Trading Gross Receipts

1. Qualified Transactions

Gross receipts from the following transactions may give rise to FTGR:

(i) The sale, exchange, or other disposition of export property;

(ii) The lease or rental of export property that is used by the lessee outside the United States;

(iii) The performance of services that are related and subsidiary to the sale, exchange, lease, rental, or other disposition of export property by the FSC;

(iv) The performance of engineering or architectural services for construction projects located outside the United States; and

(v) The performance of managerial services in furtherance of the production of FTGR (so long as at least 50 percent of the FSC's gross receipts for the taxable year is derived from activities described in (i), (ii), and (iii), *supra*).

FTGR does not include any interest, dividends, income from intangibles, or other types of investment income. In addition, it does not include income from certain unqualified transactions.

2. Foreign Management and Foreign Activity Tests

a. Foreign Management

In order for an FSC's gross receipts to qualify as FTGR, (i) all meetings of the board of directors of the FSC and all shareholder meetings must be outside the United States; (ii) the principal bank account of the FSC must be maintained outside the United States at all times during

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the taxable year; and (iii) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the FSC disbursed during the taxable year must be disbursed out of bank accounts of the FSC maintained outside the United States.

b. Foreign Activity Tests

The FSC also will be required to satisfy certain sales activity and foreign direct cost tests in order for its gross receipts to qualify as FTGR.

(1) Sales Activity

The FSC (or its agent) must participate outside the United States in either the solicitation, negotiation, or making of the contract with regard to the transactions that give rise to FTGR. Solicitation includes telephone, telegraph, and mail communications to unrelated customers, either actual or potential, but does not include advertising. Negotiation includes any communication by the FSC, or its agent, to a customer or potential customer relating to the terms of sale. Acceptance means formal legal acceptance of a contract.

(2) Foreign Direct Costs

With respect to each transaction, the FSC must incur foreign direct costs equal to at least 50 percent of the total direct costs associated with five of the following activities (or foreign direct costs equal to at least 85 percent of the direct costs associated with each of two of them):

(i) Advertising and sales promotion;

(ii) Processing customer orders and arranging for delivery of the export property;

(iii) Transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer;

(iv) Determination and transmittal of a final invoice or statement of account and the receipt of payment; and

(v) Assumption of credit risk.

F. Transfer Pricing Rules

To comply with the December 1981 GATT Understanding, arm's-length pricing principles will govern the transfer of export property from the U.S. supplier to its related FSC. Hence, the allocation of income between the FSC and its suppliers is based on arm's-length standards. Taxpayers may allocate income to the FSC based on prices (i) charged between unrelated parties not under common control, or (ii) determined under any of the pricing methods described in the §482 regulations. Alternatively, as a matter of administrative convenience, the taxpayer may use one of the following two "special administrative pricing rules" for allocating income to the FSC: (i) the 23 percent of CTI method; or (ii) the 1.83 percent of FTGR method.

To be eligible to use either of the administrative pricing rules, the FSC (or its agent) must perform all of the sales activities and all of the activities relating to disposition of export property for purposes of the foreign direct cost test. These activities may be performed in any location, including the United States.

G. Taxation of FSC Shareholders

Tax exempt FTI will not be subject to U.S. direct taxation at the FSC level nor included in the income of a U.S. shareholder under Subpart F. In addition, domestic corporate shareholders will be allowed a 100 percent dividends received deduction with respect to actual dividends from distributed earnings attributable to the tax-exempt FTI. The dividends received deduction will be in lieu of a foreign tax credit or deduction for foreign taxes. Double taxation is therefore avoided by use of the exemption instead of the credit method. Other earnings of the FSC will remain taxable to the domestic corporate shareholder on a current basis and will be eligible for a foreign tax credit. A shareholder of an FSC that is not a domestic corporation will not be allowed a dividends received deduction with respect to FSC distributions.

H. Small Business Exception

In order to provide relief for the small exporters who may find the foreign economic activity requirements onerous, small businesses will be eligible for two alternatives to the FSC rules: the interest charge DISC and the small FSC.

A DISC with $10 million or less of qualified export receipts may elect to continue to be treated as a DISC. Deemed distributions with regard to base period exports (the incremental provisions) and to one-half of the DISC's income would be eliminated. Thus, except for export sales of military property, substantially all of the DISC's income will be eligible for tax deferral, but the tax otherwise due on the deferred income will be subject to a deductible arm's-length interest charge based on the Treasury bill rate. If the DISC's qualified export receipts exceed the $10 million threshold, income attributable to the excess receipts will be deemed distributed to the shareholders and fully taxable. The DISC, however, may continue to qualify as a DISC. Any excess above the $10 million threshold cannot be channeled through an FSC.

Alternatively, if a corporation elects small FSC status, it will not be required to meet the foreign management and foreign economic process requirements in order to have FTGR. If foreign trading gross receipts exceed $5 million, the income derived from receipts in excess of the $5 million threshold will not qualify as foreign trading gross receipts. No exemption to the requirements for use of the administrative pricing rules is provided for small FSCs. Foreign trading gross receipts of FSCs within a controlled group shall be aggregated for purposes of calculating the $5 million gross receipts threshold.

III. Detailed Analysis

A. Qualification as an FSC

1. General

A corporation's status as an FSC is tested each year. In order for a corporation to qualify as an FSC for a taxable year, it must meet the following statutory requirements for that year:

(i) The corporation must be created or organized under the laws of any foreign country, which, at the

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time of incorporation, maintains with the United States either an exchange of information agreement (as described in §274(h)(6)(C)) or an income tax treaty with respect to which the Secretary of the Treasury certifies that the exchange of information program with such country under such treaty is satisfactory. In addition, an FSC may be created or organized under the laws applicable to any possession of the United States (*i.e.*, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but not the Commonwealth of Puerto Rico).[5]

(ii) The corporation may have no more than 25 shareholders at any time during the taxable year;[6]

(iii) The corporation may not have any preferred stock outstanding at any time during the taxable year;[7]

(iv) During the taxable year, the corporation must maintain an office located outside the United States in a foreign country which meets certain exchange of information requirements (see (i), *supra*), or in any possession of the United States;[8]

(v) The corporation must maintain a set of the permanent books of account (including invoices) at its office located outside the United States;[9]

(vi) During the taxable year, the corporation must maintain at a location within the United States the records which it is required to keep under §6001;[10]

(vii) At all times during the tax year, the corporation must have a board of directors which includes at least one individual who is not a resident of the United States;[11]

(viii) At no time during the taxable year may the corporation be a member of any "controlled group of corporations" of which a DISC is a member;[12]

(ix) The corporation must have made a valid election to be treated as an FSC, and that election must be in effect for the taxable year;[13] and

(x) The corporation's taxable year must be the same as the taxable year of that shareholder (or group of shareholders with the same 12-month taxable year) who has the highest percentage of voting power.[14]

Observation: Unlike the DISC, the FSC is not required to meet a "qualified export receipts" test or "qualified export assets" test.[15]

2. Incorporation Outside U.S. Customs Territory

As an initial matter, an FSC must qualify as a corporation under U.S. law. A foreign entity classified as a corporation under §7701(a)(3) (*e.g.*, associations, joint-stock companies, and insurance companies) will be considered a corporation for purposes of this requirement.

An FSC must be created or organized under the laws of a United States possession or any foreign country that is either (i) a party to an exchange of information agreement that meets the standards of the Carribean Basin legislation,[16] or (ii) an income tax treaty partner of the United States if the Secretary of the Treasury certifies that the exchange of information program with that country under the treaty is satisfactory.

Observation: The Finance Committee stated that it was "aware that exchange of information with certain countries, such as Switzerland, is limited because of the restrictions of their domestic law ... [and] that exchange of information programs may be ineffective if corporate stock may be issued in bearer share form."[17] It stated further that it "expects that the Secretary of the Treasury will take such factors into account in determining whether to qualify a country under this provision."[18] Whatever leeway may have been intended by the Finance Committee with respect to a U.S. treaty partner's obligation with regard to exchange of information appears to have been narrowed considerably by the Conference Agreement, however, where the conferees stated that they "intend that a foreign country, to qualify for this treatment, not be a country that has a statute (or other stated policy) which denies the IRS access to the home office of the FSC for audit purposes ... [and] that the Treasury assure itself of access to the home office of a FSC before certifying a treaty partner or before entering into an exchange of information agreement."[19]

Observation: On July 24, 1984, the Treasury Department released a "Discussion Draft" of an exchange of information agreement designed to satisfy the requirements of the Carribean Basin legislation. The agreement sets forth methods for the exchange of information designed to assist the contracting parties in enforcing their tax laws. Pursuant to the terms of the Discussion Draft, information concerning any person that may be subject to tax in one or both of the contracting countries is to be exchanged without regard to the residence or nationality of that person or of the person who was in possession of the information. As of this writing, it appears unlikely that any Carribean nations will enter into an exchange of information agreement along the lines of the Discussion Draft. They fear that their status as offshore financial centers may be irrevocably harmed by allowing the United States access to corporate financial records.

Observation: In the short term, it appears that U.S. possessions will be the most likely locations for the establishment of FSCs, since the Tax Reform Act of 1984 bars U.S. possessions from taxing any foreign trade income of FSCs derived before January 1, 1987.[20]

A U.S. taxpayer forming an FSC will be subject to Code provisions (*e.g.*, §367) regarding transfers of property out of the United States. These provisions —substantially modified by Section 131 of the Act — provide that certain transfers of appreciated property made in the course of corporate organization, reorganization, or liquidation can be made without recognition of gain to the corporation involved or its shareholders. All other transfers will be taxable. Qualified transfers generally will follow existing IRS guidelines for issuing favorable rulings. Although the mandatory ruling requirement of prior law for tax-free transfers of property from the U.S. to foreign corporations has been eliminated, taxpayers will be required to notify the IRS about outbound property transfers in accordance with regulations to be issued. Except to the extent provided in regulations, these rules will not apply to transfers made before January 1, 1986 (or, if later, the date one year after

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the date on which the corporation ceases to be a DISC), to an FSC of "qualified export assets" (as defined in §993(b) of the Code) held on August 4, 1983, by a DISC in a nontaxable reorganization or incorporation described in §§351 or 368(a)(1).

3. Shareholder Limitation

An FSC may have no more than 25 shareholders at any time during the taxable year. The Finance Committee Report clarifies that a member of the corporation's board of directors that holds qualifying shares required to be owned by a resident of the country under whose laws the FSC is organized will not be counted as a shareholder for this purpose.[21]

4. FSC Stock

An FSC may not have any preferred stock outstanding during the taxable year. The Finance Committee stated that it "intends that a FSC will be allowed to create more than one class of common stock for bona fide business purposes." [22] Thus, a number of small unrelated exporters might set up an FSC to handle their export sales. Each exporter would be issued a different class of common stock, which would pay dividends to each class in proportion to the exports marketed by the owner of that class through the FSC.[23]

The Finance Committee cautioned, however, that one or more of the rights of a class stock may be disregarded if the right has the effect of avoidance of Federal Income Tax. As an example, it noted that dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have net operating loss carryovers.[24]

5. Maintenance of Office Outside the United States

An FSC must maintain an office located outside the United States, although more than one FSC may share an office and the office need not be located in the country in which the FSC is organized.[25] The Finance Committee stated its intention that the office must constitute a "permanent establishment" under income tax treaty concepts to satisfy this requirement.[26]

Observation: The existence of a "permanent establishment" provides a treaty nexus for taxation of the taxable business income and "effectively connected" investment income of nonresident aliens and foreign corporations. While each treaty is a law unto itself, all U.S. treaties may be analyzed in terms of a three-fold test for determining permanent establishment status, namely: (i) the assets test (which assets, buildings, offices and "other fixed places of business" will constitute a permanent establishment); (ii) the agency/relationship test (which agencies and business relationships — dependent agents, independent agents, purchasing agents, partnerships, subsidiaries, and related entities — will or will not constitute a permanent establishment in the absence of a fixed place of business); and (iii) the activities test (which activities are permissible even through a fixed place of business (*e.g.*, the mere purchase of goods, promotional activities, and casual warehousing) and which activities may themselves constitute a permanent establishment according to the degree of sales or business activity involved).

Of the three tests, the assets test appears most appropriate for determining whether a corporation meets the foreign or possessions office requirement. Under this test, mere existence of a fixed business situs in the taxing state will not alone constitute a permanent establishment. Judicial and administrative treaty interpretations require that a fixed place of business be continuously and not sporadically used to engage in business in the taxing state. Thus, under the assets test, a permanent establishment (and, therefore, a FSC foreign or possessions office) will exist only if there is both a fixed place of business and the continuous use of such business situs for commercial activity.[27]

6. Maintenance of Permanent Books of Account

An FSC must maintain a set of the permanent books of account at its office outside the United States. According to the Finance Committee, the permanent books of account must include "at least the quarterly income statements and a year-end balance sheet of the FSC." [28]

7. Maintenance of Records, Statements, and Special Returns

Under §6001, all persons who are required to pay or collect any Internal Revenue tax (except for wage earners and farmers) must keep permanent books of account or records that are sufficient to establish the correct amount of income, credits, deductions, and other matters required to be reported on their returns. An FSC must maintain such books and records at a location within the United States during the taxable year.

8. Nonresident Director

At all times during a taxable year, the FSC must have a board of directors which includes at least one individual who is not a resident of the United States. The nonresident member of the FSC board of directors may be a citizen of the United States, however.[29]

Observation: As a practical matter, two nonresident directors are advisable because the FSC provisions make no allowances for unexpected vacancies on the board.

9. Controlled Group of Corporations Cannot Include FSC and DISC

An FSC cannot be a member of a "controlled group of corporations" of which a DISC (after December 31, 1984, the only DISCs will be "interest charge DISCs," as described in III, G, *infra*) is a member. For FSC purposes, the term "controlled group of corporations" means —

(i) *Parent-Subsidiary Controlled Group* — One or more chains of corporations connected through stock ownership with a common parent corporation if —

(a) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned, directly or indirectly, by one or more of the other corporations; and

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(b) the common parent corporation owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations;

(ii) *Brother-Sister Controlled Group* — Two or more corporations if five or fewer persons who are individuals, estates, or trusts own, directly or indirectly, stock possessing —

(a) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, and

(b) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership, is identical with respect to each such corporation.

(iii) *Combined Group* — Three or more corporations each of which is a member of a group of corporations described in paragraph (i) or (ii), and one of which —

(a) is a common parent corporation included in a group of corporations described in paragraph (i), and also

(b) is included in a group of corporations described in paragraph (ii); and

(iv) *Certain Insurance Companies* — Two or more insurance companies subject to taxation under §802 which are members of a controlled group of corporations described in paragraphs (i), (ii) or (iii). Such insurance companies shall be treated as a controlled group of corporations separate from any other corporations which are members of the controlled group of corporations described in paragraph (i), (ii), or (iii).[30]

10. Election

In order for a corporation to be treated as an FSC for a taxable year, an election must be made by that corporation "in such manner as the Secretary shall prescribe."[31] Presumably, the election will be made by filing a form similar to Form 4876 (the form currently filed by DISCs) with the Internal Revenue Service center with which the corporation will file its income tax return. Once made, the election remains in effect until revoked, even though the corporation may fail to be treated as an FSC (thus being taxed on all its foreign trade income) for a taxable year because it does not meet one of the qualification tests for that year.[32]

a. Time of Election

The time for electing to be treated as an FSC varies depending upon whether the corporation is electing for its first taxable year or for a later year. If the corporation is electing for its first taxable year, then, according to the expressed intention of the Finance Committee,[33] the election must be made on or before the 90th day after the beginning of its first taxable year. If the election is for a taxable year which is not the first taxable year of the corporation, then the election must be made during the last 90 days of the year preceding the year for which the election is to be effective.[34]

Observation: Under section 805(b)(2)(A) of the Act, taxes are forgiven on accumulated DISC income with respect to actual distributions made after December 31, 1984, by a DISC (or former DISC) that is a qualified DISC on December 31, 1984. However, if the parent of a DISC with accumulated income organizes a corporation, and if that corporation makes an FSC election during the 90-day period immediately preceding January 1, 1985 (the effective date of the FSC provisions), the FSC election will automatically terminate the DISC election under regulations to be prescribed by the Secretary pursuant to section 805(b)(5) of the Act,[35] which was added during Conference. However, the Finance Committee stated its intention that "a newly formed corporation . . . be permitted to make an election on or before the 90th day after the beginning of its first taxable year."[36] Thus, §927(f)(1)(A) provides, in part, that "the Secretary may give his consent to the making of an election at such other times as he may designate" consistent with the intent of the Finance Committee and the statute. Accordingly, the Treasury Department has indicated its intention to allow foreign corporations owned by parents of existing DISCs whose accumulated income qualifies for tax forgiveness to make an FSC election on or before the 90th day after January 1, 1985.

b. Shareholders' Consent

An election is valid only if each person who was a shareholder of the electing corporation on the first day of the first taxable year for which the election is effective consents to the election.[37] It is assumed that a shareholder may consent by signing either the consent on a form similar to Form 4876 (applicable to DISCs) or a separate statement of consent attached to such a form.

c. Termination of Election

An election to be treated as an FSC may be voluntarily revoked or involuntarily terminated.[38] An electing corporation may revoke its election at any time after the first year for which the election is effective.[39] A revocation made during the first 90 days of a taxable year is effective for that taxable year, and all subsequent taxable years. However, revocation made after the first 90 days is effective for all taxable years following the current taxable year.[40]

The Treasury is empowered to issue regulations prescribing the manner in which a termination of election shall be made.[41] Presumably, the revocation will be made in a manner consistent with the rules applicable to DISCs.[42] Accordingly, the corporation may revoke the election by filing a statement that the FSC election is revoked with the Service center with which the corporation filed its election. If the corporation has filed a return since electing FSC status, then the statement of revocation would be filed with the Service center with which the corporation filed its last return.

An FSC election automatically terminates if the corporation fails to qualify as an FSC for five consecutive

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taxable years.[43] Once an election has been terminated, the corporation can again be treated as an FSC for later taxable years, but only if it files a new election.[44]

11. Taxable Year of FSC

Under §441(h), the taxable year of the FSC must be the taxable year of the majority shareholder (or group of shareholders with the same 12-month taxable year) who has the highest percentage of "voting power" (as determined on the basis of total combined voting power of all classes of stock of the corporation entitled to vote). If two or more shareholders (or shareholder groups) are tied for the highest percentage of "voting power," the taxable year of the FSC will be the same 12-month period as that of any such shareholders (or shareholder groups). In cases where there is a subsequent change of ownership, the Secretary of the Treasury is directed to prescribe regulations under which these rules will apply, but "only if such change is a substantial change of ownership."

Observation: These rules also apply to DISCs established after March 21, 1984.

B. Effect of FSC Qualification

1. Exempt Foreign Trade Income Exclusion

If a corporation qualifies as an FSC for a taxable year, a portion of its foreign trade income will be exempt from Federal income tax.

Observation: The major advantage of an FSC over a DISC is that the exemption is permanent; there is no recapture of the benefit in future years by corporate shareholders if dividends are paid or the FSC no longer satisfies qualification requirements.

"Foreign trade income" ("FTI") is defined as gross income of an FSC attributable to "foreign trading gross receipts" and includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products or services exported by others.[45] Foreign trading gross receipts ("FTGR"), in turn, are defined as the gross receipts of an FSC which are attributable to the export of certain goods and services.[46]

To achieve exemption, the FSC provisions treat FTI as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.[47] The portion of FTI that is treated as exempt FTI depends on the "pricing rule" used to determine the amount of FTI earned by the FSC.[48] If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of §482, then exempt FTI is 32 percent (30 percent in cases involving corporate shareholders of FSCs) [49] of the FTI derived from the transaction.[50] For these purposes, FTI will not include any income attributable to patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property.[51]

On the other hand, if the income earned by FSC is determined under the "special administrative pricing rule,"[51][52] then the exempt FTI is 16/23 (15/23 in the case of corporate FSC shareholders) [53] of the FTI derived from the transaction.[54] Where applicable, the "special administrative pricing rules" permit a transfer price on a sale to an FSC (or FSC commissions) which will yield FTI equal to (1) 1.83 percent of the FTGR derived from the sale, or (2) 23 percent of the combined taxable income ("CTI") of the FSC and the transferor which is attributable to the FTGR derived from the sale, but in no event may the amount in (1) exceed 2 times the amount in (2) (*i.e.*, 46 percent of CTI).[55]

Thus, if one of the two "special administrative pricing rules" is used, tax-exempt FTI will equal either (1) 1.27 percent (1.19 percent in cases involving corporate FSC shareholders) of FTGR, or (2) 16 percent (15 percent in cases involving corporate FSC shareholders) of CTI, but in no event may the amount in (1) exceed 2 times the amount in (2) (*i.e.*, 32 percent (30 percent in cases involving corporate FSC shareholders) of CTI).

Any deductions of the FSC properly apportioned and allocated to the FTI derived by the FSC from a transaction will be allocated on a proportionate basis between exempt and nonexempt FTI.[56] Thus, deductions allocable to exempt FTI may not be used to reduce the taxable income of the FSC.

The following example illustrates the determination of exempt FTI using the three "pricing rules":

> *Example*: An FSC purchases export property from a related supplier and sells the property for $1,000 of FTGR. The FSC incurs expenses attributable to the sale of $225. The FSC's cost of goods sold (*i.e.*, transfer price) is $756.70 under the 1.83 percent of FTGR method and $752 under the 23 percent of CTI method. (For examples as to how these transfer prices were derived under the facts as set forth in this example, see the detailed discussion of the "special administrative pricing rules" in III, E, *infra*). It is assumed that if the FSC's cost of goods sold is $720, the price can be justified as satisfying the standards of §482. Finally, it is assumed that the shareholder of the FSC is a corporation. Thus, under the tax preference rules as amended by the Act (*see* footnote 49, *supra*), exempt FTI will be 15/23 of FTI (where the "special administrative pricing rules" are used) and 30 percent of FTI (where the transfer price to the FSC was determined under §482).

The FSC's FTI, exempt FTI, and expenses properly apportioned and allocated to FTI from the transaction are as follows:

(a) *If the transfer price to the FSC was determined under the 1.83 percent of FTGR method:*

FTGR	$1,000.00
Less cost of goods sold	(756.70)
FTI	$ 243.30
Exempt FTI (15/23 x $243.30)	$ 158.67
Expenses allocable to exempt FTI (158.67/243.30 x $225)	(146.73)

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Taxable income of FSC not subject to U.S. tax ($158.67 - $146.73)	$ 11.94

(b) *If the transfer price to the FSC was determined under the 23 percent of CTI method:*

FTGR	$1,000.00
Less cost of goods sold	(752.00)
FTI	$ 248.00
Exempt FTI (15/23 x $248)	$ 161.73
Expenses allocable to exempt FTI (161.73/248 x $225)	(146.73)
Taxable income of FSC not subject to U.S. tax ($161.73 - $146.73)	$ 15.00

(c) *If the transfer price to the FSC was determined under Section 482:*

FTGR	$1,000.00
Less cost of goods sold	(720.00)
FTI	$ 280.00
Exempt FTI (30% x $280)	$ 84.00
Expenses allocable to exempt FTI (84.00/280 x $225)	(67.50)
Taxable income of FSC not subject to U.S. tax ($84 - $67.50)	$ 16.50

2. Non-exempt Foreign Trade Income, Investment Income, and Carrying Charges

Section 921(d) provides that: (i) all FTI other than exempt FTI and so-called "section 923(a)(2) non-exempt income";[57] (ii) all interest, dividends, royalties, and other investment income[58] received or accrued by FSC; and (iii) all carrying charges[59] received or accrued by an FSC will be treated as income effectively connected with a trade or business conducted through a "permanent establishment" of such corporation within the United States. FTI other than exempt FTI and "section 923(a)(2) nonexempt income" generally will be taxed currently and treated as derived from sources within the United States, rather than as foreign source income, for purposes of the foreign tax credit limitation (*see* §904).[60] Investment income and carrying charges generally will be taxed currently to the FSC, subject to the normal sourcing and foreign tax credit rules (*see* §904).

Observation: The fact and numbers necessary to compute commissions to be paid a commission agent FSC will not generally be available for several months after the close of a taxable year. Thus, unless regulations allow a contractual arrangement whereby a commission agent FSC may be paid its commissions for a taxable year up to, for example, the due date of the related supplier's tax return, a portion of that payment could be regarded as a carrying charge or imputed interest taxed currently to the FSC.

"Section 923(a)(2) non-exempt income" will be taxed to the FSC as if it were not a FSC. In other words, the FSC may be taxed on such income if it were "effectively connected" with the conduct of U.S. business, or the FSC's shareholder may be taxed because it is subject to Subpart F.

3. Denial of Tax Credits and Treaty Benefits

An FSC may claim no credit other than the foreign tax and possessions tax credit,[61] the credit for tax withheld at source on nonresident aliens and foreign corporations,[62] and the credit for tax imposed on certain uses of gasoline and special fuels.[63] The foreign tax credit that may be claimed by an FSC is limited, however, to income, war profits, and excess profits taxes paid or accrued with respect to all FSC income other than FTI.[64] An FSC may not claim any benefits under any income tax treaty between the United States and any foreign country.[65]

4. Participation in International Boycotts

Pursuant to §927(e)(2), the Secretary of the Treasury is directed to issue regulations that will "limit" the exempt FTI of an FSC that participates in or cooperates with an international boycott. In addition, an FSC's exempt FTI will be "limited" to the extent that any illegal bribe, kickback, or other payment is made for an official employee or agent of a government.

The statute does not define how the regulations issued by the Secretary of the Treasury will "limit" an FSC's exempt FTI. However, the Finance Committee Print suggests that such regulations may be similar to Treas. Regs. §1.995-2(a)(b), which require DISC shareholders to recognize constructive dividends of pro rata shares of DISC income earned while the DISC participated in an international boycott, and the sum of any illegal bribe, kickbacks, or other payments paid on or in behalf of a DISC directly or indirectly to an official, employee, or agent in fact of a government.

C. Export Property

Central to the concept of the FSC is "export property." Like the DISC, the FSC provisions were enacted to encourage the sale abroad of this type of property.

1. In General

FSC "export property" is property which is not "excluded property" or "property in short supply" and meets all of the following three tests:

(i) It is "manufactured, produced, grown, or extracted in the United States by a person other than a FSC;"[66]

(ii) It is "held primarily for sale, lease, or rental in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States;"[67] and

(iii) Not more than 50 percent of its fair market value "is attributable to articles imported into the United States."[68]

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Observation: Section 927(d)(3) clarifies that for purposes of the FSC, the term "United States" includes the Commonwealth of Puerto Rico. Thus, "export property" would include property manufactured, produced, grown, or extracted in Puerto Rico.

Observation: Because the FSC definition of "export property" closely tracks the DISC definition, it may be assumed, except where otherwise indicated, that the DISC regulations underlying the DISC definition of "export property" [69] will carry over to the FSC.

2. Manufactured, Produced, Grown, or Extracted

Property is "export property" only if it is manufactured, produced, grown or extracted in the United States by any person provided that person is not qualified as an FSC and is not treated as an FSC.[70] Thus, manufacture or production by a FSC prevents property from qualifying as export property.

3. Destination

"Export property" must be held primarily for sale or lease in the ordinary course of trade or business to an FSC or to any other person, and such sale or lease must be for direct use, consumption or disposition outside the United States.[71] However, property leased or rented by an FSC for use by a corporation related to the FSC is not export property.[72]

Property is generally considered sold for direct use, consumption, or disposition outside of the United States if it satisfies the so-called "destination test." The Finance Committee echoed the current DISC regulations [73] in stating its intention that "the destination test ... will be considered satisfied if the FSC delivers the property to a carrier or freight forwarder for ultimate delivery, use, or consumption outside of the United States" and that "[t]his rule will apply without regard to (1) the F.O.B. point or place of passage of title, (2) whether the purchaser is a United States or foreign purchaser, or (3) whether the property is for use of the purchaser or for resale." [74]

4. Excluded Property

As with the DISC provisions, the term "export property" does not include "excluded property,"[75] defined as:

> (i) property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member;" [76]
>
> (ii) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property;[77]
>
> (iii) oil or gas (or any primary product thereof);[78] or
>
> (iv) products the export of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2) (C) of section 3 of the Export Administration Act of 1979 (relating to the protection of the domestic economy).[79]

In addition, property that is manufactured, produced, grown, or extracted in the United States by a person other than an FSC which the President has determined is in short supply and which he has so designated in an executive order will not be treated as export property during the period beginning with the date specified in the executive order and ending with the date specified in the executive order setting forth the President's determination that the property is no longer in short supply.[80]

a. Leases

As a general rule, if property is leased to a member of the "controlled group of corporations" which includes the FSC, it is "excluded property"; *i.e.*, it is not export property. As with the DISC, however, it is assumed that if the second member of the group in turn leases the property to an unrelated party for use predominantly outside of the United States, then that property is not excluded property.[81]

This second member could be domestic or foreign.[82] If the unrelated party subleases the property to a member of the same "controlled group of corporations" as the FSC, then the property would not be export property.[83] Thus, it is the ultimate use of the property which determines whether property is leased to a member of the "controlled group of corporations" in a manner which results in excluding the property.

Observation: In the case of films, tapes, records, or similar reproductions, the ultimate use of the property is considered to be the sale or exhibition of the property to the general public.[84] For example, film prints leased by an FSC to a foreign member of a "controlled group of corporations," which makes copies from the prints and then leases the copies to foreign persons who are not members of such group for showing to the general public, are not disqualified because the ultimate use of the prints is for leasing of the copies outside such group.[85]

b. Natural Resources

The only natural resources specifically excluded from the definition of "export property" are oil or gas (or any "primary product" thereof). Coal and uranium products, and other depletable products (other than oil and gas), specifically excluded from the definition of "export property" under the DISC rules will not be excluded under the FSC legislation, however.[86]

D. Foreign Trading Gross Receipts

1. In General

The key to whether an FSC has exempt FTI for a taxable year is whether any of its gross receipts for such year qualify as "foreign trading gross receipts" ("FTGR").

Generally, "gross receipts" are the total amounts received or accrued by a person from the sale, lease or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources.[87] In the case of a transaction which gives rise to a commission, the term "gross receipts" is defined to mean the amount of the gross receipts derived by the principal from the sale, lease, or rental of the property on which the commission arose.[88] Thus, in the case of a commission agent FSC, the reference to gross receipts is really a reference to the gross receipts of the principal of the FSC.

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An FSC's gross receipts will qualify as FTGR only if the following three requirements are met: (i) the gross receipts of the FSC must be attributable to the sale, exchange, or other disposition of export property, the lease or rental of export property, for services related and subsidiary to the sale or less of export property, engineering and architectural services, or export management services;[89] (ii) the management of the FSC during the taxable year must take place outside the United States;[90] and (iii) the economic processes with respect to a particular transaction must take place outside the United States.[91]

2. Qualified Transactions

Transactions generating gross receipts eligible for treatment as FTGR are similar to those that give rise to "qualified export receipts" for purposes of the DISC rules.[92] In view of the fact that the Finance Committee made direct reference to the regulations regarding "qualified export receipts" in explaining the transactions qualified to generate FTGR,[93] it may be assumed that the such regulations will be modified and substantially carried over to the FSC.

a. Sales of Export Property

FTGR includes gross receipts from sales, exchanges, or other dispositions of export property made directly by the FSC, as well as by any principal for whom the FSC acts as a commission agent.[94] The sale, exchange, or other disposition must be pursuant to a contract entered into with the purchaser by the FSC, or by the FSC's principle.[95]

b. The Lease or Rental of Export Property

Leases or rentals of export property by a FSC, or by any principal for whom the FSC acts as a commission agent, to unrelated persons using such property outside the United States will produce FTGR.[96] Presumably, such property must be held by the FSC (or by a principal for whom the FSC acts as a commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of such lease, and the FSC must qualify as an FSC for its taxable year in which the term of the lease begins.[97]

c. Services Related and Subsidiary to the Sale or Lease of Export Property

Gross receipts from the performance of services which are both related to and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by the corporation providing the services may qualify as FTGR. The services must actually be furnished by the FSC which realized income from the sale or exchange of the export property, or by the person who sold or leased the export property to which the services relate. In the latter case, the FSC must act as a commission agent with respect to the sale or lease of the property and with respect to the services.[98]

d. Engineering and Architectural Services

Gross receipts from engineering or architectural services on foreign construction projects which are either located abroad or proposed for location abroad may qualify as FTGR. Presumably, the services must actually be performed by the FSC or by a person who has contracted with the FSC to furnish the services, provided that the FSC acts as principal with respect to the furnishing of the services or as the commission agent with respect to the services. If, as under the DISC rules, the services can also be provided by a related supplier, the FSC would have to be a commission agent with respect to the services pursuant to a supplier's agreement.[99]

e. Export Management Services

Gross receipts for certain managerial services provided to an unrelated FSC (or DISC) may qualify as FTGR. As under the DISC rules, it may be assumed that the services must aid the other FSC (or DISC) in realizing FTGR. Like the DISC system, at least 50 percent of the gross receipts of the FSC providing the services for the year must consist of gross receipts derived from the sale or lease of export property or the furnishing of related and subsidiary services.[100] Management services will include, for example, preparing export market studies and contacting potential foreign purchasers.[101]

Observation: The FSC provisions originally passed by the Senate expanded the benefits for managerial services beyond those available under the DISC provisions.[102] Although the bill as passed requires that an FSC or DISC have at least 50 percent of its income from exporting before income from managerial services provided to an unrelated party will be accorded beneficial treatment, the conferees agreed to ask the Treasury Department for a study on services.[103] In particular, the conferees stated their expectation that the study "consider the revenue impact of FSC benefits for services" and directed the Secretary of the Treasury, in consultation with the Office of the United States Trade Representative, to undertake a study of the advisability of providing the benefits allowed under the FSC election "for profits from services performed in the United States and sold outside the United States."[104] The Treasury Department is to report on the results of this study to the Senate Finance Committee and the House Ways and Means Committee by January 18, 1985.

f. Gross Receipts Not Included in FTGR

Gross receipts from the sale, lease, or other disposition of export property or from qualified services will not constitute FTGR if: (i) they arise from the sale or lease of export property or the furnishing of services for ultimate use in the United States; (ii) they arise from the sale or lease of export property or the furnishing of services accomplished by a subsidy granted by the United States or by any instrumentality of the United States; (iii) they arise from the sale or lease of export property or the furnishing of services for use by the United States or any instrumentality of the United States where the use of the export property or the services is required by law or regulations; (iv) they arise from the sale or lease of export property or furnishing of services to another FSC which is a member of the same controlled group of corporations of which the transferor FSC is a member; and (v) they constitute investment income or carrying charges.[105]

(1) Ultimate Use Test

Property which is sold or leased for ultimate use in the United States does not give rise to FTGR.[106] This provision appears unnecessary since such property is not export property in any event.[107] Accordingly, rules for determining whether this exclusion applies will presumably be identical

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to the rules for determining when property is held for use outside the United States.[108]

(2) Use by the United States

Sales or leases of export property for use by the United States, or the furnishing of engineering or architectural services to the United States, or any instrumentality thereof will not constitute FTGR if such use of export property or services is required by law or regulation.[109]

(3) Subsidized Transactions

Sale, lease, or other disposition of export property or the furnishing of otherwise qualified services will not give rise to FTGR if the transaction is pursuant to a subsidy granted by the United States or any of its instrumentalities.[110] Current DISC regulations list several programs that may qualify as subsidies for this purpose.[111]

(4) Intra-Group Transactions

Transactions between related FSCs cannot give rise to FTGR of those FSCs.[112] For example, a sale by one FSC to a related FSC will not give rise to FTGR of the first FSC, but a sale by the second FSC of those same goods to an unrelated foreign purchaser will result in FTGR of the second FSC.[113]

(5) Investment Income and Carrying Charges

Investment income and carrying charges are excluded from the definition of FTGR.[114] Investment income includes interest, dividends, rent (except from a qualified lease or rental of export property), royalties, annuities, the income and the gain from trading in stocks, securities or commodities (and certain futures), and other miscellaneous passive income.[115] Carrying charges include any amount in excess of the price for an immediate cash sale and any other unstated interest.[116]

Observation: Income attributable to excluded gross receipts will not be FTI and, therefore, no portion of such income will be exempt from tax. For example, investment income and carrying charges will be included in the taxable income of the FSC and, therefore, subject to full U.S. tax. However, such income will be eligible for foreign tax credits.

3. Foreign Management

The gross receipts of an FSC will be eligible to be treated as FTGR for the taxable year only if the "management" of the FSC during such taxable year takes place outside the United States.[117] The "management" of an FSC fulfills this requirement for the taxable year if:

(i) All meetings of the board of directors of the FSC and all meetings of the shareholders of the corporation are outside the United States;

(ii) The principal bank account of the FSC is maintained outside the United States at all times during the taxable year; and

(iii) All dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the FSC paid during the taxable year are disbursed out of bank accounts of the corporation maintained outside the United States.

Observation: Although the three statutory management activities must take place outside the United States during a particular taxable year, they need not take place in the foreign country or U.S. possession in which the FSC is incorporated.

a. Situs of Board of Directors and Shareholders Meetings

The statute does not require that the board of directors and shareholders actually meet during the taxable year, but requires only that such meetings take place outside the United States. In addition, the statute and the Committee Reports do not indicate whether proxies may be used for shareholders meetings. Regulations should address the regularity and manner of holding such meetings, which, in any event, would have to be conducted pursuant to the commercial laws of the possession or country of incorporation.

Query: What is the location of conference telephone meetings of the board of directors? Assuming such meetings may take place under the law of the possessions or country of incorporation, the location could be determined by the location of the majority of participants.

b. Principal Bank Account

Although the principal bank account of the FSC must be maintained outside the United States at all times during the taxable year, neither the statute nor the Committee Reports do not indicate whether proxies may be used for shareholders meetings. Regulations should address the regularity and manner of holding such meetings, which, in any event, would have to be conducted pursuant to the commercial laws of the possession or country of incorporation.

c. Disbursement of Dividends, Legal and Accounting Fees, and Salaries of Officers and Board Members

FSCs must disburse all "dividends, legal and accounting fees, and salaries of officers and [board] members" from any (*i.e.*, not necessarily the principal) bank account(s) outside the United States. This requirement raises potential issues where a U.S. parent company pays employee salaries or vendor fees (in particular, audit and accounting fees) for activities affecting the entire affiliated group, but then rebills the proper portion of the total salaries or fees to other U.S. and foreign affiliates. In such cases, it would appear that as long as an FSC is billed and pays its U.S. parent or other affiliate for its share of the total cost out of a bank account of the United States, the statutory requirement will be met even though the parent's initial payment of the entire amount was disbursed from an account within the United States. This result would apply whether the FSC is billed by the parent at the time of its payment to the vendor or at some later date (*e.g.*, IRS determination of a §482 adjustment with respect to the amount to be paid by the FSC). In any event, accurate records should be maintained in order to trace such payments.

Query: Must officers and directors of an FSC be paid a salary by the FSC for acting in their respective capacities? The statute and the Committee Reports are silent on this point. Presumably, officers and directors of an FSC will be full-time employees of the related supplier or other related

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company who often do not receive compensation for acting in similar capacities for other related subsidiaries.

4. Foreign Economic Processes

The gross receipts of an FSC from any transaction will be eligible to be treated as FTGR only if the "economic processes" with respect to such transaction take place outside the United States. Such "economic processes" relate to (i) the sales portion of the transaction and (ii) the direct costs incurred by the FSC with respect to the transaction.[118] In either case, the FSC may enter into a contract with an agent for the performance of certain activities.[119] In this regard, the statute directs the Secretary of the Treasury to prescribe "such regulations as may be necessary" with regard to the economic process requirement in the case of commissions, rentals, and furnishing of services.[120]

Observation: In all cases where a FSC or its agent must perform certain activities, the FSC may contract with its U.S. parent or with any other party, related or unrelated, to act as its agent.[121]

a. Sales Portion of the Transaction

The gross receipts from a transaction will not be eligible to be treated as FTGR unless the FSC, or a person under contract with the FSC, participates outside the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to the transaction.[122] This requirement will be satisfied if the FSC, or its agent, performs any one of these three activities with respect to a transaction outside the United States. The activities need not be performed in the country or U.S. possession in which the FSC is incorporated.

(1) Solicitation

For purposes of the statute, "solicitation" refers to the "communication (either by telephone, telegraph, mail, or in person) by the FSC, or its agent, to a specific, targeted, potential customer regarding a transaction." [123]

(2) Negotiation

For purposes of the statute, "negotiation" includes any "communication by the FSC, or its agent, to a customer or potential customer of the terms of sale, such as the price, credit, delivery, or other specification." [124]

(3) Making of a Contract

For purposes of the statute, the term "making of a contract" includes "the performance by the FSC, or its agent, of any of the elements necessary to complete a sale, such as making an offer or accepting the offer." [125] In addition, the written confirmation by the FSC, or its agent, to the customer of an oral agreement which confirms variable contract terms or specifies (directly or by cross reference) additional contract terms will be considered the "making of a contract." [126]

Observation: The location of a solicitation, negotiation, or making of the contract is determined by the place where the activity is initiated by the FSC, or its agent.[127]

Query: Will export orders which are received in the United States by the related supplier, consolidated, and then forwarded to the FSC for official acceptance satisfy the sales portion of the economic process requirement? The statute and the Committee Reports are silent on this point. The related suppliers arguably should not be considered to have initiated acceptance if it merely collects orders before passing them on to the FSC for acceptance. Such a routing would avoid disrupting current order flow to the related supplier and eliminate the danger of a communications failure between customer and supplier which could result in lost U.S. exports.

Observation: The Finance Committee Print provides that the sales requirement will be considered to have been met with respect to sales to a single customer during any taxable year if "(1) the export property consists of either fungible products, or products which are substantially similar (*i.e.*, enumerated in a product category of the *Standard Industrial Classification Manual* and for manufactured products, a seven-digit level in the Bureau of the Census, *Numerical List of Manufactured Products*); (2) the products are sold by the FSC (or its agent) under a single contract; (3) the contract has a term of one year or less which specifies the material terms of each such sale; and (4) if the FSC or its agent performs any one of the three activities once with respect to all such sales." [128] The fact that the contract in such an arrangement must have a term of one year or less appears aimed at GATT concerns that sufficient foreign activity take place with respect to particular transactions. (The longer the term of the contract, the less significant may be the foreign activity associated with the groupings of transactions covered by the contract.) On the other hand, if a long term (*i.e.*, greater than one year) contract does not require the foreign purchaser to acquire all of the export property available under the contract, and, therefore, requires additional solicitation and negotiation by the FSC (or its agent) in order to sell such property, then it appears such a contract would generate adequate foreign activity for GATT purposes.

b. Direct Cost Tests

(1) The 50-Percent and 85-Percent Tests

Gross receipts from a transaction will not be eligible to be treated as FTGR unless the "foreign direct costs" incurred by the FSC attributable to the transaction equal or exceed 50 percent of the "total direct costs" incurred by the FSC with respect to the transaction (or the FSC meets an alternative 85-percent test, described below).[129]

Example: FSC A incurs total direct costs of $100 with respect to a transaction. Such costs are divided equally among the five foreign activity categories (*i.e.*, total direct costs with respect to each foreign activity category equal $20). Ten dollars of the total direct costs attributable to each foreign activity constitutes foreign direct costs. Thus, the foreign direct costs with respect to the transaction total $50. The FSC will satisfy the 50 percent test.

The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the FSC attributable to five categories of activities relating to the disposition of export property: (i) "advertising and sales promotion;" (ii) "the processing of customer orders and the arranging for delivery of the export property;" (iii) "transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning

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of such relationship for such transaction) to the delivery to the customer;" (iv) "the determination and transmittal of a final invoice or statement of account and the receipt of payment;" and (v) "the assumption of credit risk.[130] The activities generating "total direct costs" are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC.[131]

The term "foreign direct costs" means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.[132] Although the activities must be performed outside the United States, either the FSC or any person (*e.g.*, the FSC's parent) acting under contract with a FSC may perform the activities.

As noted above, the requirement that the foreign direct costs incurred by the FSC equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85-percent test. Under this alternative test, an FSC will be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of each of those two activities.[133]

Example: FSC B incurs total direct costs of $100 with respect to a transaction. Such costs are divided equally among the five foreign activity categories (*i.e.*, total direct costs with respect to each foreign activity equal $20). The foreign direct costs attributable to three of the foreign activities total $15. The foreign direct costs attributable to each of the remaining two foreign activity categories are $17. The foreign direct costs attributable to the transaction total $49. Thus, the FSC will not meet the 50-percent test. However, because the $17 in foreign direct costs incurred by the FSC attributable to each of two of the five activities relating to the transaction equal 85 percent of the total direct costs (*i.e.*, $20) of each of those activities, the FSC satisfies the alternative 85-percent test.

Observation: The Finance Committee Print states that "[o]nly the direct costs paid or accrued by the FSC *or its agent* will be taken into consideration in meeting the direct cost test." (Emphasis supplied.)[134] The implication of that statement is that the direct cost tests may be satisfied with respect to payments actually paid or accrued by an FSC agent. That implication finds no support in the statute, however, which requires that the total direct costs be incurred by the FSC (although the activities relating to such costs may be performed either by the FSC or any person acting under contract with the FSC).[135] Thus, if an FSC agent pays or accrues any direct costs with regard to any of the activities set forth in the statute, such costs must be reimbursed by the FSC in order to meet the direct cost tests.

Observation: The Finance Committee Print provides that "[i]t is not necessary to incur expenses in all categories to use either the 50-percent or the 85-percent tests . . . [and if] no costs are incurred with respect to the activities in the category, that category will not be taken into account in meeting the requirement."[136]

Query: Suppose an FSC incurs total direct costs of $100 with respect to a transaction and that such costs are attributable to only two of the five foreign activity categories (in other words, the FSC incurs no expenses in the other three foreign activity categories). Suppose further that the foreign direct costs with respect to the transaction total $50. The FSC satisfies the 50-percent test, but not the 85-percent test. However, since the 85-percent test is simply an alternative test designed to enable an FSC to satisfy the direct cost requirement in cases where it cannot meet the 50-percent test, the FSC's failure to meet the 85-percent test should have no adverse consequences.

Observation: A different direct cost test may be applied for different transactions or groupings; *i.e.*, the 50-percent test can be used in one transaction while the 85-percent test can be used in another.[137]

Observation: The principal problem with respect to the foreign direct cost test will be cost accounting. The discussion of each foreign activity category will illustrate this fact.

(2) Categories of Activities

Five categories of activities generate the "total direct costs" which must be incurred by the FSC, but these activities may be performed at any location (*i.e.*, not necessarily the foreign country or U.S. possession in which the FSC is incorporated) by the FSC or any person acting under a contract with such FSC.

(a) Advertising and Sales Promotion

This category includes two distinct activities — "advertising" and "sales promotion." Thus, if costs are incurred by an FSC with respect to either activity, this category will be satisfied. The Finance Committee Print defines "advertising" as "an appeal, related to a specific product or product line made through any medium and directed at all or a part of the general population of potential export customers."[138] Advertising not related to a specific product or product line, such as the cost of corporate image building, and advertising primarily directed at customers in the United States will not be considered advertising for purposes of the statute.[139]

The Finance Committee Print defines "sales promotion" as "an appeal made in person to a potential export customer for the sale of the specific product or product line made in the context of trade shows or annual customer meetings."[140] The cost of trade shows and annual customer meetings (including payments to organizers or other persons hired for the event), but not the cost of salaries and commissions of direct sales people, will be considered total direct costs of sales promotion for purposes of the statute.[141]

Observation: Under certain circumstances, "sales promotion" for purposes of the direct cost test aspect of the foreign economic processes requirement may also constitute "solicitation" for purposes of the sales portion aspect. For example, if the FSC (or a FSC agent) has entered into a long-term (over one year) contract for the sale, lease, or other disposition of export property with a foreign customer which does not require the foreign customer to purchase or

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lease all of the export property that might be available under the contract, the FSC (or the FSC agent) will have to communicate with (*i.e.*, solicit) the customer regarding export property as it becomes available in order to conclude another sale or lease. Such communication might well take place in the context of an annual customer meeting, and, therefore, constitute "sales promotion."

Observation: With respect to the location of advertising and sales promotion activity, the Finance Committee Print provides as follows: "For determining foreign direct costs, the location of the advertising activity will be determined by the place where it is aired, displayed, published, or otherwise presented to the potential customer. With respect to broadcast media, such as radio or television, the location will be determined by the place to which the signal is transmitted. In the case of print media, the location will be determined by where the publication is distributed, not where it is printed. The location of trade promotion activity will be determined by where the customer meeting or trade show is held." [142]

Query: Are all direct costs associated with an advertising compaign, commercial, etc., which is planned, developed, coordinated, produced and paid for in the United States, but aired only outside the United States, considered foreign direct costs? If the ad is aired or distributed only outside the United States, all direct costs associated with the ad arguably should be considered foreign costs, without regard to where they occurred.

(b) Processing Customer Orders and Arranging For Delivery

This category includes two separate activities — "processing customer orders" and "arranging for delivery." Thus, if costs are incurred by an FSC with respect to either of these activities, this category will be satisfied.

The Finance Committee Print defines "processing customer orders" as "notifying the related supplier of the order and of the requirements for delivery of the export property." [143] The Finance Committee Print defines "arranging for delivery" as "taking necessary steps to ship the export property to the customer in accordance with the requirements of the order, but . . . not . . . packaging, crating, and similar pre-transportation costs." [144] The direct costs of "arranging for delivery" will include the cost of salaries for clerks, telephone, telegraph, and documentation, but not shipping expenses.[145]

Observation: Delivery can occur within or outside the United States.[146] For example, an FSC will be considered to have arranged for delivery if the FSC or its agent contacted a trucking company and shipping line to provide transportation for a particular shipment from an interior point in the United States to the location outside the United States where the buyer assumes title.

Observation: In the case of certain property, where the normal industry practice is to make delivery at or near the place of manufacture of such property within the United States, an FSC will be considered to have arranged for delivery if the FSC or its agent notifies the buyer of the time and place of delivery.[147]

(c) Transportation

The Finance Committee Print defines "transportation" as "the activity undertaken by the FSC or its agent for shipping the export property during the period it owns such property." [148] Total direct costs of "transportation" will include expenses incurred by the FSC or its agent for transporting the export property, but not transportation costs paid directly by the customer.[149] The amount of total direct costs treated as foreign direct costs will be determined on the basis of the ratio of mileage outside the U.S. customs territory to total transportation mileage.[150]

Observation: If the FSC is acting as a commission agent, transportation will be the activity that is undertaken to ship the export property after the commission relationship begins, even if the relationship begins after the property leaves U.S. customs territory.[151]

Observation: With respect to fungible commodities, total direct costs will include only those transportation costs which are incurred after goods have been identified to a contract.[152]

Observation: Attention to shipping terms regarding passage of title to the buyer may be important in determining whether the buyer or the seller are viewed as transporting the goods. Thus, a buy-sell FSC could take title to the export property at the U.S. port of embarkation and hold title until it passes to the customer, either at sea or at a later stage, and all of the transportation costs during such period would be foreign direct costs provided they are not directly paid by the customer.

(d) Determination and Transmittal of the Final Invoice or Statement of Account and the Receipt of Payment

This category includes two separate activities — the "determination and transmittal" of the final invoice and the "receipt of payment." Accordingly, if costs are incurred by the FSC with respect to either activity, this category will be satisfied.

The Finance Committee defines "determination and transmittal" as "the assembly of the final invoice or statement of account and the forwarding of the document to the customer." [153] It defines "final invoice" as "the invoice upon which payment is made by the customer." [154] An invoice transmitted after payment is made, as a receipt for payment, would satisfy this definition. The Finance Committee Print further defines "statement of account" as "any summary statement transmitted to a customer giving the status of transactions occurring within an accounting period that does not exceed one taxable year." [155]

Observation: A single final invoice or statement of account can cover more than one transaction with one customer.[156] Presumably, therefore, a "statement of account" could be prepared by an FSC (or its agent) on an annual basis with respect to groups of transactions completed pursuant to the terms of a long-term (*i.e.*, greater than one year) contract.

The direct costs with regard to the "determination and transmittal" of a final invoice or statement of account include the costs of office supplies, office equipment, clerical salaries, mail, etc., if directly attributable to the assem-

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bly and transmittal of a final invoice or statement, but not the engineering or cost accounting functions involved in the establishment of a price.[157] For example, the cost of assembling the statement of account at the FSC's foreign office and mailing it from that office to the customer would meet this definition.[158]

The Finance Committee Print defines "receipt of payment" as "the crediting of the FSC bank account by the amount of proceeds associated with the transaction." [159]

Observation: The Finance Committee Print provides that the "total direct costs for this activity include all the expenses incurred by the FSC for maintaining a bank account in which the payment is deposited." [160] This seems somewhat at odds with the concept of the foreign economic processes requirement, since both the sales portion and direct cost portion of the requirement are to be applied on a transaction-by-transaction basis (except where grouping of transactions is permitted). Assuming, nevertheless, that the Finance Committee description of the "receipt of payment" activity and its associated costs is correct, then this activity may be satisfied where an FSC maintains its principal bank account outside the United States pursuant to the FSC foreign management requirements.[161]

Observation: Initial payment may be received in the United States as long as the proceeds are transferred immediately to a bank account of the FSC outside the United States.[162]

(e) Assumption of Credit Risk

The Finance Committee Print defines this category as "bearing the economic risk of nonpayment with respect to a sale, lease, or contract for the performance of services." [163] An FSC will be considered to bear such risk if it contractually bears such risk and if either a debt becomes uncollectible within the accounting period,[164] or an addition is made to the bad debt reserve [165] of the FSC that is allowed as a deduction under present law.[166]

If a debt becomes uncollectible within the accounting period or an addition is made to the bad debt reserve of the FSC, the FSC must subtract from its FTI the appropriate percentage of the FSC's (and related supplier's) bad debt expense.[167] The bad debt expense will be roughly equivalent to the transfer price based upon either the actual stated price of export property (in transactions between unrelated parties), an arm's-length pricing approach (*see* §482), or one of the two "special administrative pricing rules."

The following examples illustrate the manner in which the foreign direct costs (*i.e.*, the amount subtracted from FTI) associated with a transaction with respect to which an FSC has assumed the credit risk may be calculated. In each example, the FSC has purchased export property from a related supplier and sold the property for what would have been $1,000 of FTGR. The FSC has incurred expenses attributable to the sale of $225. The combined taxable income of the FSC and the related supplier would have been $100, if there had been actual payment. It is assumed that if the related supplier sold the export property to the FSC at a price of $720, the price could be justified as satisfying the standards of code §482. Further, it is assumed that the transfer price in each transaction is equivalent to the bad debt expense. Finally, it is assumed that the shareholder of the FSC is a corporation, and that, therefore, where income is determined without regard to the administrative pricing rules, 30 percent of FTI derived from a transaction will be exempt, and that where income is determined with regard to administrative pricing rules, 15/23 of FTI derived from such transaction will be exempt. (*See* footnote 49, *supra.*)

Example: *Transaction using §482 pricing method:*

30% x $720 (bad debt expense) = $216

$216 is the FSC's foreign direct cost of assuming the credit risk of the transaction.

Example: *Transaction using the 23 percent of CTI method:* [168]

23% x $752 (bad debt expense) [169] = $172.96.

$176.96 is the FSC's foreign direct cost of assuming the credit risk of the transaction.

Example: *Transaction using 1.83 percent of FTGR method:* [170]

$$\frac{\text{\$18.30 (FSC's taxable income—1.83\% X FTGR)}}{\text{\$100 (CTI from the transaction)}} \times \text{\$756.70 (bad debt expense)}\ ^{171} = \$138.47$$

$138.47 is the FSC's foreign direct cost of assuming the credit risk of the transaction.

Observation: The Finance Committee Print explains that in some circumstances, a taxpayer may not have any receivables that become uncollectible within the taxable year; even though the taxpayer was contractually assuming the risk of loss, there is no actual loss or bad debt expense.[172] In such cases, "the FSC will be considered to bear the risk of loss, only if it incurs an actual loss (or is allowed to deduct an addition to a bad debt reserve under present law) in at least one year within a three year period." [173] In this regard, the Finance Committee Print contains the following example: if an FSC contractually assumes the risk of loss but incurs no bad debt expenses in the first two years of operations as an FSC, it cannot satisfy the assumption of credit risk activity in the third year unless it actually incurs a loss in that year. However, even if the FSC does not incur a loss in a third year, it would still be treated as having satisfied the assumption of credit test in the first two years. If the FSC then incurs a loss in the fourth year, it could use the credit test in the fourth, fifth and sixth years.[174]

Query: A key point apparently missed by the Finance Committee in its discussion of the FSC's assumption of credit risk is that *actual* costs must be incurred for purposes of the direct cost requirement. The fact that a FSC may somehow "satisfy" the assumption of credit risk activity, without incurring costs, should not help an FSC meet the direct cost test.

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c. Burden of Proof

A provision in the FSC provisions originally passed by the Senate would have shifted the burden of proof with respect to the foreign management and economic process requirements to the Secretary of the Treasury if a written statement addressing the issue had been filed by an officer of the corporation.[175] The statute, as passed, does not include this provision because the conferees believed that the Senate provision "created an undesirable precedent." [176] The conferees stated their intention, however, that the IRS administer the foreign presence provisions "in a manner which facilitates the establishment of FSC and carries out the objectives of the statute." [177]

E. Transfer Pricing Rules

1. Introduction

As a general rule, all transactions between related parties must be conducted at arm's-length.[178] The Commissioner has been given the authority to reallocate amounts between related businesses if he determines that it is necessary in order to prevent evasion of taxes or clearly to reflect the income of related organizations.[179] Because entities qualifying as DISCs could operate (and, as discussed in III, G, *infra*, may continue to operate, to a degree, as "interest charge DISCs") without substance, the application of §482 would have resulted, in many cases, in no income being allocated to the DISCs. In order to make the DISC work, Congress established special intercompany pricing rules whereby a DISC would receive a share of the income from export sales without actually contributing substantially to these transactions.[180]

The FSC foreign organization, management, and economic process requirements are designed to give the FSC greater substance than the DISC in order to satisfy the GATT rules. Nevertheless, because the activities associated with the economic process requirement may be performed by a person (*e.g.*, an FSC parent) acting under a contract with an FSC, it is possible that the FSC's role with respect to transactions of export property may be minimal. Thus, as with the DISC, Congress found it necessary to establish "special administrative pricing rules" to ensure that a FSC would get a share of the income from export sales, although its foreign activity with regard to a transaction may have been insignificant. In this regard, the Finance Committee stated its intention that "the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rule." [181]

To accomplish that result, §925 provides two alternative safe-havens which may be used to establish a transfer price or a commission if their use results in more income being allocated to the FSC than would otherwise be allocated under §482. These two safe-havens are the 1.83 percent of FTGR method [182] and the 23 percent of CTI method.[183] An FSC eligible to use these two methods must use the rule that produces the greater amount of FTI.[184] However, the amount determined under the 1.83 percent of FTGR method with respect to any transaction may not exceed two times the amount which would be determined under the 23 percent of CTI method.[185] For purposes of applying these pricing methods, CTI is determined without regard to the exclusion of exempt FTI in §921.[186] FSCs ineligible to use either of these two methods must compute FTI based upon the sale price actually charged (but subject to the rules provided in §482).[187]

2. Conditions on Use of Special Administrative Pricing Rules

In order for the "special administrative pricing rules" to apply, three conditions must be met: (i) the transaction must involve the sale, lease, or other disposition of export property to an FSC by a person described in §482 (*e.g.*, a person "owned or controlled directly or indirectly by the same interests");[188] (ii) all of the five "economic process activities" [189] with respect to which the direct costs are taken into account for the 50-percent foreign direct costs test must be performed by the FSC or by another person acting under a contract with the FSC;[190] and (iii) all of the activities relating to the solicitation (other than advertising), negotiation, and making of a contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC).[191]

Observation: The second and third requirements regarding the use of the special administrative pricing rules can be met wherever the activities are performed. In other words, the activities do not have to be performed outside the United States in order for the FSC to be eligible to use the special administrative pricing rules. It is only necessary that the activities be performed by the FSC or by another person acting under contract with the FSC.

Example: The Finance Committee Print sets forth the following example to illustrate the interaction of the requirements for the use of the "special administrative pricing rules" and the foreign economic process requirements:

P, a domestic corporation, owns all of the stock of S, a corporation organized under the laws of a foreign country that qualifies as a FSC for the taxable year. P manufactures product A, which it sells to S for resale to export customers. During S's taxable year, S sells 10 units of A to F, a foreign customer. The terms of the sale are FOB P's plant in Seattle. P, acting as agent for S, performed all of the solicitation and negotiation activities with respect to the transaction with F. S accepted F's offer of purchase at its office in the foreign country. S incurred expenses of $90 for the cost of advertising, $85 of which was attributable to print advertising in the Asian editions of trade magazines. S also incurred $10 of direct costs for trade shows in the United States promoting sales of A to domestic and foreign customers, and $25 of direct costs (incurred outside the United States) in processing P's order. No costs are associated with arranging for the delivery or the transportation of the product because of the terms of sale. S incurred all of the credit costs associated with the transaction. S compensated P on an arm's-length basis for its services.

S will be allowed to use one of the two administrative pricing rules to determine its transfer price from P for the units of A sold in the transaction, because S or an agent of S performed all of the economic process activities with respect to the transaction. S will also satisfy the foreign economic process requirements with respect to the transaction because (i) S participated in making the contract outside of the United States, and

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(ii) 85 percent of S's direct costs for two of the five categories of activities subject to the direct cost test (advertising and sales promotion and processing of customer orders and arranging for delivery) were attributable to activities occurring outside the United States. (S's direct costs include payments to P for services rendered).[192]

Query: For purposes of an FSC's eligibility to use the "special administrative pricing rules," must costs be incurred by the FSC in all five activity categories associated with the direct cost test? For example, if an FSC (or its agent) contractually assumes the credit risk with regard to a transaction, will the fact that the FSC actually incurs no costs with respect to that contractual assumption of the credit risk (*i.e.*, performance) bar the FSC from using the "special administrative pricing rules"? The answer appears to be "No." Section 925(c) (relating to requirements for use of the "special administrative pricing rules") requires only that the economic process activities be "performed" by the FSC (or its agent).

Observation: If due to the nature of its business an FSC never performs a particular foreign activity, will that FSC be barred from using the "special administrative pricing rules?" For example, suppose an FSC leases export property to its parent's wholly-owned subsidiary (which, in turn, leases such property to a corporation outside the "controlled group of corporations"). Due to the "brother-sister corporation" nature of the lessor-lessee relationship, the FSC has not agreed to assume the credit risk since there essentially is none. On the face of the statute, the FSC could not use the "special administrative pricing" rules.

3. *Computation of Transfer Price*

a. *Grouping of Transactions*

The computation of the transfer price is required to be made on a transaction-by-transaction basis. However, the Finance Committee stated its intention that "regulations allow the grouping of transactions." [193] Current DISC regulations, which are expected to be carried over to the FSC, permit transfer price computations to be made on a grouping of products or product line basis.[194] Pursuant to the regulations, a taxpayer must choose a product or produce line which conforms to industry or trade usage, or which conforms to the two digit major groups (or any inferior classification or combination thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, of the Executive Office of the President.[195] As a practical matter, this means that a taxpayer may make the computations with respect to related lines of goods in the aggregate for a taxable year rather than having to make the computations for each sale. Administratively, this is particularly helpful to the manufacturer of high volume low-cost items like pencils. The DISC regulations provide that once the taxpayer has chosen to group transactions for one year, the grouping applies to all transactions with respect to the particular product or product line during that year.[196] With respect to transactions involving goods not included in the grouping, the computations must be made on a transaction-by-transaction basis.

b. *1.83 Percent of FTGR Method*

This safe-haven allows the FSC to realize taxable income attributable to a sale in an amount equal to 1.83 percent of the FTGR derived from the sale of the export property.[197] The 1.83 percent of FTGR test applies both to transactions in which the FSC actually purchases the goods for resale and to transactions in which the FSC is a commission agent (and receives a commission with respect to the sale for export of the goods).[198] If the FSC is a commission agent, it would be entitled to a direct payment equal to 1.83 percent of the FTGR, that is, generally 1.83 percent of the underlying sales price. If, however, the FSC actually incurred expenses in connection with the export sale, then the amount of the commission which the FSC could receive would be an amount equal to 1.83 percent of the FTGR from the sale plus any expenses incurred.[199]

Example: Assume an FSC purchases export property from a related supplier and sells the property for $1,000 of FTGR. The FSC incurs expenses attributable to the sale of $225. The FSC's taxable income and the transfer price to the FSC from the transaction, using the 1.83 percent of FTGR method, would be as follows:

FSC taxable income—1.83 of FTGR	$ 18.30
Supplier's Transfer Price to FSC Sales Price	1,000.00
Less:	
FSC Expenses	$ (225.00)
FSC Profits	(18.30)
Total	$ (243.30)
Supplier's Transfer Price to FSC	$ 756.70

Observation: If the supplier's cost of goods sold and expenses allocable to the sale in the example were $756.70, all of the profits would be in the FSC. However, the related supplier would realize a loss on the transaction if those expenses exceeded $756.70. In this regard, the Finance Committee stated its intention that "the administrative pricing rules will be applied under rules which will prevent pricing at a loss to the related supplier" and its belief that "the Secretary of the Treasury should consider whether the present [DISC] regulations accomplish this purpose." [200] Current DISC regulations prohibit the use of the safe-haven rules where they result in a loss to the related supplier.[201]

c. *Twenty-Three Percent of CTI Method*

Under the 23 percent of CTI method, the transfer price on a sale by a related supplier to an FSC is the price which permits the FSC to realize 23 percent of the CTI of the FSC and the related supplier attributable to the FTGR from the sale.[202] If the FSC acted as a commission agent with respect to a transaction, then the FSC would be entitled to a commission equal to 23 percent of CTI plus the cost to the FSC of the transaction.[203]

CTI is the taxable income from the export sale or sales of the FSC and its related supplier. Current DISC regula-

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tions define CTI as gross receipts of the DISC and the related supplier reduced by the costs of the DISC and related supplier which relate to those gross receipts.[204] Under the DISC regulations, gross receipts are to be reduced by expenses, losses, and other deductions definitely related to the gross receipts, plus a ratable portion of other expenses, losses, and deductions not definitely related to a class of gross income. Presumably, the DISC regulations will be modified and carried over to the FSC.

Example: An FSC purchases export property from a related supplier and sells the property for $1,000 of FTGR. The FSC incurs expenses attributable to the sale of $225. The related supplier's cost of goods sold attributable to the export property is $550. The related supplier's expense incurred in connection with the sale of the export property is $125. For purposes of this example, it is assumed that the related supplier has no other deductible expenses. The combined taxable income of the FSC and its related supplier and the FSC's taxable income and the transfer price to the FSC from the transaction, using the 23 percent of CTI method, would be as follows:

(a) *Combined Taxable Income:*

FSC's FTGR	$1,000.00
Cost of goods sold of related supplier	(550.00)
Combined gross income	$ 450.00
Less expenses:	
Direct expenses of related supplier	$ 125.00
Direct Expenses of FSC	225.00
Total expenses	$ (350.00)
CTI	$ 100.00

(b) *FSC's taxable income and transfer price under 23 percent of CTI method:*

FSC taxable income—23% of CTI ($23.00)	$ 23.00
Supplier's transfer price to FSC: Sales price	$1,000.00
Less:	
FSC expense	$ (225.00)
FSC profit	(23.00)
Total	$ (248.00)
Supplier's transfer price to FSC	$ 752.00

d. Marginal Costing

The Finance Committee stated its intention that regulations allow "marginal costing." [205] Marginal costing is a method of allocating costs for purposes of determining the CTI of an FSC and its related supplier. It would be available only where the 23 percent of CTI method of computing a transfer price or commission is adopted by the taxpayer. While the statute [206] mandates publication of regulations providing for marginal costing, no statutory guideline as to the meaning of the term is provided. However, guidance may be found in the detailed DISC regulations setting forth the rules for the use of marginal costing for purposes of the DISC 50 percent of combined taxable income method of computing transfer prices.[207]

Under these regulations, only the marginal or variable costs of producing and selling a particular item, product, or product line need be taken into account for purposes of computing combined taxable income.[208] Because fixed costs need not be taken into account, combined taxable income is increased under these regulations with a resulting increase in the income of the DISC. The marginal costs will, of course, still be deductions of the related supplier.

Marginal costing is available only if the DISC is seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property [209] for the taxable year. A DISC is treated as establishing or maintaining an export market if the marginal costing rule will yield a greater amount of income than would be yielded under the combined taxable income provisions without marginal costing.[210] Thus, as a practical matter, marginal costing is available in those cases in which the taxpayer would want to make use of it. Presumably, the DISC regulations with respect to marginal costing willl be carried over in modified form to the FSC.

e. Post-Transaction Year Computations

Section 924(a) provides that a FSC may apply whichever pricing method allocates the greatest amount of taxable income to the FSC. The basic policy is to ensure that the FSC will realize a high percentage of the taxable income from any export sale with respect to which it is a party. In furtherance of this statutory purpose, the Finance Committee Print notes that "[u]nder the administrative pricing rules, the transfer price from the related supplier to the FSC may be computed after the FSC sells the goods to a customer" and that the "FSC and its related supplier may make adjustments upwards or downwards following the close of the taxable year in which the FSC sells the goods."

F. Taxation of FSC Shareholders

1. Ordering Rules for Distribution to Shareholders

Distributions to a shareholder of an FSC made out of earnings and profits are treated as coming first out of an FSC's earnings and profits attributable to FTI, and then out of "any other earnings and profits" (*e.g.*, investment income, carrying charges, and certain receipts not included in FTGR pursuant to §924(f)(1)), regardless of whether the corporation has ceased to be an FSC before the distribution.[211]

2. Distributions to U.S. Shareholders

a. 100 Percent Dividends-Received Deduction

A U.S. corporate shareholder will generally be allowed a 100 percent dividends-received deduction for amounts distributed out of earnings and profits of another corporation attributable to FTI for a period during which such other corporation was an FSC, but not for amounts distributed out of earnings and profits attributable to "section 923(a)(2) nonexempt income." [212] Thus, there will be: (i) no

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corporate level tax on exempt FTI; (ii) only a single-level corporate tax (at the FSC level) on nonexempt FTI (other than "section 923(a)(2) nonexempt income"); and (iii) corporate tax at both the FSC and the shareholder levels on "section 923(a)(2) nonexempt income", investment income, and certain other receipts (*e.g.*, receipts not included in FTGR pursuant to §924(f)(1)).

Observation: The Finance Committee Print states that "distributions to a noncorporate shareholder of a FSC that are not attributable to foreign trade income will be subject to tax in the same manner as distributions from a foreign corporation that has not elected to be treated as a FSC." [213] That statement implies that distributions to a noncorporate shareholder of a FSC that are attributable to FTI will not be subject to tax. Nothing in the FSC provisions or the underlying legislative history supports that implication, however. Thus, it may be assumed that noncorporate shareholders must report the entire amount of an FSC dividend as income.

Observation: To the extent a corporate shareholder of an FSC distributes dividends attributable to FTI to its individual shareholders, these amounts will be taxed.[214]

b. Subpart F Income Considerations

Under the Subpart F provisions of the code, the U.S. shareholders of a "controlled foreign corporation" ("CFC") [215] are taxed by reference to the tainted income ("Subpart F income") [216] of their CFC as if they have received that income as a current dividend, even though no amount has in fact been paid out to them.[217] Section 801(b)(4) of the Act adds §951(e) to the Subpart F provisions to ensure that FTI (other than "section 923(a)(2) nonexempt income"), investment income, and carrying charges will not be treated as Subpart F income for purposes of determining the amounts included in gross income of FSC shareholders as constructive dividends.

Observation: The Finance Committee Print states that an FSC "will not be required or deemed to make distributions to its shareholders." [218] This statement does not account for the fact that the amendments made by the Act to the Subpart F provisions do not exclude from their scope "section 923(a)(2) nonexempt income" and certain receipts not included in FTGR pursuant to §924(f)(1). Nothing in the Act will prevent the deemed distribution of such income from an FSC to its shareholders in cases where the FSC and its shareholders otherwise come within the Subpart F provisions.

Observation: Section 801(f) of the Act authorizes the Secretary of the Treasury to exclude property related to the "export activities" of the FSC from the Subpart F rules relating to investments by controlled foreign corporations in U.S. property.[219] This amendment may exclude from the scope of Subpart F investments in export receivables. However, the FSC's income from factoring such receivables will be subject to immediate U.S. taxation if such receivables are acquired (directly or indirectly) from related U.S. persons and the obligors under such receivables are U.S. persons.[220]

c. Foreign Personal Holding Company Income Considerations

For purposes of determining which corporations meet the definition of a foreign personal holding company ("FPHC"), §552 sets forth both a "gross income test" and a "stock ownership test." Under the gross income test, at least 60 percent of the gross income of a foreign corporation for the taxable year must be foreign personal holding company income for it initially to qualify as an FPHC.[221] After initial qualification as an FPHC, the gross income test will be satisfied if the corporation in any subsequent year has foreign personal holding company income equal to at least 50 percent of its gross income during the taxable year.[222] Section 553 defines foreign personal holding company income to be that portion of a corporation's gross income which consists generally of dividends, interest, royalties and annuities, gains from the sale or exchange of stock or securities and commodity futures transactions, distributions from a trust or estate, amounts received under personal service contracts, amounts received as compensation for the use of corporate property by major stockholders, and rents where they constitute less than 50 percent of the corporation's gross income.

The "stock ownership test" requires that at any time during the taxable year more than 50 percent in value of the outstanding stock of a foreign corporation must be owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States.

The FPHC rules appear applicable to the FSC and, thus, where the "gross income test" and "stock ownership test" are satisfied, FSC investment income will qualify as foreign personal holding company income.[223] Accordingly, FSC shareholders may be required to recognize constructive dividends with respect to such income.[224]

d. Foreign Tax Credit Considerations

Under §901(h) as added by Section 801(d) of the Act, no credit will be permitted for foreign taxes on FSC dividends attributable to FTI (other than §923(a)(2) nonexempt income). However, foreign taxes on FSC dividends attributable to "section 923(a)(2) nonexempt income," investment income, carrying changes or receipts arising from certain transactions that are excluded from FTGR pursuant to §924(f)(1) will be fully creditable.

Observation: Under §904(d)(1)(D), distributions from an FSC (or former FSC) out of earnings and profits "attributable to foreign trade income" are subject to a separate foreign tax credit limitation. In view of §901(h), it appears that the only FTI affected by §904(d)(1)(D) will be "§923(a)(2) nonexempt income."

e. Gains from Sales or Exchanges of FSC Stock

If a U.S. shareholder, who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of an FSC at any time during the 5-year period ending on the date of the sale or exchange when the FSC was a CFC,[225] sells or exchanges stock in the FSC, then the gain recognized on the sale or exchange of such stock is included in the U.S. shareholder's gross income as a dividend to the extent of the earnings and profits of the

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FSC attributable to such stock that were accumulated while the stock was held by the U.S. shareholder while the FSC was a CFC.[226] Under §1248(d)(6), the earnings and profits of an FSC attributable to FTI will be excluded from earnings and profits for purposes of determining the gain on sale of FSC stock. However, investment income, carrying charges, and receipts arising from unqualified transactions that are excluded from FTGR pursuant to §924(f)(1) will be included in earnings and profits for purposes of determining the gain on the sale of such stock.

3. Distributions to Foreign Shareholders

Both foreign corporate and noncorporate shareholders are taxed on FSC dividends to the extent attributable to the FSC's FTI, as if the dividends were both U.S. source and "effectively connected" with the conduct of trade or business carried on through a permanent establishment in the United States.[227] This treatment subjects the dividends to U.S. tax at normal rates on net income (and without foreign tax credits) and precludes the application of treaty exemptions or reduced tax rates. To the extent that the FSC's dividends are not attributable to FTGR, this rule will not apply.

Observation: This rule may discourage foreign individuals and corporations from becoming shareholders in FSCs. This is particularly significant in view of the fact that there is no minimum U.S. shareholder ownership percentage requirement under the FSC provisions. (Indeed, an FSC need not be owned by any U.S. shareholders.) The practical effect of this rule, therefore, may be that most FSC shareholders will be U.S. corporations or individuals.

G. Small Exporters

The Finance Committee "recognize[d] that small exporters may find it difficult to comply with certain of the foreign presence and economic activity requirements," and, therefore, provided two alternatives to the FSC — the "small FSC" and the "interest-charge DISC."[228] Out of "concern that without a special effort by the Administration many small businesses which wish to export property will avoid making an election to become [a small] FSC or . . . [an interest charge] DISC because they fear that such an election will lead to undue complexity and a large administrative burden," the conferees expressed their "hope that small business will be given special encouragement and assistance by the specialized Commerce Department in establishing and operating small FSCs and small DISCs."[229]

1. Small FSCs

a. Qualification

In order to qualify as a small FSC, a corporation must meet the same requirements as an FSC, except that it must elect small FSC status rather than FSC status.[230]

Query: What must a small FSC do if it wishes to become a regular FSC? The statute and Committee Reports are silent on this point. Presumably, the small FSC election should be revoked within the period prescribed in §927(f)(3) and a regular FSC election made at that time.

Under §922(b)(2), a corporation electing small FSC status may not be a member at any time during the taxable year of a "controlled group of corporations"[231] which includes an FSC, unless such other FSC has also made an election to be treated as a small FSC which is in effect for such year.

b. Effect of Qualification as a Small FSC

(1) No Foreign Management and Foreign Economic Process Requirements

An FSC that elects to be a small FSC need not meet the foreign management and foreign economic process requirements in order to have FTGR.[232]

(2) Small FSC Limitation on Amount of FTGR

In determining the exempt FTI of a small FSC, any FTGR that exceeds $5 million will not be taken into account.

Observation: Neither the statute nor the Committee Reports explain how FTGR in excess of $5 million will be taxed to a small FSC and its shareholders. Presumably, that portion of the FTGR in excess of $5 million allocable to transactions using the "special administrative pricing rules" will be taxed currently to the small FSC as U.S. source income. With respect to such income, U.S. corporate shareholders would be entitled to the 100 percent dividends received deduction. A foreign tax credit would not be allowed to the small FSC with respect to foreign taxes on such income and foreign taxes on small FSC dividends attributable to such income would be treated as noncreditable foreign taxes. On the other hand, that portion of the amount of a small FSC's FTGR in excess of $5 million allocable to transactions based upon the sale price actually used (but subject to the rules provided in §482) might be Subpart F income carrying foreign tax credits. U.S. corporate shareholders would receive no dividends nor deduction with respect to distributions of such income. In any event, a small FSC (like an FSC) will have to keep accurate records of the pricing method used for each of its transactions.

If the FTGR of a small FSC exceeds the $5 million limitation, the corporation may select the gross receipts to which the limitation is allocated.[233] Thus, a small FSC may choose to allocate the $5 million limitation to gross receipts attributable to transactions where the profit margin is high; in such cases, the amount of exempt FTI would be greater than if the limitation were allocated to low-margin transactions.

Example: A small FSC has $5 million of FTGR with respect to transactions in which the aggregate cost of goods sold (*i.e.*, the total transfer prices for such transactions) is $4 million. Assuming a corporate shareholder of the small FSC and that the "special administrative pricing rules" were used in such transactions, exempt FTI would equal 15/23 of $1 million ($5 million minus $4 million), or $652,173.90. The same small FSC also has $5 million of FTGR with respect to transactions in which the aggregate cost of goods sold is $2 million. Exempt FTI would be 15/23 of $3 million ($5 million minus $2 million), or $1,956,521.70. Since the greater amount of exempt FTI is allocable to the $5 million of FTGR with the greater profit margin, the small FSC will allocate the $5 million limitation to the $5 million of FTGR with a higher profit margin.

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For purposes of the $5 million limitation and its allocation, small FSCs which are members of the same "controlled group of corporations" will be treated as a single corporation.[234] Regulations will prescribe how the $5 million limitation will be allocated among members of a controlled group.[235]

(3) "Special Administrative Pricing Rules" Requirements Applicable to Small FSCs

The Finance Committee Print clarifies that in order to use the "special administrative pricing rules," a small FSC is held to the same requirements as an FSC. Accordingly, a small FSC must meet two requirements. The first requirement is that all of the five "economic process activities" with respect to which the direct costs are taken into account for the 50 percent foreign direct cost test must be performed by the small FSC or by another person acting under contract with the small FSC. The second requirement is that all the activities relating to sales activity (*i.e.*, the solicitation (other than advertising), negotiation, and making of the contract for a sale) must be performed by the small FSC or by another person acting under contract with the FSC. Of course, these two requirements can be met wherever the activities are performed (*i.e.*, the activities do not have to be performed outside the United States).[236]

2. Interest Charge DISCs

a. General

A DISC may continue to defer income attributable to $10 million or less of "qualified export receipts."[237] Deemed distributions relating to base period exports (the "incremental rule") and to one-half of the DISC's income will be eliminated; thus, substantially all of the DISC's income attributable to $10 million or less of qualified export receipts may be deferred. However, unlike the present-law DISC, an interest charge will be imposed on the shareholders of the DISC.[238] The amount of the interest will be based on the tax otherwise due on the deferred income computed as if the income were distributed. The interest rate will be tied to the T-bill rate.

Observation: An interest-charge DISC will, in the early years of operation, result in a better cash flow than a small FSC. However, in future years, the small FSC will experience a more positive cash flow than the interest-charge DISC, because the DISC-related deferred tax liability will accumulate to a point at which the annual interest charge imposed upon such liability will exceed the difference between the actual current tax using a DISC and the higher total tax that would have resulted had a small FSC been used.

b. The $10 million "Qualified Export Receipts" Deferral

Pursuant to amended §995(b)(E), a shareholder of a DISC will be treated as having received a dividend with respect to his stock in an amount which is equal to his pro rata share of the "taxable income of the DISC attributable to qualified export receipts of the DISC for the taxable year which exceed $10 million." Thus, a shareholder of a DISC will not be taxed currently on income attributable to $10 million or less of "qualified export receipts." For purposes of applying the $10 million limitation, all DISCs which are members of the same controlled group will be treated as a single corporation.[239] Regulations will proscribe how the $10 million limitation will be allocated among members of a controlled group.[240]

c. Calculation of Interest Charged

For each taxable year, a shareholder of a DISC will pay interest in an amount equal to the product of the "shareholder's DISC-related deferred tax liability" for such year and the "base period T-bill rate."[241]

(1) Shareholder's DISC-Related Deferred Tax Liability

The "shareholder's DISC-related deferred tax liability" means, with respect to any taxable year of a shareholder of a DISC, the amount which would be the "tax liability" of the shareholder for the taxable year if the "deferred DISC income" of such shareholder for such taxable year were included in gross income as ordinary income minus the actual amount of the "tax liability" of such shareholder for such taxable year.[242]

Observation: Section 68(d) of the Act amends §995(b)(1)(F)(i) (relating to deemed distributions) to reduce the annual "deemed" dividend of one-half of a DISC's income (57½ percent for a corporate shareholder) to 1/17th of the DISC's income. Although the Conference Report (at page 975) makes clear Congress' intent that the 1/17th deemed dividend apply only where the shareholder is a corporation, the language of the Act itself does not reflect this limitation.

The calculation of a "shareholder's DISC-deferred tax liability" will be made without regard to carrybacks to such taxable year.[243] The Secretary of the Treasury is directed to prescribe regulations to provide any adjustments necessary to the accounts of the DISC and to the amount of any carryover or carryback of the shareholder in the case of net operating losses, credits, and carryovers and carrybacks of losses and credits.[244]

The term "tax liability," as used in the definition of "shareholders' DISC-related deferred tax liability," means the amount of the income tax imposed for the taxable year reduced by allowable credits (other than the credit for tax withheld on wages, the earned income credit, and the credit against taxes imposed upon certain uses of gasoline and special fuels).[245]

"Deferred DISC income" means, with respect to any taxable year of a shareholder, the shareholder's pro rata share of accumulated DISC income (for periods after 1984) of the DISC as of the close of the "computation year" minus the amount of the "distributions-in-excess-of-income" for the taxable year of the DISC following the "computation year."[246] The "computation year" is the taxable year of the DISC which ends with (or within) the taxable year of the shareholder which precedes the taxable year of the shareholder for which the amount of "deferred DISC income" is being determined.[247] "Distributions-in-excess-of-income," with respect to any taxable year of a DISC, equals the amount of actual distributions to the shareholder out of accumulated DISC income minus the shareholder's pro rata share of the DISC income for such taxable year.[248]

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Observation: The higher the amount of the shareholder's "distributions in excess of income," the less will be the shareholder's "deferred DISC income," and, thus, the lower will be the shareholder's "DISC-related deferred tax liability." The shareholder's "distributions in excess of income" will be reduced (and his "DISC-related deferred tax liability" will be increased) by "qualified export receipts" in excess of the $10 million limitation, because such amounts increase the shareholder's pro rata share of the DISC income for a taxable year and, thus, reduce the difference between such amount and the amount of actual distributions to the shareholder out of accumulated DISC income for purposes of determining the shareholder's "distributions in excess of income."

Example: Taxpayer A is a 10 percent corporate shareholder in DISC B. A is on the calendar year and B is on a fiscal year which ends September 30. Assume that A's pro rata share of accumulated DISC income (for periods after 1984) as of September 30, 1986 was $50,000. In 1987, A receives actual distributions of accumulated DISC income in the amount of $100,000. In 1987, B's "qualified export receipts" total $10,400,000. The deemed distribution to A of such "qualified export receipts" for 1987 is $98,823.50 ($40,000 (*i.e.*, 10 percent x $400,000 — the amount in excess of the $10 million limitation) plus $58,823.50 (*i.e.*, 10 percent x 1/17th of $10,000,000)). A's 1987 tax liability (at a 46 percent rate) equals $91,458.81 (*i.e.*, 46 percent of $198,823.50 ($100,000 in actual distributions plus $98,823.50 in deemed distribution)).

Calculation of A's DISC-related deferred tax liability:

(a) *Distribution-in-excess-of-income:*

A's 1987 actual distributions out of accumulated DISC income minus A's pro rata share of DISC income for 1987	$100,000.00 — 98,823.50
A's distributions-in-excess-of-income	$1,176.50

(b) Deferred DISC income:

A's pro rata share of post-1984 accumulated DISC income as of close of computation year (September 30, 1986) minus	$50,000.00
A's distributions-in-excess-of-income	- 1,176.50
A's deferred DISC income	$48,823.50

(c) *A's 1987 tax liability including deferred DISC income:*

A's 1987 taxable income	$198,823.50
+ A's deferred DISC income	$ 48,823.50
	$247,647.00
A's tax liability (at a 46% rate) =	$113,917.62

(d) *A's DISC-related deferred tax liability:*

A's 1987 tax liability including deferred DISC income	$113,917.62
- A's actual 1987 "tax liability"	$ 98,823.50
A's DISC-related deferred tax liability	$ 15,094.12

(2) "Base Period T-bill Rate"

The rate of interest imposed on a shareholder's "DISC-related deferred tax liability" is determined by reference to the "base period T-bill rate." The "base period T-bill rate" is the annual rate of interest that is equivalent to the average investment yield of U.S. T-bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30th of the calendar year ending with the close of the taxable year of the shareholder.[249] The Secretary of the Treasury will be expected to publish this rate in October of each year.[250]

Example: Assume that the "base period T-bill rate" determined by the Secretary of the Treasury as of September 30, 1987, is 12 percent. The interest on A's "DISC-related deferred tax liability" in the above example (*i.e.*, $15,094.12) would be $1,811.29.

d. Payment, Assessment and Collection of Interest

The interest on "DISC-related deferred tax liability" will be due at the same time the shareholder's regular tax is required to be paid. It will be paid to the Treasury, not to the DISC, and will be fully deductible.

e. Technical DISC Amendments

(1) Definition of DISC

Section 992(a)(1) (defining DISC) has been amended by §802(c)(1) of the Act to provide that a DISC is not "a member of any controlled group of which an FSC is a member." This revision of the definition of DISC meshes with §804(b)(5) of the Act which provides that "[u]nder regulations prescribed by the Secretary, if any controlled group of corporations of which a DISC is a member establishes a FSC, then any DISC which is a member of such group shall be treated as having terminated its DISC status."

(2) Treaty Partner Residents

Section 801(d)(10) clarifies present law to make it clear that a resident of a treaty partner cannot avoid tax on DISC distributions.[251] This clarification was effective on June 22, 1984.

H. Special Rules

1. "Qualified Cooperatives"

The FSC provisions contain three special rules for agricultural products marketed through a so-called "qualified cooperative." A "qualified cooperative" generally will be an organization that qualifies under §521 (relating to

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exempt farmers' cooperatives).[252] The special FSC rules relating to such cooperatives concern: (i) calculation of CTI for purposes of the 23 percent of CTI "special administrative pricing rule;" [253] (ii) the extent to which FTI will be treated as exempt income to the FSC;[254] and (iii) the extent to which the 100 percent dividends-received deduction is available to a cooperative shareholder of an FSC.[255] The Finance Committee emphasized that these special rules will be available "only if the income of the cooperative eligible for FSC benefits is based on arm's-length transactions between such cooperative and its members or patrons." [256] The Committee stated its intention that such restriction "should prevent the cooperative and its members or patrons from getting additional FSC benefits from transfer prices that do not reflect the fair market value of the property sold to or through the cooperative by its members or patrons." [257]

a. CTI Computations

In any case in which a "qualified cooperative" sells export property to an FSC, the CTI of the cooperative and the FSC will be computed without taking into account "patronage dividends," [258] "per-unit retain allocations," [259] and certain "deductions for nonpatronage distributions" [260] under §1382 (relating to the taxable income of cooperatives).

The Finance Committee stated that as a result of this special rule, "the cooperative will not be required to distribute the income attributable to exempt foreign trade income (generally [15]/23 of foreign trade income) to benefit from the exemption from corporate level tax on this income." [261] Since under §521 there is no corporate-level tax with respect to amounts attributable to patronage dividends, per-unit retain allocations, and certain deductions for nonpatronage distributions, such amounts will be allocable to otherwise non-exempt FTI (generally 8/23 of FTI), rather than FTI that is already exempt regardless of §521. This special rule will apply only to the cooperative shareholder of the FSC and not to members or patrons of the cooperative that may be cooperatives themselves (higher-tier cooperatives).[262]

b. Exempt FTI Distribution Requirement

The second rule provides that 100 percent of the FTI determined with regard to the "special administrative pricing rules" will be treated as exempt income to the FSC, but only if such income is distributed to the cooperative shareholder for any taxable year before the due date for filing the return of tax for such taxable year.[263] If such income is not distributed currently, it will be taxed at the FSC level.

The effect of this rule is to make the FSC essentially a pass-through entity to the members of the cooperative. In other words, only at the cooperative shareholder level will such FTI be characterized as exempt or not exempt. The Finance Committee Print clarified that "[d]istributions from the FSC to the cooperative shareholder that are attributable to foreign trade income treated as exempt foreign income [(generally 15/23 of foreign trade income)] will be includible in the taxable income of the cooperative (*i.e.*, income eligible for distribution as a patronage dividend as defined in §1388(a)(3))." [264] Non-exempt FTI (generally 8/23 of FTI), which was not taxed at the FSC level, will be taxed at the member or patron level. The Finance Committee Print further makes clear that distributions by an FSC attributable to FTI will be considered attributable first to nonexempt FTI (even if such income is treated as exempt income at the FSC level).[265]

c. No 100 Percent Dividends Receive Deduction for Distributions of Nonexempt FTI

The final special rule with respect to "qualified cooperatives" provides that the cooperative shareholder of an FSC will not be allowed the 100 percent dividends-received deduction for distributions from the FSC that are attributable to nonexempt FTI.[266] The Finance Committee Print explains that the bill provides this rule "because although the nonexempt foreign trade income is treated at the FSC level as exempt in this case, the committee intends that this portion of the income be includible in the income of the members and patrons without the deferral accorded to exempt foreign trade income." [267] Like other corporations, the cooperative will be allowed a dividends-received deduction for distributions attributable to exempt FTI but not for distributions attributable to investment income and carrying charges.

2. Exporters of Military Property

Two special rules are available for exporters of so-called "military property" (*i.e.*, "any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to the Military Security Act of 1954 (22 U.S.C. 1934)" (*see* §995(b)(3)(B))). The rules concern (1) the foreign direct cost test and (2) calculations of FTI.

a. The Foreign Direct Cost Test

Sales of certain "military property" must be made through the United States Government to foreign governments. Accordingly, because of negotiations and other activities with the United States Government, many of the expenses incurred by an FSC in connection with such sales must be incurred within the United States. The Finance Committee "recognize[d]" these characteristics of foreign military sales and, therefore, stated that it "intends" that for purposes of the 50 percent and alternative 85 percent tests, the FSC's expenses and the expenses of the United States Government in connection with such sales "will not be taken into account." [268]

b. Exempt FTI Attributable to Sales of "Military Property"

The Secretary of the Treasury has been empowered to prescribe regulations which will reduce by half the amount of exempt FTI that an FSC might otherwise have had (either with or without regard to the "special administrative price rules") with respect to its FTGR for the taxable year attributable to the disposition of, or services relating to, "military property."

c. Webb-Pomerene Export Organizations

Webb-Pomerene export organizations [269] may be shareholders of an FSC. Members of a Webb-Pomerene organization will be allowed to sell products through an FSC to the Webb-Pomerent organization and, thus, benefit from the FSC provisions as well as the special provisions under the 1918 Webb-Pomerene Export Trade Act.

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d. Foreign Tax Credit Limitation of Related Parties

A special rule (§927(e)(1)) governs the source of income earned by a person related to an FSC (within the meaning of §482 (*i.e.*, "owned or controlled directly or indirectly by the same interest")) from transactions giving rise to FTGR of an FSC. Pursuant to regulations to be prescribed by the Secretary of the Treasury, the foreign source income of such related person will be reduced to the amount of foreign source income it would have had if its exports had been made through a DISC using the transfer pricing rule most comparable to the one used by the FSC. For this purpose, the DISC "4 percent of gross receipts method" [270] is analogous to the FSC "1.83 FTGR method;" [271] the DISC "50 percent CTI method" [272] is analogous to the FSC "23 percent of CTI method;" [273] and the DISC §482 pricing rule [274] is analogous to the FSC §482 pricing rule.[275]

It was Congress' intention that this special sourcing rule result in foreign source income that is comparable to the foreign source income on the same transaction under the DISC provisions.[276] The table below from the Finance Committee Print [277] illustrates the application of the DISC provisions to a DISC's parent with excess foreign tax credits that exports by selling to its DISC. In the particular transaction illustrated, the export sale has resulted in a profit of $100. The table presupposes that 50 percent of the parent's income from the export sale is foreign source income, as might be the case under §863(b) (related to income partly from within and partly from without the United States). The table assumes a 17 percent deferral rate for CTI of DISC and parent:

DISC—50/50 Split of CTI—§863(b)

(Exporter With Excess Foreign Tax Credits)

Parent		DISC	
U.S. source (taxable)	$25	Deferred	$17
Foreign source (exempt)	25	Deemed distribution	33
	$50		$50
Taxable:			
U.S. source income of parent			$25
Deemed distribution—separate basket			33
			$58
Exempt:			
Foreign source income of parent			$25
Deferred in DISC			17
			$42

The following table from the Finance Committee Print [278] illustrates the application of the FSC provisions (absent the special rule governing the source of income) to facts identical to those in the above table. It presupposes that the export sale is subject to the FSC "23 percent of CTI method."

FSC—77/23 Split of CTI Absent Resourcing Rule

(Exporter With Excess Foreign Tax Credits)

Parent		FSC	
U.S. source (taxable)	$38.50	Exempt	$17
Foreign source (exempt)	38.50	Taxable	6
	$77.00		$23
Taxable:			
U.S. source income of parent			$38.50
Taxable income of FSC			6.00
			$44.50
Exempt:			
Foreign source income of parent			$38.50
Exempt in FSC			17.00
			$55.50

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Under the DISC provisions, the parent's share of CTI is $50. The parent's foreign source income might be $25 under the DISC provisions. Exemption of $55.50 under the FSC provisions (absent the special resourcing rule) would exceed the combination of exemption and deferral of $42 for a parent of a DISC with excess credits under the DISC provisions (with a 17 percent deferral rate).[279] To maintain parity with the DISC, the FSC special resourcing rule would reduce the foreign source income of the parent in the FSC example (absent resourcing rule) from $38.50 to $25, which would result in an exemption of $42 (comparable to the DISC). The parent's U.S. source income would increase, under this special rule, from $38.50 to $52. The following table from the Finance Committee Print [280] illustrates the effect of the special resourcing rule:

FSC—77/23 Split of CTI With Resourcing Rule

(Exporter With Excess Foreign Tax Credits)

Parent		FSC	
U.S. source (taxable)	$52	Exempt	$17
Foreign source (exempt)	25	Taxable	6
	$77		$23
Taxable:			
U.S. source income of parent			$52
Taxable income of FSC			6
			$58
Exempt:			
Foreign source income of parent			$25
Exempt in FSC			17
			$42

I. Effective Dates and Transition Rules

1. Effective Dates

a. General

The FSC provisions and the amendments to the DISC provisions generally apply to transactions after December 31, 1984, in taxable years ending after that date.[281] The amendments to §441 that require the taxable year of the DISC and the FSC to conform to the taxable year of the majority shareholder apply to any DISC established after March 21, 1984.[282] The provision that clarifies present law to make it clear that a resident of a treaty partner country cannot avoid tax (under §996(g)) on DISC distributions is effective on June 22, 1984.[283]

b. Special Rule for Certain Contracts

(1) Taxpayers Using the Completed Contract Method of Accounting

A special transitional rule for long-term contracts provides that the foreign management test [284] and the economic process test [285] "shall not apply" to any contract with respect to which the taxpayer uses the completed contract method of accounting and which an FSC (1) entered into before March 16, 1984, or (2) was entered into by the FSC after March 15, 1984, and before January 1, 1985, pursuant to a written plan to enter into such a contract which was in effect on March 15, 1984.[286]

(2) Contracts Entered Into Before March 16, 1984

A further special transitional rule for long-term contracts provides that the foreign management test [287] and the economic process test [288] "shall not apply" to any contract which an FSC enters into before March 16, 1984.[289] This special transitional rule applies only to the first two taxable years of the FSC ending after January 1, 1985, "or such later taxable years as the Secretary of the Treasury may designate." [290]

(3) Contracts Entered Into After March 15, 1984, and Before January 1, 1985

A final special transitional rule for long-term contracts provides that the foreign management test [291] and the economic process test [292] "shall not apply" to contracts entered into after March 15, 1984, but before January 1, 1985.[293] The special transitional rule applies only to the first taxable year of the FSC ending after January 1, 1985, "or such later taxable years as the Secretary of the Treasury may designate." [294]

Observation: The Act provides that the foreign management and economic process tests "shall not apply" to the above-described long-term contracts. The rule described in (1) applies for all future years of an FSC; the rule described in (2) applies to an FSC's first two taxable years ending after January 1, 1985; and the rule described in (3) applies for an FSC's first taxable year ending after January 1, 1985. By using the term "shall not apply," the Act

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appears to mean that (for the period of time allotted an FSC under the particular rule) the FSC's gross receipts will qualify as FTGR without regard to the foreign management and economic process tests. The Senate Finance Committee Print, however, states (at pp. 660-661) that with respect to all three rules, "the taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984." Thus, even though the Act itself makes those tests inapplicable to FSCs for the period of time allotted under the particular rule, the Senate Finance Committee would have the tests apply to activities taking place and costs incurred with respect to the contract after December 31, 1984, and during the periods of time that the Act itself states they are inapplicable. The nature of a long-term contract means that activities will take place and costs will be incurred over the life of the contract. If the special long-term contract rules are to have any effect whatsoever in terms of providing transitional relief, the terms of the Act (rather than the Committee Print) ought to apply.

Query: Must such long-term contracts have been entered into by the FSC itself, or may the FSC's parent (or other related party for whom the FSC acts as a commission agent) have entered into the contract? Neither the Act nor the legislative history clarifies this matter, although the staffs of the Senate Finance Committee and the Joint Committee on Taxation drafted the transition rules with the view that a parent could be considered the principal of a commission agent FSC for purposes of the special long-term contract transition rules.

Query: In all three of the special long-term contract transition rules, a corporation that qualifies as an FSC after December 31, 1984, will be treated as having satisfied the foreign management and foreign economic process tests with regard to the contracts described in the special rules for gross receipts received prior to specified periods of time. Does the deemed satisfaction of those tests mean, in addition, that all of the foreign sales activities (*i.e.*, solicitation, negotiation, and making of the contract) and all five foreign activities for direct cost purposes will be deemed to have been performed for purposes of the "special administrative pricing rules"? Given that the long-term contract transition rules are designed to help FSCs avoid unnecessary hardship, it would be consistent with that purpose to deem the requirements for the use of the "special administrative pricing rules" to have been satisfied.

2. Transition Rules for DISCs

a. December 31, 1984, Close to DISCs' Taxable Years

The taxable year of all existing DISCs will close on December 31, 1984, regardless of whether a DISC may be on a fiscal-year basis.

b. "Qualified Export Assets" Test Made Inapplicable

Section 992(a)(1)(B) provides that for a taxable year, "the adjusted basis of the qualified export assets . . . of the corporation at the close of the taxable year [must] equal[ ] or exceed[ ] 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year." As a measure of relief to fiscal year DISCs that would have had to struggle to satisfy the "qualified export assets" test for the short taxable year ending December 31, 1985, the Act makes the "qualified export assets" test inapplicable to any taxable year ending on December 31, 1984.[295]

c. Underpayments of Estimated Tax

To the extent provided in regulations prescribed by the Secretary of the Treasury, no addition to tax will be made (pursuant to §6654 or §6655) with respect to any underpayment of any installment required to be paid before April 13, 1985, to the extent the underpayment was created or increased by reason of the termination of a DISC's taxable year on December 31, 1984.[296]

d. Exemption of Accumulated Disc Income from Tax

Actual distributions of any accumulated "DISC income" [297] of a DISC or former DISC qualified as a DISC on December 31, 1984, which is derived before January 1, 1985, will be treated as "previously taxed income." [298] The tax exemption for accumulated DISC income will not apply to that portion of accumulated DISC income that may have been deemed distributed as a result of the revocation of a DISC election or the failure of a DISC to qualify prior to requalification and prior to the earning of income that is eligible for forgiveness.[299]

e. Installment Treatment of Certain Deemed Distributions

If a shareholder of a DISC so elects, any "qualified distribution" (*i.e.*, any deemed distribution (within the meaning of §995(b)) from a DISC attributable to income derived by the DISC in the first taxable year of the DISC which begins in 1984 after the date in 1984 on which the taxable year of the shareholder begins) will be treated as received by the shareholder in ten equal installments; the installments will be treated as received on the last day of each of the ten taxable years of the shareholder which begins after the shareholder's taxable year beginning in 1984.[300] Regulations to be prescribed by the Secretary of the Treasury may allow taxpayers to accelerate this inclusion if they elect to do so.[301] A shareholder may elect such installment treatment even though the DISC may cease to exist after December 31, 1984.[302]

Example: A DISC's taxable year ends January 31, and the corporate shareholder of the DISC is a calendar year taxpayer. In 1984, the corporate shareholder will include in income the deemed distributions from the DISC for the DISC's year ending on January 31, 1984, and, absent the ten-year spread, the deemed distributions for the eleven-month taxable year ending on December 31, 1985. Almost two years of deemed distributions will be includible in income in 1984. However, if a shareholder of a DISC so elects, the deemed distributions for the eleven-month period ending December 31, 1984, will be spread over a ten-year period and includible in the income of the shareholder in ten equal installments on December 31st of 1984 through 1993.

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3. Special Rule for Export Trade Corporations

Export Trade Corporations ("ETCs") may elect to discontinue operating as ETCs or elect to be FSCs. If an ETC so elects before January 1, 1985, the previously untaxed income attributable to earnings derived before January 1, 1985, will be treated as previously taxed income.[303]

Observation: ETCs that do not elect to discontinue operating under the ETC rules may continue to operate as ETCs. However, no portion of the untaxed income of the ETC will be treated as previously taxed income.[304]

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[1] P.L. 92-178, 92d Cong., 1st Sess., 85 Stat. 497.
[2] P.L. 94-12, 94th Cong., 1st Sess., 89 Stat. 26.
[3] P.L. 94-455, 94th Cong., 2d Sess., 90 Stat. 1520.
[4] P.L. 97-248, 97th Cong., 2d Sess., 96 Stat. 324.
[5] §§922(a)(1)(A)(i) and (ii); 927(d)(3) and (5); 927(e)(3).
[6] §922(a)(1)(B).
[7] §922(a)(1)(C).
[8] §922(a)(1)(C)(i).
[9] §922(a)(1)(D)(ii).
[10] §922(a)(1)(D)(iii). Code §6001 provides, in part, that "[e]very person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe."
[11] §922(a)(1)(E).
[12] §922(a)(1)(F). Section 927(b)(4) provides that the term "controlled group of corporations" has the meaning given to such term by §1563(a), which defines "controlled group of corporations", except that the phrase "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein and §1563(b) shall not apply.
[13] §922(a)(2).
[14] §441(h).
[15] §992(a)(1)(A) and (B).
[16] P.L. 98-67, 98th Cong., 1st Sess., 97 Stat. 369.
[17] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 637 (1984).
[18] *Id.*
[19] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 976 (1984).
[20] §927(e)(5)(A). It should be noted that section 801(d)(7) of the Act amends §934 (Limitation on Reduction in Income Tax Liability Incurred to the Virgin Islands) to permit the U.S. Virgin Islands to reduce the tax liability of FSCs. However, new §927(e)(5)(B) ensures that FSCs established in the Virgin Islands, as well as other U.S. possessions, will not escape possessions taxes on income other than foreign trade income.
[21] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 637 (1984).
[22] *Id.*
[23] *Cf.*, Rev. Rul. 73-442, 1973-2, C.B. 296. The Service ruled there that where a shareholder's proportionate share of a corporation's receipts, assets, property, and income is based on the size of his transactions with the corporation rather than the number of shares which he owned, there is more than one class of stock, and, therefore, the corporation cannot qualify as a DISC. The ruling, effectively quashing the method by which a number of small unrelated exporters might have set up a DISC to handle their export sales, apparently will not apply to FSCs.
[24] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 637 (1984).
[25] *Id.*
[26] *Id.*
[27] *See*, Williams, "Permanent Establishments in the United States," 29 Tax Law. 277, 280, 310 (1976).
[28] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 637 (1984).
[29] *Id.*
[30] *See* §1563(a) and §927(d)(4).
[31] §§922(a)(2) and 927(f)(1)(B).
[32] §927(f)(3)(B).
[33] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 657 (1984).
[34] §927(f)(1)(A).
[35] *See also* Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 977 (1984).
[36] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 657 (1984).
[37] §927(f)(1)(B).
[38] §927(f)(3).
[39] §927(f)(3)(A).
[40] §§927(f)(3)(A)(i) and (ii).
[41] §927(f)(3).
[42] *See* Regs. §1.992-2(e) for rules regarding revocation of the DISC election.
[43] §927(f)(3)(B).
[44] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 657 (1984).
[45] §923(b). *See also* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 638 (1984).
[46] §924(a). For a detailed discussion of FTGR, *see* III, D, *infra*.
[47] §921(a).
[48] §923(a)(1).
[49] Section 68(b) of the Act amends paragraph (4) of §291(a) (relating to corporate tax preference items) to provide that "[i]f a corporation is a shareholder of the FSC, in the case of taxable years beginning after December 31, 1984, section 923(a) shall be applied with respect to such corporation by substituting —
(A) '30 percent' for '32 percent' in paragraph (2), and
(B) '15/23' for '16/23' in paragraph (3)."
[50] *See* §923(a)(2), which provides that where the "special administrative pricing rules" set forth in §§925(a)(1) and (2) do not apply, "32 percent of the foreign trade income derived from such transaction shall be [exempt from tax]." The Finance Committee Print clarifies that in such cases, arm's-length pricing or the §482 rules apply. S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 638 (1984).
[51] §923(a)(2).
[52] §925(a)(1) and (2). For further discussion of the special administrative pricing rules, *see* III, E, *infra*.
[53] *See* footnote 49, *supra*.
[54] §923(a)(3).
[55] §§925(a)(1) and (2); 925(b); 925(d).
[56] §921(b).
[57] §927(d)(6) defines "section 923(a)(2) non-exempt income" as "any foreign trade income from a transaction with respect to which paragraph (1) or (2) [(*i.e.*, the special administrative pricing rules)] of section 925(a) does not apply and which is not exempt foreign trade income." Since under §923(a)(2), 32 percent (30 percent in cases involving corporate shareholders of FSCs) of the FTI derived from a transaction will be treated as exempt FTI in the case of any transaction to which the special administrative pricing rules do not apply, "section 923(a)(2) non-exempt income" equals 68 percent (70 percent in cases involving corporate shareholders of FSCs) of FTI.
[58] §927(c) defines "investment income" as —
"(1) dividends,
(2) interest,
(3) royalties,
(4) annuities,
(5) rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States),
(6) gains from the sale or exchange of stock or securities,
(7) gains from futures transactions in any commodity on, or subject to the rules of, a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct business of the FSC in the manner in which such business is customarily conducted by others),
(8) amounts includible in computing the taxable income of the corporation under part I of subchapter J, and
(9) gains from the sale or other disposition of any interest in an estate or trust."
[59] §927(d)(1) provides that the term "carrying charges" means both "carrying charges" and "under regulations prescribed by the Secretary, any amount in excess of the price for an immediate cash sale and any other unstated interest."
[60] §921(d).
[61] §27(a).
[62] §33.
[63] §34.
[64] §906(b)(5). In this regard, section 801(d)(2) of the Act amends §904(d)(1) so that FTI (other than "section 923(a)(2) non-exempt in-

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come") will be taken into account under a separate limitation for purposes of determining the foreign tax limitation of an FSC.

[65] §927(e)(4).
[66] §927(a)(1)(A).
[67] §927(a)(1)(B).
[68] §927(a)(1)(C). The Finance Committee stated its intention that "the Secretary of the Treasury . . . prescribe regulations for the determination of foreign content of any product, without necessarily following current regulations," and that in considering this issue it "expects the Secretary will take into account the effect of any change on revenue, location of employment, and neutrality between similarly situated taxpayers." S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., pp. 652-653 (1984).
[69] Regs. §§1.993(3)(a)-(g).
[70] *Cf.*, Regs. §1.993-3(a)(1), and (c).
[71] *Cf.*, Regs. §1.993-3(d).
[72] §927(a)(2)(A).
[73] Regs. §1.993-3(d)(2).
[74] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 651 (1984).
[75] §927(a)(2).
[76] §927(a)(2)(A).
[77] §927(a)(2)(B).
[78] §927(2)(C).
[79] §927(2)(D).
[80] §927(a)(3).
[81] *Cf.*, Regs. §1.993-3(f)(2).
[82] *Cf.*, Rev. Rul. 74-217, 1974-1 C.B. 195, holding that products leased to a wholly-owned foreign marketing subsidiary for sublease to foreign customers are not excluded from the definition of export property.
[83] *Cf.*, Regs. §1.993-3(f)(2)(iii).
[84] *Cf.*, Regs. §1.993-3(f)(2)(iv).
[85] *Id*
[86] *See* §993(c)(2)(C).
[87] §927(b)(1).
[88] §927(b)(2).
[89] §924(a).
[90] §924(b)(1)(A).
[91] §924(b)(1)(B).
[92] §993(a)(1).
[93] S. Rep. No. 169 (Vol. I), 98th Cong. 2d Sess., p. 639 (1984).
[94] *Cf.*, Regs. §1.993-1(b). *See* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 639 (1984).
[95] *Cf.*, Regs. §1.993-1(b).
[96] *Cf.*, Regs. §1.993-1(c). *See also* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 639 (1984).
[97] *Cf.*, Regs. §1.993-1(c).
[98] *Cf.*, Regs. §1.993-3(d). *See also* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 639 (1984).
[99] *Cf.*, Regs. §1.993-1(h). *See also* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 639 (1984).
[100] *Cf.*, Regs. §1.993-1(i).
[101] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 640 (1984).
[102] S. Rep. No. 169 (Vol. II), 98th Cong., 2d Sess., p. 640 (1984).
[103] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 976 (1984).
[104] *Id.*
[105] §924(f).
[106] §924(f)(1)(A)(i).
[107] §927(a)(1)(A).
[108] *See* III, B, *supra.*
[109] §924(f)(1)(A)(ii).
[110] §924(f)(1)(B).
[111] *See* Regs. §§1.993-1(j)(3)(i)-(vi), which sets forth the following programs as subsidies for DISC purposes which may also qualify as subsidies for FSC purposes:

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151);

(ii) The Public Law 480 program (7 U.S.C. 1691);

(iii) The Export Payment Program of the Commodity Credit Corporation (15 U.S.C. 714c(d) and (f));

(iv) The "section 32 export payment programs" (7 U.S.C. 612c);

(v) The Export Sales Program of the Commodity Credit Corporation (15 U.S.C. 714c(d); and

(vi) Other than the GSM-4 Program.

[112] §924(f)(1)(C).
[113] *Cf.*, Rev. Rul. 76-127, 1976-1 C.B. 212.
[114] §924(f)(2).
[115] §927(c).
[116] §927(d).
[117] §924(b)(1)(A).
[118] §924(d)(1).
[119] §§924(d)(1)(A) and (3)(A).
[120] §924(d)(4).
[121] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 640 (1984).
[122] §924(d)(1)(A).
[123] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 641 (1984).
[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.*
[128] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 641 (1984).
[129] §924(d)(1)(B) and (2).
[130] §924(d)(3)(e).
[131] §924(d)(3)(A).
[132] §924(d)(3)(B).
[133] §924(d)(2).
[134] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 642 (1984).
[135] §924(d)(3)(A).
[136] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 642 (1984).
[137] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 642 (1984).
[138] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 642 (1984).
[139] *Id.*
[140] *Id.*
[141] *Id.*
[142] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 643 (1984).
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644 (1984).
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] §924(c)(2).
[162] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644 (1984).
[163] *Id.*
[164] In this regard, §166(a) provides a deduction for "any debt which becomes worthless within the taxable year." Section 166(b) provides that "the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property." In the case of property included as inventory (the most likely FSC export property), §1011 cross references §1013, which provides that the basis for such property will be the "last inventory value thereof."
[165] §166(c) provides that in lieu of the bad debt deduction provided in §166(a), "there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts."
[166] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644 (1984).
[167] *Id.*
[168] §925(c)(2) and S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644 (1984).
[169] S. Rep. No. 861 (Vol. I), 98th Cong., 2d Sess., p. 648 (1984).
[170] §925(a)(1) and S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644 (1984).
[171] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 649 (1984).
[172] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 644-645 (1984).
[173] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 645 (1984).
[174] *Id.*
[175] S. Rep. No. 169 (Vol. II), 98th Cong., 2d Sess., p. 645 (1984).
[176] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 976 (1984).
[177] *Id.*
[178] §482.
[179] *Id.*
[180] For the scope of the DISC intercompany pricing rules, *see* Regs. §1.994-1(a).
[181] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 646 (1984).
[182] §925(a)(1).

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[183] §925(a)(2).
[184] §925(a).
[185] §925(d).
[186] §925(e).
[187] §925(a)(3).
[188] §925(a).
[189] §924(e).
[190] §§925(a) and (c)(1).
[191] §§925(a) and (c)(2).
[192] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 647 (1984).
[193] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 649 (1984).
[194] *See* Regs. §1.994-1(c)(7).
[195] *See* Regs. §1.994-1(c)(7)(ii).
[196] *See* Regs. §1.994-1(c)(7)(iii).
[197] §925(a)(1).
[198] §925(b)(1) provides that the Secretary shall prescribe regulations setting forth rules which are "consistent" with the 1.83 percent of FTGR test, the 23 percent of CTI test, and the test based upon the sale price actually charged (but subject to the rules provided in §482) in the case of commissions, rentals, and other income.
[199] *Cf.*, Regs. §1.994-1(b)(2).
[200] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 649 (1984).
[201] Regs. §1.994-1(e)(1).
[202] §925(a)(2).
[203] §925(b)(1); *Cf.*, Regs. 1.994-1(d)(2).
[204] Regs. §1.994-1(c)(6).
[205] S. Rep. No. 269 (Vol. I), 98th Cong., 2d Sess., p. 649 (1984).
[206] §925(b)(2).
[207] Regs. §1.994-2.
[208] Regs. §1.994-2(b)(1).
[209] Regs. §1.994-2(a).
[210] Regs. §1.994-2(c)(1).
[211] §§926(a) and (c).
[212] §§245(c)(1) and (2)(A).
[213] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 652 (1984).
[214] *Id.*
[215] §957.
[216] §952.
[217] *See* §951.
[218] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 651 (1984).
[219] §956(b)(2)(I).
[220] §956(b)(3).
[221] §552(a).
[222] *Id.* The gross income percentage will rise to 60 percent again after three consecutive taxable years expire in each of which less than 50 percent of the corporation's gross income is foreign personal holding company income or until the taxable year during the whole of which the stock ownership test is not satisfied.
[223] As earlier noted, such income will not be subject to the Subpart F rules. *See* §951(e).
[224] §551(a).
[225] Section 957(a) defines a CFC as "any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned . . . by United States shareholders on any day during the taxable year of such foreign corporation."
[226] §1248(a).
[227] §926(b).
[228] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 636 (1984).
[229] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 975-976 (1984).
[230] §922(b)(1). *See* III, A, *supra.*
[231] *See* §927(d)(4).
[232] §924(b)(2)(A).
[233] §924(b)(2)(B)(ii).
[234] §924(b)(2)(B)(iii).
[235] §924(b)(2)(B)(iv).
[236] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 659 (1984).
[237] §995(b)(1)(E).
[238] §995(f).
[239] §995(b)(4)(A).
[240] §995(b)(4)(B).
[241] §995(f)(1).
[242] §995(f)(2)(A).
[243] *Id.*
[244] §995(f)(2)(B).
[245] §995(f)(2)(C).
[246] §995(f)(3)(A).
[247] §995(f)(3)(B).
[248] §995(f)(3)(C).
[249] §995(f)(3) [should read (4)].
[250] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 658 (1984).
[251] §996(g).
[252] §927(a)(4).
[253] §925(f).
[254] §923(a)(4).
[255] §245(c)(2)(B).
[256] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 654 (1984).
[257] *Id.*
[258] The term "patronage dividend" is defined as an amount paid to a patron by a cooperative which satisfies the following three conditions: (i) it is paid on the basis of the quantity or value of business done with or for the patron (*see* §1388(a)); (ii) there is a valid, enforceable, and preexisting written obligation to pay that amount (*see* §1388(a)); and (iii) the amount is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons (*see* §1388(a)).
[259] The term "per-unit retain allocations" refers to amounts allocated to and retained by a cooperative from patrons without reference to the net earnings of the cooperative, pursuant to an agreement between the cooperative and the patron (*see* §1888(f)).
[260] "Deductions for nonpatronage distributions" include: (i) amounts paid during the taxable year as dividends on capital stock (*see* §1383(c)(i)); (ii) distributions to patrons of earnings derived from business done for the United States or any of its agencies or from sources other than patronage (*see* §1382(c)(2)(A)); and (iii) distributions and redemptions of nonqualified written notices of allocation (*see* §1382(c)(2)(B)).
[261] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 653 (1984).
[262] *Id.*
[263] §923(a)(4). In this regard, distributions made before the due date for filing the return of tax for a particular taxable year shall be treated as made on the last day of such taxable year.
[264] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 653 (1984).
[265] *Id.*
[266] §245(c)(2)(B).
[267] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., pp. 653-654 (1984).
[268] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 642 (1984).
[269] Webb-Pomerene export organizations are special export combinations that are granted a statutory exemption from application of the antitrust laws to the extent necessary to perform their export function.
[270] §994(a)(1).
[271] §925(a)(1).
[272] §994(a)(2).
[273] §925(a)(2).
[274] §994(a)(3).
[275] §925(a)(3).
[276] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 655 (1984).
[277] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 633 (1984).
[278] S. Rep. No. 169, 98th Cong., 2d Sess., p. 655 (1984).
[279] In the DISC table, the taxpayer with excess credits was taxable on $58: $25 of U.S. source income plus $33 deemed DISC distribution, but paid no tax on $25 of foreign source income or on $17 deferred in the DISC.
[280] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 656 (1984).
[281] Section 805(a)(1) of the Act.
[282] Section 805(a)(4) of the Act.
[283] Section 805(a)(3) of the Act.
[284] §924(c).
[285] §924(d).
[286] Section 805(a)(2)(A) of the Act.
[287] §924(c).
[288] §924(d).
[289] Section 805(a)(2)(B) of the Act.
[290] The grant of regulatory authority to the Secretary of the Treasury to extend the rules allowing waiver of the foreign management and foreign economic process requirements for long-term contracts entered into before March 16, 1984, for years after December 31, 1986, was added in Conference.
[291] §924(c).
[292] §924(c).
[293] Section 805(a)(2)(C) of the Act.
[294] The grant of regulatory authority to the Secretary of the Treasury to extend the rules allowing the waiver of the foreign management and foreign economic process tests for such contracts for years after December 31, 1985, was added in Conference.
[295] Section 805(b)(1)(A) of the Act.
[296] Section 805(b)(1)(B) of the Act.
[297] Section 996(f) defines "DISC income" as "[t]he earnings and profits derived by a corporation during a taxable year in which such corporation

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is a DISC, before reduction for any distributions during the year, but reduced by amounts deemed distributed under §995(b)(1)." Section 996(f) further provides that "[t]he earnings and profits of a DISC for a taxable year include any amounts includable on such DISC's gross income pursuant to §951(a) for such year," and that "[a]ccumulated DISC income shall be reduced by deemed distributions under §995(b)(2)."

[298] Section 805(b)(2)(A) of the Act.

[299] Section 805(b)(2)(B) of the Act.

[300] Section 805(b)(3)(A) of the Act.

[301] Section 805(b)(3)(C) of the Act.

[302] Section 805(b)(3)(A) of the Act.

[303] Section 805(c)(1) of the Act.

[304] S. Rep. No. 169, 98th Cong. (Vol. I), 2d Sess., p. 660 (1984).

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Chapter 65

TRANSFERS OF PROPERTY OUTSIDE THE UNITED STATES—§§367 and 1491 [1]

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I. Overview

A. *Introduction*

Subchapter C of the Code (specifically, §§332, 351, 354, 355, 356, and 361) provides for nonrecognition of gain to a transferor of assets or stock in connection with certain exchanges involving the organization, reorganization, or liquidation of a corporation. However, where such an exchange involves a transfer by a U.S. person to a foreign corporation (*i.e.*, a so called "outbound" transfer), §367(a) may deny such nonrecognition treatment by denying corporate status to the foreign transferee. Prior to the Tax Reform Act of 1984 amendments, nonrecognition treatment generally was denied in respect of such outbound transfers unless the U.S. transferor timely requested and obtained a ruling from the Internal Revenue Service to the effect that the transfer did not have a principal tax avoidance purpose.

The scope of §367(a) was and as amended will continue to be extremely broad. It applies to any direct transfer by a U.S. person to a foreign corporation pursuant to an exchange falling within one or more of the specified nonrecognition provisions, such as the organization of a foreign corporation pursuant to a §351 exchange,[2] the direct acquisition of a U.S. corporation by a foreign corporation pursuant to a reorganization under §§368(a)(1)(B), (C), (D) or (F),[3] or the liquidation of a U.S. subsidiary into its foreign parent under §332.[4] Moreover, a particular transaction may trigger the application of §367(a) even though it does not involve a direct transfer by a U.S. person to a foreign corporation and may appear even to fall outside the specified nonrecognition provisions. For example, the statute applies to certain "indirect" outbound transfers,[5] such as a transfer to a foreign corporation by a foreign or U.S. partnership having one or more U.S. partners,[6] a transfer by a foreign grantor trust of which a U.S. person is treated as the owner,[7] and a transfer of stock or assets to a U.S. corporation in exchange for stock of a foreign corporation in control of the transferee U.S. corporation pursuant to a "triangular" reorganization.[8]

Section 367(a) also applies to certain "constructive" exchanges,[9] such as a contribution of property to the capital of a foreign subsidiary,[10] a termination of the §1504(d) status of a contiguous country subsidiary that had been included in a domestic corporation's affiliated group,[11] the "reclassification" of a foreign partnership as a foreign corporation,[12] and certain intercorporate sales of stock subject to §304.[13]

In some instances, a taxpayer could "elect" to have §367(a) apply in the case of certain "overlap" transactions that qualify both as "foreign-to-foreign" reorganizations within §367(b) and as outbound §351 or §361 exchanges within §367(a).[14] Finally, certain transactions that initially may not appear to involve an outbound transfer of appreciated property, such as the organization of a foreign subsidiary with U.S. currency,[15] nevertheless may be considered to involve a transfer of valuable intangible property with respect to which §367 applies, such as the right to use the parent's corporate name,[16] the right to enter into certain contractual arrangements with third parties,[17] or existing goodwill or going concern value associated with the parent's direct operations in particular foreign countries.[18]

The pre-1984 legislative history of §367(a) indicates that the tax avoidance sought to be prevented in the case of "outbound" transactions was the permanent removal from U.S. taxing jurisdiction of the previously untaxed income or gain inherent in certain types of appreciated property.[19] To accomplish this purpose, the Service developed certain objective standards that were set out in published "Guidelines" applicable to the issuance of §367(a) rulings.[20] These Guidelines generally described when the Service would issue a favorable §367(a) ruling and, often by implication, when it would not. One set of limitations related to the transaction itself and, if those provisions were not satisfied, a favorable §367(a) ruling generally would not be issued and the U.S. transferor would be forced to recognize gain on the entire transaction. For example, the Guidelines established as threshold requirements for a favorable ruling that (1) the transferred property be devoted by the transferee to the active conduct of a trade or business abroad, and (2) the foreign transferee have need for a substantial investment in fixed assets in such business (or be engaged in the purchase and sale abroad of manufactured goods).[21] In addition, favorable treatment was generally not given to transfers of stock under §368(a)(1)(B) and triangular reorganizations in which the stockholders of the acquired U.S. corporation owned after the exchange more than 50 percent of the acquiring corporation's stock.[22]

A second set of limitations contained in the Guidelines related to the transferred assets and identified certain "tainted" assets the outbound transfer of which generally would be presumed to be in pursuance of the prohibited tax

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avoidance purpose. In the case of such transfers, issuance of a §367(a) ruling ordinarily could still be obtained for the overall transfer but it would be conditioned on the transferor's agreeing to currently recognize as a "toll charge" the income or gain inherent in the "tainted" assets.[23]

The types of income or gain inherent in "tainted" assets in respect of which tax avoidance was presumed and a toll charge generally was imposed included: (i) appreciation in the value of certain investment assets, such as stock or securities, that may be sold or otherwise disposed of by the transferee foreign corporation;[24] (ii) passive income attributable to certain intangibles, or rents or royalties to be received in connection with property that may be leased or licensed by the transferee;[25] and (iii) fully "matured" income that had effectively been earned but had not yet been reported by the U.S. transferor, such as the income reflected in accounts receivable and inventory.[26]

In addition, where the transferor had incurred losses for U.S. purposes in respect of the assets being transferred abroad (typically the assets associated with a foreign branch operation), the Service, notwithstanding the Tax Court's rejection of its position in *Hershey Foods Corp. v. Comr.*,[27] ordinarily conditioned the issuance of a favorable ruling on the transferor's agreeing to include in income the amount of the cumulative net losses incurred by the branch since its inception (not to exceed the gain realized on the transfer) reduced by any "overall foreign loss" recaptured under §904(f)(3).[28] By contrast, favorable rulings generally were issued without any condition in respect of the transfer of fixed assets, most intangibles, and other property to be devoted by the transferee foreign corporation to an active trade or business abroad.[29]

The foregoing Guidelines and rulings positions represented only presumptions and thus theoretically could be modified or rebutted where the facts and circumstances of a particular case otherwise established the absence, or existence, of the prohibited tax avoidance purpose.[30] However, favorable rulings under the "facts and circumstances" exception were issued only rarely.[31] The "reasonableness" of an adverse ruling or toll charge could be challenged in the Tax Court under the §7477 declaratory judgment procedure enacted in 1976, a procedure that was utilized by taxpayers with consistent success. *Kaiser Aluminum & Chemical Corp. v. Comr.*,[32] struck down the Service's refusal to permit a tax-free transfer of stock which, in the court's view, represented more of an operating asset than a passive investment security. The first declaratory judgment proceeding under §7477, *Dittler Bros. Inc. v. Comr.*,[33] required the Service to take into account transferor intent notwithstanding the inability to satisfy the terms of the Guidelines. *Hershey Foods* [34] successfully challenged the validity of the loss "recapture" requirement of Rev. Rul. 78-201 in connection with foreign branch incorporations.

B. Substantive Changes Effected by the Tax Reform Act of 1984

The tax avoidance purpose standard and the ruling requirement have been eliminated. Under the 1984 Act, gain generally must be recognized on a transfer of appreciated property to a foreign corporation pursuant to one of the "tax-free" exchanges described in §367(a). The principal exception to this general, automatic toll charge rule is for transferred property that will be used by the transferee in "the active conduct of a trade or business outside of the United States." [35]

However, certain types of property are made ineligible for the active trade or business exception and their transfer to a foreign corporation will result in automatic recognition of gain. Such "tainted assets" include inventory, installment obligations, accounts receivable, foreign currency or property denominated in foreign currency, intangible property, and property being leased by the transferor (except where leased to the transferee). §367(a)(3)(B). For this purpose, transfers of general partnership interests are to be treated as transfers of each U.S. partner's pro rata share of partnership assets. §367(a)(4). The Secretary is authorized to exempt certain transactions by regulation from the general automatic toll charge rule. §367(a)(5).

Stock and securities, which formerly were treated as tainted assets under the Guidelines (subject to limited exceptions), are omitted from the statutory list of tainted assets and, according to the Committee Reports, their outbound transfer ordinarily will be deemed by regulation to meet the active business test for nonrecognition treatment (i) where the transfer falls within the Guidelines' or certain newly developed exceptions, or (ii) where the transferor enters into a special closing agreement to ensure recognition of gain in the event of a subsequent disposition of the stock by the transferee.

The branch loss recapture toll charge of Rev. Rul. 78-201 [36] has been codified. Under the new provision, upon the incorporation abroad of a foreign branch that has operated at a net loss the U.S. transferor must recognize as ordinary income the cumulative net amount of the prior losses (reduced by the amount, if any, recaptured under §904(f)(3)) to the extent of the gain realized on the transfer. §367(a)(3)(C).

Under a special set of rules applied to transfers of intangible property, a transferor generally will be treated as having sold the intangibles for payments that are "contingent upon the productivity, use or disposition of such property" and must include such constructive payments in income annually over the useful life or lives of the transferred intangibles (or currently, if the transferee disposes of the intangibles). §367(d).

Although §336 is not one of the nonrecognition provisions enumerated in §367(a)(1), a special rule will require recognition of gain by liquidating domestic corporations on distributions of appreciated property to their foreign shareholders (whether or not pursuant to a §332 liquidation) to the extent required under regulations that are to adopt "principles similar to the principles" of §§367(a) and (d).

The provisions of §§1491-1494, which impose a 35 percent excise tax on outbound transfers of appreciated property to foreign partnerships, trusts, estates and noncontrolled foreign corporations (as paid-in surplus or capital contributions) are amended to require the application of "principles similar to the principles of §367." §§1492(2)(B) and 1494(b).

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C. *Procedural Changes Effected by the Tax Reform Act of 1984*

It is no longer necessary to obtain an IRS ruling with respect to transfers described in §367(a), although the Committee Reports make clear that rulings will continue to be obtainable on a discretionary basis.

The declaratory judgment provisions of §7477, which granted the Tax Court jurisdiction to review the reasonableness of IRS rulings under §367(a), are repealed. Act §131(e). A notification procedure is established under which each U.S. person that makes an outbound §367(a) or §367(d) transfer or §367(e) liquidating distribution will be required to report the transaction on an information return to be filed in the time and manner prescribed by regulations. Failure to file the return will toll the applicable statute of limitations and, unless due to reasonable cause, will subject the transferor to a 25 percent penalty. Act §131(d).

D. *Effective Dates*

The 1984 Act amendments generally are effective with respect to transfers or exchanges occurring after December 31, 1984. If a request for a ruling was filed prior to March 1, 1984, however, the old rules will continue to apply even if the transfer occurs after 1984.

Although the new liquidating distribution rules under §367(e) are effective January 1, 1985, §367(e) by its terms requires implementing regulations and thus may not become effective until some later date.

Under a special transitional rule, transfers of intangible property occurring after June 6, 1984, but before January 1, 1985, will be deemed to be in pursuance of a principal tax avoidance purpose and, thus, to be ineligible for nonrecognition treatment under applicable pre-1984 Act rules, unless a "waiver" of this automatic toll charge is obtained from the Service.

II. Detailed Analysis

A. *The General Automatic Toll Charge Rule*

The general rule under §367(a)(1), as amended by §131 of the 1984 Act, is that gain must be recognized when appreciated property is transferred to a foreign corporation in connection with an exchange otherwise qualifying for tax-free treatment under §§332, 351, 354, 355, 356 or 361.

1. *Scope of the General Rule*

Except for the special rules governing outbound transfers of intangibles (§367(d)) and liquidating distributions (§367(e)), the basic scope and mechanics of §367 are not materially altered by the 1984 Act amendments. The toll charge mechanism continues to operate by denying corporate status to a foreign corporate transferee in connection with certain specified Subchapter C transactions in respect of which the transferee's corporate status is a prerequisite to the transferor's (and possibly other parties') eligibility for nonrecognition treatment. The amended statute applies, as did prior law, to direct, indirect and constructive outbound transfers pursuant to statutory nonrecognition provisions that otherwise would permit the tax-free expatriation of U.S. stock or assets into foreign corporate solution outside the reach of direct U.S. tax jurisdiction. It applies only to "transfers," not to loans, leases, licenses or other transactions involving less than full and irrevocable relinquishment by the transferor of all substantial rights in the subject property.[37] It applies only to transfers of "property," not to the right to enter into executory contracts, or other items that do not rise to the level of a valuable proprietary right or interest.[38] Although relief from the automatic toll charge is provided by statutory (and regulatory) exception, many of the substantive standards formerly applied under the rulings Guidelines will continue to have relevance in determining the results of transactions under the amended statutory scheme.

2. *The "Foreign Party Stock" Exception*

New §367(a)(2) preserves the prior law exception for outbound transfers of stock or securities of a foreign corporation which is a party to the exchange or reorganization. By virtue of this exception, as under prior law, the general rule of §367(a)(1) is made inapplicable to the recapitalization of a foreign corporation that qualifies as a reorganization under §367(a)(1)(E), and to contributions of transferor or transferee stock or securities to a foreign corporate transferee.[39] This exception also might continue to have relevance in foreign holding company reorganizations, permitting a U.S. parent's transfer of the stock of its foreign operating subsidiary to an existing or newly-formed foreign holding company to be subject solely to the §367(b) regulations applicable to foreign-to-foreign "B" reorganizations rather than to the §367(a) standards applicable to outbound §351 transfers of stock. However, the legislative history leaves uncertain whether the current rule granting priority to "B" treatment in "B"-§351 overlap cases will be retained.[40]

B. *The Active Trade or Business Exception*

1. *In General*

The principal exception to the general automatic toll charge rule is contained in §367(a)(3)(A), which provides that the general rule will not apply, and thus that gain need not be recognized, with respect to "any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States." Assets which produce passive income, such as interest or rent, ordinarily will not satisfy the active trade or business exception. In addition, other types of property that otherwise might satisfy the exception, such as inventory and receivables, are specifically excluded from tax-free treatment.[41]

The active trade or business exception is drawn from Sec. 3.02 of the Guidelines, under which a favorable §367(a) ruling ordinarily was issued if the transferred "property is to be devoted by the transferee foreign corporation to the active conduct, in any foreign country, of a trade or business. . ." The Service is urged to issue regulations by January 1, 1985, the effective date of the amendments, prescribing the standards that are to be used in determining whether the active trade or business test is satisfied.[42] In the interim, taxpayers are authorized to rely on current IRS rulings practice under the Guidelines' active business standard, as reflected in private letter rulings upon which the regulations presumably will be modeled.[43]

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2. The "Managerial and Operational Activities" Standard

In a series of private letter rulings, some issued since the amendments made by the 1984 Act were proposed,[44] the Service stated that the "active trade or business" test will be satisfied only if the foreign transferee conducts both managerial and operational activities using its own employees.[45] The rationale for this interpretation was the Service's view that the Guidelines' active business requirement generally should have the same meaning as the identical phrase in §355(b), which limits tax-free "spin-offs" to situations where the distributing corporation and the controlled corporation have been and will continue to be "engaged . . . in the active conduct of a trade or business." In a succession of revenue rulings focusing on the §355(b) active business test,[46] the Service had held that §355, "by requiring that a trade or business be *actively conducted*, connotes substantial management and operational activities directly carried on by the corporation itself, and not the activities of others outside the corporation, including independent contractors." This position subsequently was adopted in the proposed regulations under §355(b).[47]

In PLR 8305036, characterization of tenant farmers as independent contractors rather than employees prevented an outbound transfer of Canadian farm land from satisfying the "operational" prong of the Guidelines' active business test and led to an adverse ruling on the transaction.[48] In *Dittler Bros., Inc. v. Comr.*, the Tax Court held that under the Guidelines' "facts and circumstances" exception the outbound transfer of know-how (rub-off lottery tickets) did not have a principal tax avoidance purpose, even though the transferee's activities were conducted exclusively through related corporations on an independent contractor basis. However, the court indicated that it "might be inclined to sustain respondent's adverse determination" if the transferee's conduct of an active business was, as it is now, an absolute requirement.[49]

If the forthcoming regulations adopt the Service's current interpretation of the active business test, the ability to meet the statutory exception could well turn on whether particular employees abroad are viewed as performing *both* managerial *and* operational activities. As recent rulings suggest, this requirement could present a serious obstacle to foreign oil and gas and other natural resource exploration and development ventures. Given the magnitude of the costs and risks involved, such ventures often are carried out under joint operating agreements that delegate day-to-day operational responsibilities to one co-venturer. The remaining co-venturers, notwithstanding substantial capital commitments, generally are not engaged in day-to-day operational activity, but nevertheless are actively involved in the monitoring and analysis of testwell data and in a broad range of decisions regarding drilling, recovery, and other procedures under the joint operating agreement. Although the Service formerly had granted favorable clearance to outbound transfers of oil and gas working interests (as distinguished from most overriding royalty and similar "passive" interests) without regard to the transferee's operator status, recent rulings have taken the position that the active business requirement ordinarily will not be met, and nonrecognition treatment thus will not be available, unless more than 50 percent of all working interest properties transferred represent operating interests; *i.e.*, properties in respect of which the transferor possesses (and the transferee will assume) operating control.

In PLR 8407012, for example, none of the transferor's employees was viewed as performing the requisite "operational" functions. Thus, an adverse ruling was issued because the transferor was not the operator in respect of the transferred oil and gas working interest properties and, thus, was not engaged in day-to-day drilling activities, even though its employees performed substantial related activities in connection with the development of the properties under the joint operating agreement. If the functions performed by the transferee's engineer and geologist employees could have been characterized as "operational" as well as managerial, a favorable ruling might have been obtainable.

How the foreign corporation's business is characterized also may be important under the active business test. For example, in Rev. Rul. 73-237,[50] a corporation was held for §355(b) purposes to be actively engaged in the general contracting business (by preparing bids, negotiating contracts, purchasing equipment and supplies, and supervising subcontractors) although its employees were not directly engaged in any day-to-day construction activity.

3. The "Foreign" Business Requirement

Section 367(a)(3)(A), like the Guidelines provision on which it is modeled, requires that the transferee foreign corporation conduct its business outside the United States.[51] Nonrecognition treatment ordinarily would be unavailable in respect of a transfer of the assets of a domestic business to a foreign corporation where the transferee planned to continue the business in the United States after the transfer. The Service formerly had been willing to grant favorable clearance with respect to a foreign parent's §332 liquidation of its domestic subsidiary, even where the subsidiary's U.S. business would be continued by the parent in branch form, apparently in recognition of the fact that a foreign corporation generally is taxed on its effectively connected U.S. branch income in a manner comparable to a U.S. corporation.[52] However, recent rulings have taken the position that such a transfer is proscribed by the Guidelines' requirement that the transferred property be devoted by the transferee to the conduct of an active business abroad, not in the United States.[53]

Under the Guidelines, stock transfers were tested under somewhat different criteria than transfers of assets, with the foreign situs requirement being applied primarily to the latter. This distinction likely will be retained under the statutory active business exception. For example, where a foreign corporation acquires control of a domestic corporation in an outbound "B" reorganization, the foreign situs requirement presumably will be deemed to be satisfied even though the subsidiary is engaged in business in the U.S.[54]

4. The "Transferee's" Business

Although §367(a)(3)(A) literally requires that the property transferred to a foreign corporation be used by "such corporation" in an active business, the regulations hopefully will preserve the existing rule permitting the property to be retransferred to a lower-tier foreign subsidiary. The Service's longstanding position under the Guide-

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lines had been to permit transfers "from one controlled corporation to another," with the "ultimate recipient of the property [being] required to satisfy" the active trade or business test.[55] Similarly, the current rulings practice of permitting property transferred to a foreign corporation to be retransferred to a foreign partnership hopefully also will be continued.[56]

5. Application of the Active Business Exception to Partnership Interests

Section 367(a)(4) provides that the active business exception is to be applied to outbound transfers of partnership interests by treating the transaction as a transfer by each U.S. partner of its pro rata share of the partnership assets. The Committee Reports indicate that since the focus of §367(a)(4) is on transfers of partnership interests, it represents an extension of the rule contained in Regs. §1.367(a)-1(b)(3), which treats U.S. partners as having transferred a proportionate share of partnership assets only when the *partnership* transfers its assets.[57] In fact, however, the Service's existing rulings practice has been to apply the relevant Guidelines' standards with respect to the underlying partnership assets in cases involving the transfer of general partnership interests. If the partnership held "tainted" assets, such as inventory or portfolio securities, a favorable §367 ruling ordinarily would be issued only if the U.S. partner-transferor agreed to include in income as a toll charge its proportionate share of the gain attributable to the partnership's tainted assets.[58] This should also be the result (albeit without a ruling) under §367(a)(4).[59]

The foreign transferee of a partnership interest generally will be treated as using the transferred partnership interest in an active trade or business if the partnership's assets are so used by the partnership. This, too, was the rule prior to the 1984 Act.[60] Where tiered partnerships are involved, so that the assets of the partnership whose interest is transferred consist of interests in a second partnership, the regulations likely will provide that §367(a) will be applied as though the second partnership's assets had been transferred.[61]

Although §367(a)(4) makes no distinction between limited and general partnership interests, the Committee Reports state that the "rule will not apply to most transfers of limited partnership investments." [62] According to the Committee Reports, such interests are comparable to stock and are to be treated as stock in applying §367(a).[63] Since the treatment of outbound stock transfers under the amended provisions (as discussed below) represents a substantial liberalization of pre-1984 Act treatment, it is possible that the intention of the Committee Reports was to extend such liberalized treatment to limited partnership interests as well. Given the Service's largely unfavorable treatment of such interests under the Guidelines, however, it is questionable whether such a change in treatment in fact was intended.

Limited partnership interests generally were treated as tainted assets under the Guidelines.[64] The sole exception to this treatment was the case of an incorporating transfer in which all partners participated. In such cases, the Service looked to the underlying assets of the partnership and each U.S. partner, both limited and general, was required to recognize its proportionate share of gain attributable to any tainted assets held by the partnership.[65] Whether or not the forthcoming regulations adopt rules similar to those applicable to transfers of stock, those rules hopefully will include the exception for incorporating transfers in recognition of the fact that the exception would produce a result consistent with the treatment of a transfer of assets by the partnership, followed by a distribution of the transferee stock to the limited and general partners.

C. "Tainted" Assets Ineligible for the Active Business Exception

1. In General

In a provision modeled after Secs. 3.02(1)(a) and (b) of the Guidelines, §367(a)(3)(B) lists several categories of "tainted" assets which, even if otherwise transferred for use by the foreign transferee in an active business, are deemed to be ineligible for tax-free treatment. Although gain therefore must be recognized on the transfer of any such assets, tax-free treatment may be obtained with respect to any non-tainted assets transferred (*i.e.*, assets not falling within any of the tainted categories), provided they satisfy the active trade or business exception.[66]

The categories of tainted assets listed in §367(a)(3)(B) are inventory, installment obligations, accounts receivable, foreign currency and property denominated in foreign currency, and certain property with respect to which the transferor is a lessor. Also included is a broad collection of intangible property. (Except in the case of outbound §332 liquidations to which new §367(e) applies, §367(d) (as discussed below) generally removes intangible property from the ambit of the general toll charge rule of §367(a), subjecting such property instead to a separate set of taxing rules.) [67]

Although stock and securities were considered tainted assets under the Guidelines,[68] under the 1984 Act amendments such property is omitted from the statutory list of tainted assets and may receive tax-free treatment if the active business exception is satisfied.[69] Similarly, although there are no statutory provisions comparable to Secs. 3.02(1)(a)(iv) and (1)(b)(ii) of the Guidelines, which generally required gain to be recognized on the transfer of property which was likely to be sold, leased, or otherwise disposed of by the transferee, the Committee Reports suggest that such transfers in most cases would not satisfy the active business exception and, thus, would continue to result in recognition of gain.[70]

2. Inventory

As under the Guidelines, §367(a)(3)(B)(i) treats as a tainted asset "property described in paragraph (1) . . . of section 1221" (*i.e.*, stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer). The Service's rulings position under the Guidelines, which may well continue to be applied under the 1984 Act provision, is that "inventory" encompasses not only finished goods, but also raw materials and work-in-process. This point, however, should be clarified in the regulations.

The Service's stated rationale for prohibiting tax-free transfers of inventory was that inventory by definition is virtually certain to be sold by the transferee shortly after

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the transfer and its transfer abroad merely represents a diversion of income that could as easily have been earned by the transferor within U.S. tax jurisdiction. In addition, the benefit of U.S. tax deferral in respect of such income is particularly inappropriate in that the cost of the materials and labor necessary to produce the inventory likely has been or will be claimed by the U.S. transferor as a deduction against its U.S. tax liability.[71] These same considerations presumably influenced the decision to include inventory within the statutory list of tainted assets.

3. Installment Obligations and Accounts Receivable

Also as under the Guidelines, §367(a)(3)(B)(ii) requires recognition of gain on the transfer of "installment obligations, accounts receivable, or similar property."[72] If the income represented by a receivable has already been included in income, the taxpayer's basis will have been increased accordingly and no additional gain should be recognized on its transfer in an exchange described in §367. Conceivably, however, the fair market value of the receivable at the time of transfer could exceed its face amount and, in the absence of an exception in the regulations, additional gain could be recognized.

4. Foreign Currency

Under §367(a)(3)(B)(iii), "foreign currency or other property denominated in foreign currency" is made ineligible for tax-free treatment under the active business exception. Although such property is not listed as a tainted asset in the Guidelines, it was so treated in Rev. Rul. 81-4 as well as in a succession of private letter rulings.[73] This position is premised on the historic treatment of foreign currency as "property" for U.S. tax purposes, and the application of the "two transaction" principle for purposes of determining the tax consequences of foreign currency transactions (sales, repayments of borrowings, etc.). Under that principle, the foreign currency aspect of the transaction is treated as a separate transaction from the underlying transaction and, thus, may separately give rise to taxable gain or loss (depending upon the relevant exchange rate and U.S. dollar basis in the acquired currency) without regard to the results of the underlying transaction.[74]

The Senate Report notes that "other property denominated in foreign currency" includes foreign currency receivables and installment obligations.[75] Where such property is transferred abroad, a separate toll charge will be imposed (in addition to the toll charge in respect of the receivables or installment obligations themselves) to reflect any exchange gain realized by the U.S. transferor as a result of an increase in the dollar value of the underlying foreign currency between the date the property was acquired and the date of transfer.[76] However, under the normal principles applicable to determining the character of foreign exchange gain or loss, such character generally will be the same as the character of the gain or loss recognized on the underlying transaction; *e.g.*, ordinary in the case of trade account receivables.[77]

On the other hand, where the foreign currency has appreciated in value in relation to the U.S. dollar and produces exchange losses to the U.S. transferor in respect of the transferred receivables, installment obligations, or other foreign currency denominated property, such losses are not recognized in connection with the transfer; nor reduce the amount of gain or income includible with respect to the underlying asset (if a tainted asset). Moreover, exchange losses attributable to one class of foreign currency receivables may not be "netted" against exchange gains attributable to others.[78]

The House and Senate Reports state that "other property denominated in foreign currency" also will be considered to include "accounts payable" (and apparently other liabilities and obligations) denominated in foreign currency, noting specifically that such "property" had not been considered to fall within the tainted asset category under the Guidelines.[79] Although the Senate Report definition is not inadvertent, it may be questioned whether it is appropriate to treat the foreign currency amount of a payable or other liability as an item of property. If a taxpayer's liability is lower in dollar terms at the time of discharge than at the time incurred by reason of a decline in the dollar value of the foreign currency in which such liability is denominated, it could be argued that the resulting "gain" is more in the nature of discount or reduced interest cost than taxable gain, or might be treated as discharge of indebtedness income excludible under §108 (subject to §1017 basis adjustments).[80]

The treatment of foreign currency payables as tainted assets also could produce somewhat anomalous results by virtue of the inability to net gains and losses. For example, a transfer of the assets of a foreign branch with accounts payable roughly in balance with accounts receivable could result in recognition of gain with respect to one but no offsetting loss with respect to the other. Just how the regulations will deal with this new item of "property" for §367 purposes remains to be seen.

5. Property Leased by the Transferor

Section 367(a)(3)(B)(v), which is modeled after Sec. 3.02(1)(b)(i) of the Guidelines, treats as a tainted asset "property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee." The stated rationale for the Guidelines provision was to prevent the diversion from U.S. tax jurisdiction of passive income that could have been as easily received by the U.S. transferor as by the foreign transferee.[81] By contrast, where the transferred property is being leased to the transferee, the Service ordinarily ruled favorably under the Guidelines on the premise that the potential for diversion was minimal because the foreign transferee, which had been using the property, would be unlikely to dispose of it after the transfer.[82]

6. Other Tainted Assets

Except for intangible assets, which are discussed separately below, the statute lists no other categories of tainted assets. The Committee Reports contemplate, however, that passive investment-type assets (*e.g.*, certain non-working oil and gas and mineral interests) which in the past had been treated by the Service as tainted assets,[83] in most cases will fail to meet the active business exception and will continue to be ineligible for tax-free treatment.

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D. Property Likely to be Leased by the Transferee to Third Parties

Both the House and Senate Reports indicate that, in appropriate circumstances, tax-free treatment may be obtained under the active business exception even though the transferred property will be leased to third parties by the transferee rather than used directly in the transferee's business.[84] Tax-free treatment will not extend to property which is already subject to a lease, however, as such property is specifically made ineligible for the active business exception.[85]

Ordinarily, rental income is considered passive income to the lessor and any attempt to transfer property generating rental income to a foreign corporation will result in recognition of gain for failure to satisfy the active business exception. Under Sec. 3.02(1)(b)(iii) of the Guidelines, property likely to be leased by the transferor was specifically characterized as a tainted asset, the transfer of which would generally be subject to a toll charge. An exception was developed to cover situations where the foreign transferee conducted an active leasing business. As formalized in Rev. Proc. 80-14,[86] and as adopted in the 1984 Act Committee Reports,[87] tax-free treatment may be obtained on the transfer of property that will be leased by the transferee provided the following requirements are satisfied:

(i) The property will be leased to persons who will not use the property in the U.S.;

(ii) The foreign transferee will have employees performing substantial marketing, customer servicing, repair, and maintenance activities with respect to the leased property; and

(iii) The foreign transferee will have need for a substantial investment in fixed assets of the kind transferred.

E. Treatment of Stock and Securities

1. In General

Stock and securities, which represent the principal category of property that was formerly treated as a tainted asset category under the Guidelines, is omitted from the list of tainted assets enumerated in new §367(a)(3)(B). Although the availability of nonrecognition treatment in respect of an outbound transfer of stock or securities literally turns on whether the active business exception can be met, the Committee Reports direct that the regulations prescribe the circumstances under which the active business exception will be deemed to be met.

In particular, the Committee Reports indicate that outbound stock or securities transfers generally should be deemed to meet the active business exception (and thus qualify for nonrecognition treatment) under those circumstances with respect to which favorable treatment formerly had been granted under the Guidelines and IRS rulings practice (described below).[88] In addition, the Committee Reports contemplate that the regulations will specify certain newly-developed exceptions under which such transfers will be deemed to qualify for nonrecognition treatment as well as provide a special closing agreement procedure pursuant to which such treatment will be available in "appropriate" cases (and subject to certain conditions), even where none of the specific regulatory exceptions is met.[89]

2. The Guidelines Exceptions

a. The 50 Percent-or-Less Ownership Exception

Several types of outbound reorganizations involving the acquisition of domestic corporations by foreign corporations or their domestic subsidiaries were permitted to be effected on a tax-free basis under the Guidelines. A threshold question that determined which of several Guidelines' tests would be applied by the Service was whether the reorganization involved a transfer of assets by the acquired domestic corporation (in which case the tainted asset and related rules would be applied and, presumably, will continue to be applied under the 1984 Act amendments) or a transfer of stock by the-acquired corporation's shareholders (in which case certain special rules, described below, would be applied).[90]

The types of reorganizations which have been (and should continue to be) treated for §367 purposes as outbound transfers of stock by the acquired domestic corporation's shareholders include the following: (i) a "B" reorganization, in which a foreign corporation (or its domestic subsidiary) acquires "control" of a domestic corporation solely in exchange for the foreign corporation's voting stock;[91] (ii) a reverse triangular merger under §§368(a)(1)(A) and (a)(2)(E), in which a domestic subsidiary of a foreign corporation merges into a second domestic corporation, whose shareholders receive voting stock of the foreign parent;[92] (iii) a forward triangular merger under §§368(a)(1)(A) and (a)(2)(D), in which a domestic corporation is merged into a domestic subsidiary of a foreign corporation in exchange for the foreign parent's stock;[93] and (iv) a triangular "C" reorganization, in which a domestic corporation transfers substantially all of its assets to a domestic subsidiary of a foreign parent in exchange for voting stock of the foreign parent.[94]

Under the Guidelines, gain realized on the transfer of stock or securities in connection with one of the foregoing reorganizations generally had to be recognized unless, after the reorganization, the shareholders of the acquired domestic corporation owned stock of the acquiring foreign corporation possessing no more than 50 percent of the voting power of such stock.[95] If after the reorganization the acquired domestic corporation's shareholders owned 80 percent or more of the acquiring foreign corporation's stock, the transaction was tested under the Guidelines criteria applicable to §351 stock transfers and ordinarily resulted in the recognition of gain unless the "same country" exception applied (as discussed below).[96]

The professed rationale for the Guidelines' 50 percent-or-less ownership exception was that the acquired corporation's shareholders should not be in a position after the reorganization to dictate a possibly tax-free sale by the foreign corporation of the acquired domestic corporation's stock.[97] For example, in PLR 8121093, even though the domestic corporation's shareholders acquired less than 50 percent of the acquiring foreign corporation's voting stock, a favorable §367(a) ruling was denied under the Guidelines' facts and circumstances exception because the large block of stock which they did acquire gave them effective

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control.[98] In light of the rationale advanced for the 50 percent test, the regulations adopting this exception under the 1984 Act amendments appropriately might exempt all reorganizations involving widely-held corporations on the theory that in such cases no group of shareholders will ordinarily have the power to effect a pre-planned sale following the reorganization.

b. The "Same Country" Exception

A second exception under current law to the general prohibition on tax-free transfers of stock is the "same country" exception. Under the "same country" exception, which has long been the principal tax-free route by which a domestic corporation could place a foreign operating company under a foreign holding company or by which foreign brother-sister corporations could be realigned into a parent-subsidiary structure, stock (but not securities) may be transferred tax-free provided: (i) the corporation whose stock is transferred is incorporated in the same foreign country as the transferee; (ii) a substantial part of the assets of the transferred corporation are used in a trade or business carried on in such country; (iii) after the transfer the transferee holding company will own at least 80 percent of the stock of the transferred corporation; and (iv) after the transfer, the transferee in turn will be at least 50 percent owned by persons who, immediately prior to the exchange, controlled the corporation whose stock was transferred.[99] Transfers which meet these requirements presumably will be deemed to satisfy the new active business exception and will continue to be accorded tax-free treatment.

To qualify for the same country exception the foreign holding company must be "controlled" by the transferor within the meaning of §368(c). Thus, unless the "solely for voting stock" requirement of §368(a)(1)(B) is not satisfied, a transfer qualifying for the same country exception normally should qualify both as an outbound §351 transfer and as a foreign-to-foreign "B" reorganization. Regs. §1.367(b)-4(b) provides that such transfers generally will be considered foreign-to-foreign "B" reorganizations subject to the rules set forth in Regs. §7.367(b)-7, rather than outbound §351 transfers of stock subject to §367(a).[100] The Senate Report states that such "overlap" transfers should be tested solely under §367(a) as outbound §351 transfers, which reverses the priority rule contained in the current regulations.[101] However, the Conference Report appears to take a somewhat different view, stating that the Service "will carefully consider whether there are cases where [such a] transfer should be treated as a §351 exchange." [102]

Characterization as a foreign-to-foreign "B" reorganization ordinarily would be more favorable to taxpayers than outbound §351 treatment in that current, tax-free treatment would not be dependent upon satisfaction of the "same country" or other exceptions or the entry into a closing agreement.[103] In addition, under Regs. §7.367(b)-9(c), the earnings and profits of the acquired corporation (and any lower tier subsidiaries) would be automatically included in the earnings and profits of the acquiring corporation, whereas an actual, post-transfer distribution of such earnings and profits following a §351 transfer may have given rise to Subpart F income.[104] On the other hand, there are circumstances in which combining the earnings and profits of the acquired corporation and its subsidiaries with the earnings and profits of the acquiring corporation may not be desirable; *e.g.*, where the effect would be to dilute a high effective rate of foreign tax paid with respect to the acquiring corporation's earnings and profits for foreign tax credit purposes. Moreover, Regs. §7.367(b)-4(b) in some cases exacted a current §1248 toll charge as the price for foreign-to-foreign "B" treatment, an additional cost that might not be present if outbound §351 treatment made the transaction eligible for nonrecognition under one of the forthcoming regulatory exceptions.

c. The Kaiser Aluminum Exception

A third, rather limited exception to the treatment of stock as a tainted asset developed in response to the Tax Court's decision in *Kaiser Aluminum and Chemical Corporation v. Comr.*[105] The taxpayer in that case successfully challenged an unfavorable §367(a) ruling on the ground that the stock which it had transferred to a foreign corporation, although representing a minority interest that did not qualify for the "same country" exception, was in substance an operating asset and should not be characterized as stock for purposes of the Guidelines. Ownership of the stock both entitled and required the stockholder to take and pay for a proportionate share of raw materials produced by the company, and the stock thus ensured a source of supply for the foreign transferee.[106]

3. The "Substantial Ownership" "Integrated Business" Exception

The House and Senate Reports indicate that, in addition to continuing the Guidelines' exceptions, the regulations also will identify certain other circumstances under which an outbound transfer of stock will be deemed to satisfy the active business exception and, thus, be entitled to nonrecognition treatment even though such treatment would not have been available under the Guidelines. According to the Committee Reports, such "additional circumstances" should include "substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee." [107]

The rationale for such an "integrated business" exception apparently would be similar to the rationale for the Guidelines' "same country" exception; namely, that under such circumstances the likelihood should be minimal that the transferee will dispose of the transferred stock after the transaction. In view of this similarity, it would appear likely that "substantial ownership" would be similarly defined in the regulations to require at least 80 percent control (within the meaning of §368(c)) of the transferred corporation by the transferee. However, the intended parameters of the "integrated business" requirement are somewhat less certain.

It is possible that the regulations will require merely financial or managerial "integration" of a type normally present in most groups of commonly controlled corporations. Under this approach, a transfer of operating subsidiary stock to an existing or newly formed holding company might satisfy the exception if the holding company, even though not directly engaged in any business, performed general policymaking, managerial, financial and other

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"stewardship" functions on behalf of or for the benefit of the operating subsidiary.

On the other hand, the regulations could adopt a stricter test that might require "operational" integration. Such a concept might be modeled after the "complete business" concept developed in the revenue rulings involving application of the Rev. Rul. 78-201 loss recapture toll charge to outbound transfers of all or part of several foreign branches or divisions of a single taxpayer.[108] By analogy to those rulings, as discussed in more detail below, the businesses of separate corporations might be considered "integrated," even though the corporations are domiciled and operate in different countries, if the businesses involve the same product line or vertically integrated phases of the same line; *e.g.*, where one corporation manufactures components (or extracts minerals) for assembly (or processing) by the other into finished products or where one corporation is responsible for marketing the output of another. Operational integration also might be evidenced under the rulings by reference to such factors as common purchasing, accounting, personnel and record-keeping departments, a common sales force, headquarters staff and management team, shared manufacturing facilities and processes, and/or substantially identical customers and distribution channels. However, such an approach could make the exception generally unavailable to pure holding company structures and even to many horizontally-integrated corporate groups.

Alternatively, the regulations could take a middle course between managerial and operational integration, perhaps adopting principles analogous to those developed by the courts in determining whether and to what extent a group of corporations constitutes a "unitary business."[109] Under this approach, the relevant indicia of integration might include centralization of management and policy-making functions, intercorporate financing and guarantee arrangements, personnel and technical services sharing arrangements, and similar evidences of "mutual interdependence" between or among the relevant corporations.

Given the relatively narrow ambit of the Guidelines' exceptions, the new "integrated business" exception, depending upon its breadth, could well become the primary technique for realigning the structure of foreign corporate groups on a tax-free basis. How broadly the regulations define this exception, however, will likely turn on how broad a role the Service decides to carve out for itself in connection with the new closing agreement procedure.

4. Closing Agreements

The Committee Reports state that, even where none of the regulatory exceptions are satisfied, an outbound transfer of stock still may be effected on a tax-free basis in "appropriate" cases if the transferor enters into a specially-designed closing agreement. According to the Committee Reports, such a closing agreement could contain the transferor's agreement, presumably to be executed pursuant to a rulings request filed before the close of the taxable year in which the transfer is effected, that the transferred stock will not be disposed of by the foreign transferee within a specified "substantial" period following the transfer (*e.g.*, 15 years), and that, in the event of such a disposition, the transferor will pay U.S. tax as if it had been required to recognize gain on the original transfer (*i.e.*, with the gain computed by using the basis and fair market value of the stock as of the date of the initial transfer) together with interest on any tax due for the period from the initial transfer to the date of the subsequent disposition.[110]

The Committee Reports carefully indicate that the closing agreement procedure may not be appropriate in all cases, but that "when the outbound transfer of stock or securities not registered or traded on any securities exchange and which represent a majority interest in a foreign corporation is at issue, the principles underlying the use of closing agreements could have a beneficial impact both on the transferor's willingness to undertake the transaction, and the Internal Revenue Service's ability to enforce section 367."[111]

Taxpayers have long argued for the use of closing agreements in the context of transfers of stock to foreign corporations and the Tax Court in *Kaiser Aluminum* indicated that a closing agreement would have been appropriate in that case.[112] With the exception of a case factually similar to *Kaiser Aluminum*, however, such as the oil refinery ruling earlier discussed,[113] the Service generally has declined to enter into closing agreements.[114] It typically has justified this position by reference to perceived administrative difficulties in enforcing closing agreements and to the impossibility of foreseeing all possible tax ramifications of the transfer and providing for them in advance.[115]

In the closing agreement entered into in PLR 8313099, the taxpayer agreed that for a period of five years or until the statute of limitations had expired on the year of transfer, whichever occurred earlier, there would be no disposition of the transferred stock outside of the affiliated group. In the event of any such prohibited disposition the transferor agreed to recognize gain on its original transfer and pay any tax arising therefrom with interest. The transferor was required annually to notify the district director having audit jurisdiction over its return that no prohibited disposition had occurred. If any such disposition were to occur, the transferor was required within 30 days thereof to furnish a detailed notice of the relevant facts both to the district director and to the Associate General Counsel (Technical).[116]

In recognition of the Service's practical enforcement concerns, the Committee Reports suggest that the special §367 closing agreement procedure may call for the transferor to annually certify compliance with the closing agreement, to file annually a waiver of the statute of limitations on assessment, and to post adequate security to ensure payment of any tax later due as a result of a disposition of the transferred stock by the transferee.[117]

F. Exemptions from the Automatic Toll Charge

New §367(a)(5) authorizes the Secretary to promulgate regulations exempting certain transfers of property from the automatic toll charge rule of §367(a)(1).

The intended scope of this regulatory authority is not clear from the Committee Reports. It is possible that regulations under this provision might provide for specific exceptions from tainted asset classification in particular cases, thus permitting the excepted items to be tested under the general active business exception. On the other hand, it may be contemplated that regulations simply would deem

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the active business exception to be satisfied in respect of certain nontainted assets, such as machinery and equipment, that ordinarily should satisfy the exception in any event.

Analogous regulatory authority was created in 1976 under §367(a)(2), ostensibly to eliminate the ruling requirement and to establish automatic treatment in conformity with settled rulings practice in respect of certain routine types of transactions. Since this authority was never exercised, it is difficult to predict precisely what use may be made of new §367(a)(5). At the least, however, the provision should offer a "catchall" mechanism to correct, without need of further legislation, any problems that may arise in administering the general automatic toll charge rule.

G. Incorporation of a Foreign Loss Branch

1. Statutory Scheme

New §367(a)(3)(C) establishes a special, "branch loss recapture" exception to the general active business exception of §367(a)(3)(A), under which nonrecognition of gain generally will be wholly or partially precluded in connection with outbound transfers of property incident to the incorporation of a foreign loss branch.

Under the new provision, except as provided in regulations, all or a portion of any gain realized upon the outbound transfer to a foreign corporation of appreciated assets associated with a foreign loss branch must be recognized currently by a U.S. transferor. The amount required to be recognized is the excess of (1) pre-transfer branch losses with respect to which deductions previously were allowed to the transferor, over (2) the sum of (a) any post-loss year taxable income of the branch through the close of the year of transfer, plus (b) any amount recognized under §904(f)(3) on account of the transfer. Such amount is to be treated for Chapter 1 purposes as foreign source income having the same character (ordinary or capital) as the previously deducted losses.

2. Genesis of the Statutory "Loss Recapture" Rule

a. Rev. Rul. 78-201 [118]

Section 367(a)(3)(C) represents a codification of the so-called "added amount" toll charge first formally articulated by the Service in Rev. Rul. 78-201. In that ruling, P, a domestic corporation engaged in the manufacture and sale of plastic radio and television components, had operated since 1975 a foreign branch, A, which had experienced steadily declining losses ($50X, $30X, and $10X, respectively) through its initial three years of existence (1975 through 1977). During these years, P operated other foreign branches which produced aggregate net income in excess of the losses of A (*i.e.*, P did not incur an "overall foreign loss" within the meaning of §904(f)(2) for any of the relevant years). In late 1977, the assets of A were transferred to a wholly-owned foreign subsidiary newly-organized in the foreign country in which A's business had been conducted. P requested the requisite §367(a)(1) ruling that the transfer was not in pursuance of a principal tax avoidance purpose and would qualify for nonrecognition treatment under §351.

Acknowledging that the transferred assets met the Guidelines' requirements (under §3.02(1)) for the issuance of a favorable §367 ruling, Rev. Rul. 78-201 noted that the losses incurred by the branch prior to its incorporation had the effect of reducing P's worldwide income subject to Federal income tax. The ruling stated that "as a result of the incorporation of the foreign branch, the income to be produced by these operations will not be taken into account by [P] and, thus, will not increase the amount of [P's] worldwide income subject to Federal income tax." Accordingly, the ruling concluded that the transfer "will be deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 367 of the Code," unless P agreed to recognize in the year of the transfer an amount of ordinary foreign source income equal to the sum of A's prior losses ($90X).[119]

b. Hershey Foods Corp. v. Comr. [120]

In codifying Rev. Rul. 78-201, new §367(a)(3)(C) also legislatively overrules the Tax Court decision in *Hershey Foods Corp. v. Comr.* In that case, the Tax Court held "unreasonable" under the §7477 declaratory judgment standard the Service's imposition of the Rev. Rul. 78-201 toll charge as a condition to the issuance of a favorable §367 ruling on the incorporation of Hershey's Canadian loss branch.

The court observed that the judicial analysis and "ranking" of taxpayer motives under the "substantial evidence" standard of review established in *Dittler Brothers* [121] was necessary only if "some tax avoidance potential" were found to exist. In the court's view, the requisite tax avoidance potential could not be found to exist in the case at hand solely by virtue of the fact that the foreign branch to be incorporated had incurred U.S. tax-reducing losses.

The opinion went on to respond to the Service's contention that the loss recapture requirement was necessary to ensure the clear reflection of income. The opinion noted that the clear reflection doctrine is to be applied on an annual, not a transactional, basis, and that no evidence was advanced that Hershey's income had not been clearly reflected in each of the years it suffered losses from its branch operations. According to the court, "every foreign incorporation of a United States business operating abroad takes the future profits involved outside of United States tax jurisdiction. We fail to perceive any crucial difference between a domestic corporation's foreign incorporation of a foreign loss branch and its foreign incorporation of a foreign profit branch. In both cases, only future, currently unearned, operating income is being removed from the clutches of Federal income taxation."

Although not developed in the parties' briefs, the court on its own initiative dismissed the possible contention that recapture could be justified under the tax benefit inclusionary rule, noting that the incorporation of a branch did not constitute the "recovery" of previously deducted expenses necessary to trigger the application of that rule.

The court also observed that the legislative objective of §367 in the outbound context is to prevent the avoidance of U.S. tax by means of the tax-free removal from U.S. tax jurisdiction of those types of assets (*e.g.*, inventory, know-how or stock) "that might carry passive income which could just as easily be earned or realized in the United States or income which had essentially already been

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earned." In contrast, Rev. Rul. 78-201 improperly "looks to currently unearned, future operating (not passive) income as the income upon which tax is being avoided."

Finally, the court held that the Service's position was preempted by the 1976 amendments to §904, which reflected Congress' intent to provide a comprehensive and exclusive legislative solution with respect to any unwarranted tax benefits arising from the tax treatment of foreign losses, including losses associated with the foreign branch operations of U.S. taxpayers. That legislative solution consisted of (i) the repeal of the per-country method of calculating the annual limitation on the foreign tax credit, thereby requiring the "netting" of overall foreign source losses against overall foreign source income for foreign tax credit purposes; (ii) recharacterization of certain succeeding year foreign source income as U.S. source income under §904(f)(1) so as to "recapture" prior year foreign losses in excess of foreign income; and (iii) immediate recapture of such excess foreign losses under §904(f)(3) upon a disposition of foreign branch assets. According to the court, the purpose of these amendments was "to ensure, in the long run, that foreign losses reduce only foreign income — any foreign loss matched against United States source income either will cause a recharacterization of later foreign source income as United States source income or will itself be recognized upon a disposition of foreign branch assets. Thus, the objective of Congress, that United States income bear its Federal income tax share, is met."

By contrast, the court observed, the application of the foregoing legislative steps combined with the Rev. Rul. 78-201 recapture mechanism would improperly result in the "double counting" of a U.S. parent's foreign branch losses —"first, to reduce other foreign source income and thus to reduce foreign tax credits, and second, as additional foreign source income. In effect [by sustaining the Service's position], we would undermine the whole rationale behind the foreign tax credit — the prevention of double taxation."

c. Service's Rulings Position After Hershey

The Service has not acquiesced in the *Hershey* decision but has continued to apply and refine Rev. Rul. 78-201 with respect to a variety of outbound §351 and 361 transactions. Post-*Hershey* letter rulings [122] have reflected a gradual shift in rationale from the "mismatching," clear reflection underpinnings of the early rulings toward a more refined interpretation of the tax benefit doctrine, derived in material part from an expansive reading of the Supreme Court's decision in *Bliss Dairy*.[123]

In *Bliss Dairy*, a corporation that had purchased feed for use in its farming operations and had properly deducted the cost of acquiring the feed in that year, was liquidated under §333 during the first week of the succeeding year. Since the feed was unconsumed as of the date of liquidation, the shareholders, who continued the business as sole proprietors, were able to allocate a portion of their stock basis to this asset under §334(c) while also claiming an immediate deduction. The Service contended that the corporation must include an amount equal to the portion of the shareholders' stock basis allocated to the unconsumed feed, relying on the tax benefit rule as interpreted in Rev. Rul. 74-396 [124] and *Tennessee-Carolina Transportation* [125] to require the recoupment of previously deducted amounts, notwithstanding the absence of an actual "recovery," where an event occurring in a subsequent period was "inconsistent" with the basis for the prior deduction. Upholding the Service's position, the Supreme Court noted that the tax benefit rule was designed not merely to tax recoveries but to correct artificial results flowing from the application of annual accounting principles by substituting in appropriate cases the results that would have obtained under a transactional system of taxation. Since the deduction in *Bliss Dairy* was premised on full consumption of the feed in the corporation's business and conversion of the property to shareholder use through its distribution was inconsistent with this premise, the liquidation itself was an inconsistent event that justified application of the tax benefit rule to override §336 and require the corporation's recoupment of the prior deduction.

In PLR 8427066,[126] the Service justified its imposition of a Rev. Rul. 78-201 toll charge upon the incorporation of an unprofitable foreign partnership (FP) by its U.S. partners P, a domestic parent, and S, its domestic subsidiary, on the ground that, under the tax benefit rule as interpreted in *Bliss Dairy*, the incorporation of FP was "a transaction which is fundamentally inconsistent with the prior deductions taken by P and S."

By contrast to a liquidation such as that involved in *Bliss Dairy*, a §351 incorporation generally has been viewed as a mere "change in form" from direct to indirect ownership [127] with respect to which the judicial exceptions to nonrecognition treatment, such as the assignment of income and tax benefit doctrines, have been considered inapplicable.[128] Further, in Rev. Rul. 72-528,[129] the Service held that the tax benefit rule normally could only be applied to recoup deductions representing the cost of acquiring, as in *Tennessee-Carolina* and *Bliss Dairy*, unconsumed, short-lived tangible assets, as distinguished from goodwill, going concern value and such similar intangible assets having indeterminate lives as typically are involved in a §351 incorporation of a branch operation.

In PLR 8427066, the Service appears to have overcome such distinctions between a liquidating distribution of previously expensed cattle feed in *Bliss Dairy* and the outbound §351 incorporation of a foreign loss partnership on the theory that "[b]y virtue of §367, the operative provisions of §351 do not prevent an inclusion in income in this instance." In other words, whatever theoretical obstacles might exist to prevent the tax benefit rule from overriding §351 in the context of a purely domestic incorporating transaction according to the Service apparently do not prevent its operation in the context of an outbound transaction where the application of §351 is itself made contingent upon the satisfaction of §367 anti-tax avoidance principles, including tax benefit principles.

PLR 8427066 also took issue with certain of the other conclusions regarding the validity of Rev. Rul. 78-201 reached by the Tax Court in the *Hershey* decision. With respect to the court's views on the "clear reflection" doctrine, the letter ruling declared that Rev. Rul. 78-201 "focuses on past deductions" in recognition of the fact that "[t]he Code permits business deductions because of the symmetrical expectation that [they] will be eventually offset by the recognition of income." According to the ruling, absent Rev. Rul. 78-201 recapture, this "symmetri-

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cal expectation" would be frustrated, resulting in an improper "distortion of income," because the incorporation abroad of FP would permit P and S to avoid ever having to recognize the income generated by FP's business which otherwise would offset the deductions previously allowed to P and S.

With respect to the *Hershey Foods* court's conclusion that §367 is limited to the taxation of untaxed earnings and appreciation inherent in the particular assets being transferred abroad, the letter ruling noted that the literal terms of §367(a)(1) are "phrased in terms of the gain to be recognized on the entire transfer; the statute is not limited to only certain classes of property." Finally, with respect to the court's holding that Rev. Rul. 78-201 is preempted by the 1976 amendments to §904, the letter ruling observed that the limited "overlap" between Rev. Rul. 78-201 and §904(f) (which has been eliminated under the priority rule established by Rev. Rul. 80-246 [130]) "does not preclude the application of the revenue ruling" because the legislative history of §904(f) evidences no intent to limit the operation of §367, and because "Rev. Rul. 78-201 seeks to correct an income distortion, while §904(f) prevents the abuse of the foreign tax credit provisions."

d. The Congressional Response

In developing the statutory loss recapture rule now contained in §367(a)(3)(C), Congress apparently was persuaded that the theoretical shortcomings of Rev. Rul. 78-201 identified by the Tax Court in the *Hershey Foods* opinion were rendered moot by the elimination of the tax avoidance purpose standard, were limited to *Hershey Foods'* special facts, and/or otherwise were based on incorrect inferences regarding Congressional intent in 1976.

In explaining the codification of Rev. Rul. 78-201, the Conference Report indicated that the statutory loss recapture mechanism generally should be applied "in a manner consistent with the IRS' published rulings under present law." [131] Rulings issued subsequent to Rev. Rul. 78-201 clarified a number of uncertainties regarding the intended scope and application of the loss recapture rule in particular contexts, including the operation of the gain limitation, the interaction with §904(f)(3), the consequences of partial transfers involving the retention of loss assets, and the consequences of transfers of multiple branches or divisions of the same taxpayer or of affiliated taxpayers. According to the Committee Reports, these amplifications, described below, are to continue to govern the application of the new recapture provision. However, certain other potential ramifications of the provision, such as its relationship to the new rules concerning intangibles transfers and "tainted" asset toll charges, the scope of the "branch" concept, and the possibility of relief from recapture in cases involving no tax benefit, are only partially defined in the Committee Reports and existing rulings and ultimately will require regulatory clarification.

3. The Gain Limitation

Section 367(a)(3)(C) by its terms limits the amount of losses that may be recaptured on a branch incorporation to the amount of gain realized on the transaction. The statute generally adopts the Service's current rulings position regarding the gain limitation.

The Service only recently conceded the necessity for a gain limitation. In Rev. Rul. 80-163,[132] the Service had taken the contrary view, ruling that the full amount of losses must be recaptured under Rev. Rul. 78-201, even though in excess of the amount of gain realized on the transfer. Although some taxpayers transferring only tainted assets or assets having limited value effectively could escape the recapture toll charge by simply proceeding without a ruling and treating the transaction as a taxable exchange,[133] the Service's position was particularly harsh with respect to taxpayers transferring substantial amounts of appreciated, nontainted assets (including goodwill and going concern value) the nonrecognition of gain on which was conditioned on payment of the Rev. Rul. 78-201 toll charge. In the course of the *Hershey* litigation, the Service in fact initially agreed to a gain limitation, but subsequently revoked that decision shortly before issuance of Rev. Rul. 80-163. Two years later, the Service reconsidered its position and issued Rev. Rul. 82-146,[134] revoking Rev. Rul. 80-163. As clarified in subsequent letter rulings,[135] the revocation signalled the Service's adoption of the gain limitation for purposes of applying Rev. Rul. 78-201. As a result of the 1984 Act amendments, the limitation now has statutory authority.

4. Relationship of Loss Recapture to Other §367 Toll Charges

a. "Tainted" Asset Toll Charges

The Service's rulings position generally has been that the Rev. Rul. 78-201 toll charge should be reduced by the amount of any toll charges imposed under the Guidelines on the transfer of "tainted" assets in connection with the same exchange.[136] The rationale for this offset rule apparently has been that the Rev. Rul. 78-201 toll charge is limited to the cumulative *net* amount of losses incurred by the branch from its inception through the incorporating transfer, and that any toll charges imposed on the transfer of the branch's tainted assets should be considered gross income of the branch for the taxable year of the transfer for purposes of computing the recapturable cumulative net loss.

The status of this offset rule under the new provisions is uncertain. The House Report expressed the intent that the loss recapture rule "operate — to the extent possible — independently of other rules imposing tax on transfers of appreciated property to foreign corporations." [137] It illustrated this principle through an example involving the incorporation of a foreign branch with prior losses of $100. The taxpayer transferred tainted assets of the branch with "built-in gain" of $30, and goodwill worth $90, with a basis of zero. On these facts, the House Report stated that the result would be a tax "on $120 — not $100." In other words, in the House Report's view, no offset would be permitted against the amount of the $100 loss recapture toll charge for the amount of the $30 tainted asset toll charge. (According to the House Report, if the goodwill had been worth $60 rather than $90, the result would have been a tax on $90.) Rather, the two toll charges would be imposed independently, with the loss recapture toll charge being limited only by the amount of gain realized on the transfer in excess of any recognized gain (*e.g.*, pursuant to the tainted asset toll charge).

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The Senate Report was silent on the offset rule. However, the Conference Report, in adopting the Senate amendment, noted that "in applying the rule requiring gain recognition, a pre-incorporation loss is reduced by taxable income derived by the foreign branch in a taxable year after the taxable year in which the loss was incurred and before the close of the taxable year of the transfer." [138] This "technical modification," although not specifically reflected in the statute itself, could be interpreted as conveying the Conference Committee view that a toll charge imposed on the transfer of tainted assets pursuant to the incorporation of a loss branch will be considered "taxable income derived by the foreign branch ... before the close of the taxable year of the transfer," and thus will reduce the amount of pre-incorporation loss subject to the recapture toll charge. However, it is not entirely clear whether a tainted asset toll charge (as distinguished from branch operating income) will be considered taxable income of the branch for this purpose. The issue hopefully will be resolved in the regulations.

b. The Intangibles Toll Charge

The Conference Report indicates that the transfer of intangibles generally will be subject to the special rule for intangibles (new §367(d), discussed at II, I, *infra*), not the loss branch recapture rule.[139] This presumably means that to the extent a foreign branch's pre-incorporation losses are attributable to intangibles, the transfer of such intangibles pursuant to the incorporation of the loss branch will be treated as a deemed sale of the intangibles subject to the constructive royalty provisions of §367(d). In such a case, the branch losses attributable to intangibles apparently would not be recapturable under §367(a)(3)(C).

It is not clear from the Conference Report just how the portion of branch losses attributable to intangibles is to be determined for purposes of the foregoing priority rule. The assets of insurance, engineering, and other service business branches might consist largely, if not exclusively, of intangibles. Most if not all of the cumulative net losses of such a branch thus might be considered attributable to such intangibles and, therefore, excepted from §367(a)(3)(C) upon the transfer of the intangibles pursuant to the incorporation of the branch. However, would losses that are demonstrably caused by market and other factors unrelated to the branch's intangibles also be excepted from the loss recapture rule? And how would the portion of the losses of a manufacturing branch that are attributable to intangibles, as distinguished from depreciation, R&E, and similar deductions, be determined for purposes of delimiting the scope of §367(a)(3)(C) recapture?

It is possible that the statement in the Conference Report as to the priority of §367(d) over §367(a)(3)(C) was intended to confirm that any intangibles transferred in connection with the incorporation of a loss branch generally would be treated as tainted assets to the extent subject to the "deemed sale" toll charge of §367(d), and that the §367(d) toll charge in respect of such property should reduce the amount of loss subject to recapture under §367(a)(3)(C) (consistent with the Service's rulings practice but contrary to the implication contained in the House Report previously discussed). However, if the intent of the Conference Report was to confirm the continued applicability of the "offset rule," it is not clear why this intent was limited solely to intangibles (as distinguished from all tainted assets). The more plausible explanation would seem to be that the Conference Report statement was specifically directed at intangibles-related losses.[140] The forthcoming regulations hopefully will clarify this point.

5. The §904(f)(3) Overlap

Section 367(a)(3)(C) by its terms grants priority of application to §904(f)(3) in situations where both recapture provisions may apply by removing from the amount of recapturable losses "the amount which is recognized under §904(f)(3) on account of the transfer." [141]

Under §904(f)(3), if property used predominantly outside the United States in a trade or business is disposed of by a taxpayer (other than to a domestic corporation in a §381(a) distribution or transfer) in a year in which such taxpayer has an overall foreign loss remaining unrecaptured, the taxpayer will be deemed to recognize any gain on the disposition, regardless of whether a nonrecognition provision (*e.g.*, §351) otherwise would apply, to the extent of the lesser of (1) the excess of the fair market value of the transferred assets over their adjusted basis or (2) the full amount of the taxpayer's cumulative overall foreign losses not previously recaptured under §904(f)(1).[142] An "overall foreign loss" is defined as the excess of properly allocable expenses over gross income from foreign sources for a particular taxable year.

If a transferor does not have an unrecaptured overall foreign loss, §904(f)(3) will not apply to the asset transfer and only §367(a)(3)(C) (and any other applicable toll charges) potentially will apply. If the transferor has an overall foreign loss, the income imputed to it under §904(f)(3) is treated as foreign source income under that section, but is then converted to U.S. source income by virtue of the application of §904(f)(1).[143] The net effect is to cause a "recapture" of all or a portion of the transferor's overall foreign loss by requiring the transferor to report a specified amount of U.S. source income for the year it makes an outbound transfer of its foreign situs assets.

Prior to the Service's issuance of Rev. Rul. 80-246,[144] an open question existed as to whether Rev. Rul. 78-201 and §904(f)(3) could be applied simultaneously, thus potentially recapturing the same losses twice. This issue had been raised in the *Hershey Foods* litigation to support Hershey's argument that §904(f) (together with the repeal of the per country limitation on the foreign tax credit) preempted the application of Rev. Rul. 78-201. The Service was under some pressure to attempt to remove the potential for any overlapping application of the two recapture mechanisms.

Amplifying the facts of Rev. Rul. 78-201 to indicate that the U.S. parent had no other foreign operations, income, or losses and that the branch losses had resulted in an overall foreign loss, Rev. Rul. 80-246 held that the full amount of such overall foreign losses was to be recaptured solely under §§904(f)(3) and 904(f)(1), without any additional recapture being required under Rev. Rul. 78-201. In other words, the ruling concluded that, to the extent of any overlap, §904(f)(3) would preempt Rev. Rul. 78-201, apparently on the theory that the income resulting from the application of §904(f)(3) will offset, and in Rev. Rul. 80-

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246 eliminate, the cumulative net losses that otherwise would be recapturable under Rev. Rul. 78-201.

In codifying the priority rule of Rev. Rul. 80-246, the Committee Reports nevertheless made clear that the §367(a)(3)(C) recapture amount could not be reduced by the amount of any losses previously recaptured under §904(f)(1), even though the effect of applying both provisions potentially could be tantamount to a "double counting" of the same losses — first, to trigger conversion of later foreign income to U.S. source income to the extent of such losses for foreign tax credit purposes, and second, to require recognition of gain to the extent of the same losses upon incorporation of the branch.[145]

6. The "Branch" Concept

The loss recapture toll charge under §367(a)(3)(C) is limited by its terms to the transfer of the assets of "a foreign branch" of a U.S. person. The term "branch" is not defined in the new provision, the Committee Reports, nor elsewhere in the Code and regulations. Authorities in other contexts, such as those involving the branch requirement for adoption of the profit and loss method of branch accounting, generally describe a branch as involving regular, ongoing substantive business activity conducted at a foreign office or other fixed place of business by the U.S. company's employees or agents.[146] If this description generally were adopted for §367(a)(3)(C) purposes, losses would be recapturable if derived from business operations conducted at a foreign office, but might not be recapturable in the absence of such an office.

The existence of a foreign branch was not a prerequisite to recapture under Rev. Rul. 78-201 and its progeny. However, the somewhat analogous concept of a "complete business" or "single business" was developed by the Service in a series of rulings involving the application of the loss recapture toll charge to partial transfers, simultaneous transfers of profitable and unprofitable divisions, and simultaneous transfers of the branches of affiliated taxpayers. Since the Conference Report indicates that §367(a)(3)(C) is to be applied in a manner consistent with these rulings,[147] they should have continued relevance with respect to the scope of the branch concept.

In Rev. Rul. 80-247,[148] P, a domestic corporation, was engaged in the exploration, development and sale of mineral properties in the United States and in country A through its branch. The branch incurred losses for taxable years 1977 through 1979 totaling $300X, which were used to offset P's worldwide taxable income. P's income from its other foreign branches exceeded the losses from its country A branch. On January 1, 1980, P incorporated a portion of the branch assets in Newco, a country A corporation. Losses of $100X that were directly attributable to properties having no commercial value were not transferred in the transaction but were instead abandoned as worthless. The question presented was whether the losses allocable to the non-transferred assets ($100X of the $300X loss) would have to be recaptured under Rev. Rul. 78-201 as a condition to obtaining a favorable §367 ruling. Holding that the full $300X of losses was subject to the recapture requirement, the ruling reasoned that "P's mineral exploration, development and property sales operations in country A was a complete business operation in itself, and that the losses incurred by that business were unrelated to P's other worldwide business operations." According to the ruling, since P's branch "was comprised of both the properties that were transferred and the properties that were not transferred ... P effectively incorporated the entire branch A business. It was the business and not the specific parcels of property that incurred the losses."

The "complete business" concept was extended in Rev. Rul. 81-82,[149] which held that where separate branches or divisions bear a sufficiently close operational relationship to one another to constitute a complete business operation distinct from other operations conducted by the taxpayer, the profits and losses of all components of such business may be combined for purposes of determining the net amount of losses subject to Rev. Rul. 78-201 recapture upon the incorporation of that business. In the ruling, P, a domestic corporation, operated five divisions in country A: a totally separate garment division (division #1, which generated $300X of profits for the years 1977 through 1979); two plastics components divisions (divisions #2 and #3, which had $300X of losses and $150X of profits, respectively) located in different regions of country A, which, although treated as separate for financial reporting and accounting purposes, had common purchasing, accounting, personnel and record-keeping departments, a common sales force, headquarters staff and management team, identical manufacturing facilities and processes, and substantially identical customers and distribution channels; and two television manufacturing divisions (divisions #4 and #5), each of which sold its manufactured components exclusively to the other for assembly into finished products, and both of which shared common purchasing, accounting, record-keeping and headquarters staff departments, and had substantially the same employees, operational facilities, and managements.

On January 1, 1980, P transferred all of the property of divisions #1 through #4 to Newco, a country A subsidiary, but continued to operate division #5 as a branch. On these facts, the ruling held that: (i) the garment division (#1) was a complete business in itself and, since profitable, would not be subject to Rev. Rul. 78-201 in connection with the transfer; (ii) the two plastics divisions (#2 and #3) constituted a complete business and their profits and losses could be "netted" for purposes of determining the amount of recapturable losses, if any; and (iii) the two television divisions (#4 and #5) also constituted a complete business with integrated operations and under Rev. Rul. 80-247 the losses of both would be subject to Rev. Rul. 78-201 recapture, even though the assets of one of the divisions were not transferred in the transaction.

In Rev. Rul. 81-89,[150] the Service applied the "complete business" concept to the simultaneous transfer of the branches of affiliated taxpayers. In the ruling, which closely paralleled the facts in *Hershey Foods*, P, a domestic manufacturer of plastic components, incurred losses from its country A branch operations of $200X for each of the years from the inception of the branch in 1977 through 1979. S, which was engaged in the same business as P and became a wholly-owned domestic subsidiary of P following a "B" reorganization on January 1, 1979, earned profits from its separate country A branch operations, also established in 1977, of $100X for each of the years 1977 through

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1979. P and S elected to file a consolidated return for 1979 and subsequent years and, during those years, integrated their respective branch operations so that the branches shared common purchasing, accounting, personnel, and record-keeping departments; a common sales force, headquarters staff, and management team; and had substantially the same customers, employees, distribution channels, operational facilities and processes.

On January 1, 1980, P and S transferred the assets of their respective branches to Newco pursuant to a transaction qualifying under §351 which met the requirements of §3.02(1) of the Guidelines. P agreed to the Rev. Rul. 78-201 toll charge but requested that it be determined by treating the P and S branches as a single business from the time of their inception in 1977, thus reducing the total toll charge from $600X to $300X. The ruling held that the toll charge could be determined by treating the two branches as a single business only for 1979, when the consolidated return was filed and the branch operations were completely integrated, thus reducing the toll charge for that year from $200X (P's losses) to $100X (P's losses less S's profits of $100X).

Since the foregoing rulings generally involved fully-developed foreign branch (or divisional) operations, they contribute little to demarcation of the "interior" boundary line between branch and nonbranch status. Nevertheless, they are highly pertinent to demarcation of the outer boundaries of the branch concept. In particular, they highlight a dimension of the branch concept that could well prove to be a trap for the unwary under the automatic recapture mechanism of §367(a)(3)(C). A taxpayer incorporating abroad a profitable division, line of business, or branch might find itself unexpectedly subject to the loss recapture rule if the transferred operation were considered to be part of a "complete business" that encompassed other, unprofitable divisions, business lines, or branches, even though the latter were not transferred in the transaction. Although the rulings to date appear to have applied principles similar to those applied in the unitary tax context, the precise parameters of those principles are not yet entirely clear. Given the potentially significant ramifications of applying the "complete business" concept under §367(a)(3)(C), it is hoped that the regulations will provide a detailed explanation, including examples, of the intended application of those principles.

It is unclear whether the requirement of a "foreign branch" effectively will preclude the application of §367(a)(3)(C) in respect of foreign partnerships and individuals. This result could be supported under the literal terms of the new provision, although it would represent a departure from the Service's prior rulings position under Rev. Rul. 78-201.

In Rev. Rul. 80-293,[151] P, a foreign partnership engaged in the farming business in Country Z, incurred net losses for each year prior to 1977. A pro rata portion of the losses was taken into account by X, a domestic corporate partner of P, which reduced the amount of X's worldwide income subject to U.S. tax for such years. However, P earned net profits beginning in 1977, when interests in P were acquired by A and B, U.S. resident individuals. In 1978, P transferred its farming assets to Y, a newly-formed country Z corporation, pursuant to a transaction qualifying under §351 that met the requirements of §3.02(1) of the Guidelines. On these facts, the ruling held that X would be required to include in income for the year of the transfer a Rev. Rul. 78-201 toll charge equal to its proportionate share of the sum of P's prior losses as a condition to obtaining the requisite §367 ruling on the transfer. However, since P earned net profits while A and B were partners, so that A and B were unable to utilize P's net losses, the ruling held that the Rev. Rul. 78-201 toll charge would not apply to A and B in connection with the transfer.

7. Collateral Consequences — Source, Character, Basis, Earnings & Profits

Section 367(a)(3)(C) specifically provides for the treatment of the loss recapture toll charge as foreign source income, which is consistent with prior law.[152] However, the Conference Agreement modified the Senate bill and prior law to provide for characterization of the toll charge by reference to the character (capital gain, ordinary income, foreign oil-related income, foreign oil and gas extraction income, etc.) of the previously incurred losses.[153] As explained in the Conference Report, "[i]f a branch incurred a capital loss (or a foreign oil extraction loss) in an earlier year, its later incorporation would yield capital gain (or foreign oil extraction income)." [154] The principal impact of this modification will be to reduce the ability to obtain an offsetting foreign tax credit advantage in respect of the toll charge by requiring capital gain treatment (rather than ordinary income treatment as under prior law) to the extent the recapturable losses consisted of capital losses.[155]

The Conference Report also indicates that, as under prior law, the basis of the transferred assets in the transferee's hands, as determined under the carryover basis rule of §362, is to be increased by the amount of the loss recapture toll charge imposed under §367(a)(3)(C).[156] In addition, it would appear, again as under prior law, that the transferor's earnings and profits will be increased by the amount of such toll charge.[157]

8. Exceptions

Under the prefatory clause of §367(a)(3)(C), the Secretary is authorized to except certain transactions from the loss recapture toll charge. The Committee Reports provide few clues as to which transactions, if any, might fall within such an exception. The House Report states that "[t]he Committee is aware that foreign branch losses may offset foreign source income that is effectively exempt from U.S. tax by virtue of the foreign tax credit. In that case recapture may not always be appropriate. If the foreign branch of a U.S. person incurs a loss that offsets high-taxed foreign income, that income would be free of U.S. tax anyway under the foreign tax credit." [158] The Senate Report, in noting the *Hershey Foods* decision, suggested that the decision may be reconcilable with §367(a)(3)(C) on the ground that "[i]n that case the branch losses had not resulted in a tax benefit to the U.S. corporation because the corporation had foreign tax credits that would have eliminated U.S. tax on foreign income in any event." [159]

Statements such as the foregoing, which are premised on the perceived tax benefit rationale for §367(a)(3)(C), suggest that the regulations may well except from the loss

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recapture toll charge situations in which otherwise recapturable losses did not give rise to any prior tax benefit to the transferor, by virtue of available foreign tax credits,[160] possibly domestic operating losses, or otherwise.

H. Incorporation of Domestic Branch

The Conference Report states that the regulations under the amended §367(a) "will require gain recognition on the transfer of assets that were used in the United States, to the extent of depreciation deductions previously claimed by the taxpayer with respect to the transferred property," in a manner consistent with the foreign branch loss recapture rule of §367(a)(3)(C).[161]

No specific provision to this effect is contained in the statute as enacted. Nor is any reference to such a rule contained in the House Report or Senate Report. Further, it appears questionable whether such a rule, even if prescribed in the regulations, would be considered to fall within the scope of any of the new §367(a) provisions, or otherwise be effective to override the apparently contradictory provisions of §§1245(b)(3) and 1250(d)(3).

I. Treatment of Intangible Property

1. Statutory Scheme

New §367(d)(1) removes outbound transfers of intangible property from the general automatic toll charge rule of §367(a) (except in the case of outbound liquidations subject to §336) and subjects such transfers to a separate set of rules.[162] Under the rules contained in §367(d)(2), a U.S. transferor transferring intangibles to a foreign corporation pursuant to a §351 or §361 exchange is treated as having sold the intangibles in exchange for "payments which are contingent upon the productivity use or disposition of such property." [163] Where the transferred intangibles are retained by the transferee, the U.S. transferor must include in income annually over the useful life or lives of the intangibles "amounts which reasonably reflect the amounts which would have been received" had the U.S. transferor entered into a contract for the sale of the intangibles in exchange for such annual, contingent payments.[164] Where the intangibles are disposed of (directly or indirectly) by the transferee following the transfer, the U.S. transferor must include in income currently an amount that reasonably reflects the amount which would have been received had the transferor sold the intangibles in exchange for "payments which are contingent upon the disposition" of the intangibles.[165] The amounts so included by the transferor are to be treated in all cases as U.S. source ordinary income.[166] However, the foreign transferee is permitted to reduce its earnings and profits by such amounts as and to the extent included in income by the transferor.[167]

2. Definition of Intangible Property

For purposes of §367(d), the term "intangible property" is broadly defined, by reference to §936(h)(3)(B), to mean any (i) patent, invention, formula, process, design, pattern, or knowhow; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item which has substantial value independent of the services of any individual.

Notwithstanding its apparent breadth, the foregoing definition is subject to two important caveats. First, as discussed below, there is strong evidence in the Committee Reports suggesting that the regulations will exclude goodwill, going concern value, trademarks, trade names and similar "marketing" intangibles from the definition of "intangible property" for both §§367(d) and 367(a)(3)(B)(iv) purposes, thus permitting such intangibles to be transferred abroad tax-free provided only that the active business exception is satisfied (presumably under principles similar to those contained in the existing Guidelines applicable to such intangibles).[168]

Second, even where an outbound transfer involves an item ostensibly described within one of the §936(h)(3)(B) categories, §367(d) presumably will not apply unless transfer of the item also qualifies under the particular circumstances involved as a "transfer of property" for purposes of both §367 and §351 or §361. The criteria applicable to determining whether particular intangibles constitute "property" for §367 purposes were developed through a series of rulings and revenue procedures that may have increased relevance under the new statutory scheme. Under these criteria, the outbound transfer of patents and patent rights, for example, has been considered a transfer of property for §367 purposes only if "all substantial rights" in such property are granted exclusively and in perpetuity to the transferee pursuant to the transfer — a requirement that, as applied by reference to the §1235 standard for "sale or exchange" treatment, ordinarily would exclude a grant that is limited geographically, in duration, in field of use, in claims or inventions covered, is terminable at will by the grantor, or prohibits sublicensing or assignment.[169] Notwithstanding the foregoing criteria, at least one court decision, *E.I. DuPont de Nemours & Co.*,[170] has adopted a more expansive view of the "transfer of property" requirement for §§351 and 367 purposes, holding those provisions to apply to a U.S. parent's royalty-free, nonexclusive patent license to its wholly-owned French subsidiary on the theory that, although all rights under the patents were not transferred, the rights which were transferred nevertheless "were perpetual, irrevocable, and quite substantial in value." [171] Although the Service to date has not followed *DuPont*, query whether §367(d) might prompt it to reevaluate this position.

The Service has developed similar criteria to determine the "property" status of know-how, another item included within the definition of "intangible property" under §367(d). Under these criteria, a transfer of know-how generally has been treated as a property transfer for §367 purposes only if: (i) the know-how is secret; (ii) the transfer is exclusive and includes "all substantial rights" within the territory of one or more countries; (iii) the grant is in perpetuity; and (iv) the transferee's country of operation affords substantial legal protection against unauthorized disclosure and use of the know-how.[172]

Whether the Service will adhere to the foregoing concepts in applying new §367(d) is a point that hopefully will be clarified in the forthcoming regulations.[173] Possibly even more troublesome under the new statutory scheme, however, are those types of intangibles with respect to which the state of the law regarding their "property" status continues to be unsettled. A prime example involves contracts and

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contract rights, which are specifically included within the §367(d) definition of "intangible property."[174] At what point contract rights rise to the status of property was at issue in two recent §367 court cases, *Hospital Corp. of America v. Comr.*[175] and *Shell Oil Co.*,[176] and one case under §721, *U.S. v. Stafford*.[177] In the *Hospital Corp. of America* case, the court held that the right to enter into and perform a hospital management contract in Saudi Arabia that was made available by a U.S. parent to its second-tier Cayman Islands subsidiary represented merely a "business opportunity" rather than a "legally enforceable right in specific property" and, thus, that no transfer of property had occurred to which §367 could apply. In the *Shell Oil Co.* case, in which the Government conceded that no tax avoidance purpose was involved (thereby mooting, without conceding, the transfer of property issue), the latter unresolved issue related to the right to negotiate a reinsurance contract with two Allstate companies which Shell had reserved in connection with entering into insurance contracts with those companies and which it made available to its second-tier Bermuda reinsurance subsidiary.[178] In *U.S. v. Stafford*, however, a letter of intent, which was specifically found not to be enforceable under applicable state law, was nevertheless held to constitute "property" for purposes of §721, thereby allowing nonrecognition of gain on its contribution to a partnership in exchange for a partnership interest. With the possible applicability of new §367(d) now at stake, the question of when contract rights rise to the level of "property" likely will assume even greater significance.

3. Types of Transfers Subject to 367(d)

Section 367(d) by its terms applies only to transfers described in §§351 and 361. Thus, an outbound distribution of intangible property in connection with a §332 liquidation, as discussed below, will be subject to the general automatic toll charge rule applicable to tainted assets rather than to §367(d).[179]

4. Amount of the §367(d) Toll Charge

a. Intangibles Retained By the Transferee

Where the transferred intangibles are not disposed of but are retained by the transferee following the transfer, §367(d)(2)(A)(ii)(I) provides that the amount to be included in income by the transferor is to equal "amounts which reasonably reflect the amounts which would have been received . . . annually in the form of [payments contingent upon the productivity, use, or disposition of such property] over the useful life of [the transferred property]" if such property had been sold in exchange for such payments rather than being transferred in exchange for stock.

Precisely what amounts "would have been received" by reason of such a deemed sale/exclusive license may be difficult to ascertain in many cases, which is one reason why some taxpayers formerly assigned intangibles to their foreign subsidiaries rather than selling them outright or licesing them in return for an appropriate royalty. The §482 regulations applicable to the transfer or use of intangible property indicate that the best measure of the required "arm's length" royalty rate ordinarily will be the rate charged by the licensor to unrelated parties for use of the same or similar intangibles under the same or similar circumstances.[180] In the absence of such "comparables," the regulations list a number of factors to be taken into account in determining an arm's length rate, including the prevailing rates in the same industry for similar property, the terms of the license (*e.g.*, its exclusive character and geographical scope), the uniqueness of the property, the degree and duration of protection afforded to the intangibles under applicable foreign law, prospective profits to be realized by the licensee through its use of the intangibles, the start-up expenses required of the licensee, and the costs incurred by the licensor in developing the intangibles.

Typically, a royalty will take the form of a fixed or variable percentage of gross sales or revenues, although there is also precedent for utilizing a percentage of net profits. The requirement of §367(d)(2)(A)(i) that the payments deemed to be received by the transferor be "contingent upon the productivity or use" of the intangibles appears to contemplate that the amount of such payments will be determined in a manner consistent with normal, arm's length practice; *i.e.*, that the payments ordinarily must represent a fixed or variable percentage of the transferee's gross sales, profits or some equivalent base reflecting the relative value and contribution of the intangibles to the transferee's business. However, the fact that the statute requires only that the amount of such payments "reasonably reflect" the otherwise applicable arm's length charge suggests that some latitude was intended and that strict adherence to §482 standards may not be required.

The aspect of the §367(d) toll charge that represents the most significant departure from prior practice under the Guidelines is its intended duration. Section 367(d)(2)(A)(ii)(I) requires that the payments deemed to be received by reason of the constructive sale/license must be included in the transferor's income "annually . . . over the useful life" of the transferred intangibles. Some intangibles, such as trademarks and trade names, have indeterminate useful lives. If such intangibles are included within the definition of "intangible property" for §367(d) purposes, therefore, the transferor presumably will be required to include the constructive payments in income annually for an indefinite period.

Similar problems arise in respect of other types of intangibles, such as know-how, the "useful life" of which may depend upon when the item ceases to be secret or protectible under local law and becomes a matter of public knowledge. In such cases, the regulations hopefully will provide that no further amounts need be included in income. However, "useful life" can be an elusive concept in many contexts and defining its varying parameters in respect of the various types of intangibles and various factual situations that potentially could arise under §367(d) unquestionably will present a keen regulatory challenge.

By virtue of the "useful life" measure, the amount of the §367(d) toll charge in many cases will exceed the amount that formerly would have been imposed as a "tainted asset" toll charge under the Guidelines (or that would have been includible in the case of an outright sale of the intangibles). This is because the amounts to be included in income must reflect not only the value of the intangibles at the time of transfer (as under the Guidelines) but also their future value, which could increase substantially (*e.g.*, as the

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transferee's business becomes increasingly profitable) over the useful lives of the intangibles. In addition to the risk of annually increasing toll charges, §367(d) also effectively could require a "revaluation" of the transferred intangibles at the end of each successive year following the transfer in order to establish the appropriate amount to be included in income for such year.

b. Intangibles Disposed of by the Transferee

Section 367(d)(2)(A)(ii)(II) provides that the amount to be included by the transferor "in the case of a disposition (whether direct or indirect)" of the transferred intangibles following the transfer is the amount that "reasonably reflects" the amount which would have been included "at the time of the disposition" if the transferor had sold the intangibles for "payments which are contingent upon the . . . disposition" of the intangibles. Although the statutory language is not lucid, the Conference Report makes clear that the amount of the toll charge in the case of such a post-transfer "disposition" will depend on the value of the transferred intangibles at that time.[181] Thus, even after including annual toll charges in income, the §367(d)(2)(A)(ii)(II) toll charge may well exceed in amount the toll charge that would have been imposed if the intangibles had originally been treated as tainted assets under the Guidelines (or had been sold outright to the transferee rather than being transferred in exchange for stock).

With respect to the intended scope of the term "disposition," although §367(d) applies to transfers described in both §§351 and 361, it is obvious that §361 transfers in connection with an outbound "C" or "D" reorganization could not fit easily into the "useful life" toll charge prescribed under §367(d)(2)(A)(ii)(I), for the simple reason that the domestic corporate transferor of intangibles in such a case will be liquidated in connection with the reorganization.[182] In such cases, taxation should result under the disposition rule of §367(d)(2)(A)(ii)(II), which applies to "indirect" as well as direct dispositions of the transferred intangibles. The Committee Reports indicate that this provision is intended to include a disposition by the transferor domestic corporation of the *stock* of the transferee foreign corporation.[183] Since an outbound "C" or "D" reorganization, as distinguished from an outbound §351 transfer, will involve a distribution by the transferor domestic corporation to its shareholders of the transferee foreign corporation's stock in complete liquidation of the transferor, such a distribution apparently will be treated as an "indirect disposition" of the transferred intangibles by the liquidating transferor, thus triggering a toll charge under §367(d)(2)(A)(ii)(II) which generally should equal the amount of toll charge that would have been imposed if §367(d) had not applied and the "tainted asset" rules were in effect.[184]

The foregoing interpretation of the "indirect disposition" rule effectively would except all §361 exchanges pursuant to outbound acquisitive reorganizations from the more onerous, "useful life" toll charge, thus limiting that toll charge solely to outbound §351 transfers and subjecting §361 exchanges solely to the "disposition" toll charge. Aside from the pragmatic considerations that might have influenced this result (*i.e.*, the nonexistence of a transferor on whom the continuing, "useful life" toll charge could be imposed), the policy reasons for such a distinction are not entirely evident. The statute itself, at §367(d)(1), purports to apply all of "the provisions of this subsection" without distinction to both §§351 and 361 exchanges. Moreover, there is no clear indication in the Committee Reports that §351 transfers were alone intended to be subject to the "useful life" toll charge, with §361 exchanges subject only to the "disposition" toll charge.

Post-transfer "indirect dispositions" other than by reason of the liquidation of the transferor pursuant to a "C" or "D" reorganization (*e.g.*, a post-transfer sale or other disposition of some or all of the transferred intangibles by the transferee) also would trigger the "disposition" toll charge. However, the fact that other transactions also might trigger that toll charge does not explain why the statute would have made §361 exchanges uniformly subject only to the "disposition" toll charge. It is conceivable, albeit unlikely, that the regulations could adopt a somewhat different interpretation than that offered above. For example, some mechanism might be developed in the regulations under which a liquidating transferor's liability for future year "useful life" toll charges could be "carried over" to its U.S. shareholders after the liquidation. Absent any suggestion of such a novel approach either in the statute or the Committee Reports, however, the most likely and reasonable interpretation, whatever its policy justification, would seem to be that the "useful life" toll charge should be limited to §351 transfers. The regulations hopefully will clarify this point.

The regulations hopefully also will clarify what other post-transfer events will be deemed to trigger the "disposition" toll charge, as well as the manner in which the amount of the toll charge is to be determined in such cases. For example, if the transferee sells only some of the transferred intangibles after the transfer, is the toll charge to be imposed on the transferor only to the extent of the intangibles sold with the "useful life" toll charge continuing to apply with respect to the intangibles retained by the transferee? Would the transferee's licensing of some or all of the intangibles to another party trigger the "disposition" toll charge? How would the "useful life" toll charge be affected by an acquisition of the transferor following the transfer? Or by a post-transfer acquisition of the transferee pursuant to a reorganization? [185]

5. Source, Character, Earnings & Profits, and Basis Consequences of the §367(d) Toll Charge

Section 367(d)(2)(C) requires that the amount of any §367(d)(2)(A) toll charge included in income be treated as U.S. source ordinary income. As a consequence of domestic source treatment, the amount of the toll charge will be includible in the denominator but not in the numerator of the §904(a) foreign tax credit limitation fraction. Thus, in addition to imputing taxable income to the transferor, §367(d) in many cases (*e.g.*, where the transferor or its U.S. affiliated group is in or near an excess credit position) will also operate to reduce the amount of foreign tax credits that currently may be claimed against the transferor's (or its affiliated group's) U.S. tax liability.

By contrast, if the intangibles were licensed instead of being transferred in exchange for stock, the royalty pay-

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ments generally would be treated as foreign source income to the transferor.[186] Similarly, if the intangibles were sold outright to the transferee, the gain or income recognized on the sale might have been treated as foreign source income if the normal title passage rules dictated such treatment.[187] In addition, if the transferred intangibles were of a type excepted by regulation from the definition of "intangible property" and subject to a toll charge (if at all) only under the general rule of §367(a)(1), the toll charge could be treated as foreign source to the same extent as it would be so treated in the case of an outright sale.[188] Given the potentially costly results of U.S. source treatment, therefore, it may be anticipated that in many cases taxpayers will choose the licensing or outright sale alternatives over a transfer in exchange for stock to the extent the intangibles involved fall within the ambit of the §367(d) provisions.

The outright sale alternative also could be preferable from the tax standpoint to a §367(d) transfer in those cases where the gain recognized on such a sale otherwise could be treated as capital gain rather than ordinary income. Section 1249 requires ordinary income treatment only if the foreign transferee is more than 50 percent-controlled by the transferor, which it might not be in the case of an outbound "C" reorganization or the formation of a joint-venture or consortium company under §351. Moreover, the categories of intangibles covered under §1249 are not coterminous with §367(d) and, thus, §1249 may well not apply to a sale of particular types of intangibles the transfer of which otherwise would trigger an ordinary income toll charge under §367(d). Similarly, although a sale for contingent payments of a franchise, trademark or trade name may result in ordinary income under §1253, §367(d) applies to a broader range of intangibles than §1253.

Section 367(d)(2)(B) permits the earnings and profits of the transferee foreign corporation to be reduced by the amount of any §367(d) toll charge included in income by the transferor. This correlative adjustment apparently is intended to place the transferee in the same position it would have been had it actually made the "payments" which are included in the transferor's income. The adjustments will have an effect on future dividends or Subpart F income of the transferee, the taxability of which to the transferee's U.S. shareholders generally is limited by the amount of the transferee's earnings and profits. However, to the extent the transferee is less than 100 percent-owned by the transferor, the benefit to the transferor of such adjustments obviously will be diluted proportionately. Further, if the transferee were subject to U.S. tax directly (*i.e.*, by virtue of being engaged in a U.S. trade or business), such adjustments would not (as would an actual deduction) reduce the transferee's U.S. income tax liability in respect of the profits effectively connected with its U.S. business.

Neither the statute nor the Committee Reports contain any indication as to the intended basis consequences of the §367(d) toll charge. The "disposition" toll charge, which except for character and source is determined in the same manner as are "tainted asset" toll charges, possibly could result in a step up in the basis of the transferred intangibles in the transferee's hands, and of the transferee stock in the transferor's hands, by the full amount of such toll charge.[189] Such a result also might be premised on the statutory treatment of the transfer as a deemed sale.[190] However, since §367(d) does not in terms alter the nature of the underlying transaction as a §351 or §361 exchange and since the §367(d) toll charge is treated as ordinary income rather than capital gain, it would appear that neither the transferee's basis in the intangibles nor the transferor's basis in the stock is affected by the toll charge. Moreover, even if basis adjustments otherwise could be supported, it is not clear how such adjustments could be made on a continuing basis in the case of the "useful life" toll charge. The regulations hopefully will clarify this point.

6. *Application of §367(d) to Service Businesses — "Marketing" vs. "Manufacturing" Intangibles*

Absent ameliorative provisions in the regulations, §367(d) could be particularly harsh with respect to the incorporation of foreign service businesses, such as insurance companies, banks, other financial institutions, engineering, construction and similar businesses. The principal assets necessary to the conduct of a manufacturing business (other than patents and know-how) may consist of fixed assets (machinery and equipment) that would not fall within either the tainted asset categories or the §367(d) intangibles rule and generally could be transferred tax-free under the active business exception. By contrast, the principal assets necessary to the conduct of most service businesses — particularly where such businesses previously were conducted by the U.S. transferor in branch form — typically will consist of intangibles, such as goodwill, going concern value, names, service marks, marketing data, computer software and other intangible property having substantial value independent of the services of any individual.

An outright sale of such intangibles, or their licensing in return for an arm's length royalty, could be prohibitively costly and/or could place the subsidiary at a competitive disadvantage as compared with its foreign-owned counterparts. In addition, in some cases the licensing option may not be available as a practical matter by virtue of local exchange control restrictions on (or confiscatory taxation of) royalty payments.[191] Moreover, the Committee Reports suggest that a key legislative rationale for §367(d) was to "recapture" the special U.S. tax incentives (*e.g.*, the §44F credit for "qualified research expenses," the §174 current deduction for R&E expenditures, the TEFRA exception (extended by §126 of the 1984 Act) from the §861 R&E expense allocation rules for U.S. situs research activities) granted to U.S. developers of certain types of intangibles upon the expatriation of the "fruits" of such subsidized development. However, since those tax incentives relate principally to "manufacturing" intangibles, it may be questioned whether the professed legislative objective is appropriately served by taxing service business and service related "marketing" intangibles, the development of which neither received nor was entitled to such incentives.

Notwithstanding the breadth of the §367(d) definition of intangible property, the Committee Reports contain strong indications that at least under some circumstances certain types of nonmanufacturing intangibles may be excepted by regulation from §367(d) and subjected instead to the general active business test of §367(a). The House Report expresses the expectation that a "transfer of goodwill or going concern value developed by a foreign branch will be treated under [the active business] exception rather

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than the separate rule applicable to intangibles." [192] The Senate Report more broadly contemplates that "ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business. Similarly, it is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names) in appropriate cases." [193] The Conference Report appears to adopt the Senate view, albeit somewhat obliquely, stating that "[t]he conferees wish to clarify that, as under present law, gain will generally be recognized under section 367(a) on transfers of marketing intangibles (such as trademarks or trade names) for use in connection with a U.S. trade or business, or in connection with goods manufactured, sold, or consumed in the United States." [194]

The reference in the Conference Report to the taxation of U.S.-nexus intangibles is a clear reference to the Guidelines' criteria that presumably would continue to be applied under the §367(a)(3)(A) active business exception if, as the Committee Reports suggest will be the case, "marketing" intangibles are excluded by regulation from the definition of "intangible property" for purposes of both §367(d) and the tainted asset category under §367(a)(3)(B)(iv). (The "tainted asset" intangibles would then have relevance solely for purposes of §332 liquidations subject to §367(e).)

Under the Guidelines' standards, intangibles were treated as tainted assets and a toll charge was imposed on their outbound transfer if they constituted (i) U.S. intangibles to be used in connection with either a U.S. trade or business or the manufacture of goods for sale or consumption in the United States,[195] (ii) foreign intangibles to be used in connection with the sale of goods manufactured in the United States,[196] or (iii) U.S. or foreign intangibles likely to be licensed by the transferee.[197] If these standards were to continue to be applied under the statutory active business exception with respect to "marketing" intangibles, goodwill and going concern value excluded from the definition of "intangible property" for §367(d) and tainted asset purposes, it would follow that most service businesses generally could continue, as under present law, to incorporate their foreign operations on a tax-free basis provided that those businesses lacked the prohibited U.S. nexus.[198]

Whether the regulations under §367(d) will interpret the Committee Report cues broadly enough to permit continued nonrecognition treatment in respect of the outbound transfer of "marketing" and related intangibles remains to be seen. Moreover, even if those cues are acted upon, it is not at all clear where the line appropriately should be drawn between "marketing" and "manufacturing" intangibles. While names, trademarks and similar items are specially mentioned as excludible items in the Committee Reports (along with goodwill and going concern value), on which side of the line should contracts or contract rights, franchises, customer lists, computer software, various types of non-manufacturing know-how, and innumerable other items fall?

7. Planning Considerations

To the extent §367(d) would apply to an outbound §351 or §361 transfer of intangible property, taxpayers generally will choose to make such property available to the foreign subsidiary either by licensing the property or by selling it outright to the subsidiary.

If the sale alternative is selected, the sale ought to be in consideration for cash or possibly notes rather than stock. A purported "sale" for stock likely would be viewed as a §351 (or §361) transfer subject to §367(d). If notes are used, the notes should be formalized in writing, bear arm's length terms, and be repaid (with interest) in accordance with a periodic repayment schedule. The use of demand notes (or open account debt), particularly in the case of a wholly-owned transferee, would expose the sale to possible recharacterization as an equity contribution and, thus, even absent any issuance of transferee stock, as a §367(c) transfer subject to §367(d). In addition, care should be taken in the valuation of the intangibles to be sold. If full value is not received, the excess of the value given over the value received may be treated as a capital contribution subject to §§367(c) and 367(d).[199]

Similarly, if the licensing alternative is selected, care should be exercised in drafting the terms of the agreement so as to ensure its characterization as a license rather than as an assignment, which could subject the transaction to §§367(c) and 367(d) even though no transferee stock is issued. Thus, substantial rights in the intangible property (such as the licensor's right to terminate the license at will) should be retained by the transferor, the license should be nonexclusive, and it should be subject to other limitations concerning the geographical coverage and use of the subject property. Although, as earlier noted, the Service to date has not adopted the *DuPont* decision's expansive concept of a "transfer of property," this position could change.

8. Transitional Rule

Like §131 of the 1984 Act generally, the special tax treatment of intangible assets under §367(d) is effective with respect to transfers occurring after December 31, 1984, unless a ruling request was pending on March 1, 1984. A special rule for intangible property was incorporated when the bill emerged from conference, however, which (unless a ruling request was pending on March 1, 1984) effectively amends present law with respect to transfers of intangible assets occurring after June 6, 1984 and before January 1, 1985.[200] Transfers of intangible assets during this period are deemed to be for a principal tax avoidance purpose and gain must therefore be recognized under §367(a) (not §367(d)) whether or not the present Guidelines would have permitted tax-free treatment.

The presumption of tax avoidance on transfers of intangible assets is theoretically absolute, but a waiver of the interim rule may be requested, in which case the old rules will be applicable.[201] Issuance of a ruling in which the Service finds no tax avoidance purpose on a transfer of intangible property will be considered a waiver of the interim rule.[202] The Conference Report directs the Secretary to "carefully examine transfers of intangibles before giving such a waiver," and further notes that "[t]ransfers of intangibles that are not fully developed or that are not essential to the active conduct of a trade or business abroad should not be given a waiver." [203] Nevertheless, in cases where a transaction had been planned for some period prior to the rule change, or where the transfer is of goodwill, "marketing" intangibles or similar items which the Com-

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mittee Reports indicate might be excluded from §367(d) in any event, the Service may be willing to issue a waiver.

On August 31, 1984, the IRS issued Temp Regs. §1.367(a)-4T, which set forth the standards that will be applied to of waivers of the transitional rule for transfers of intangible property occurring after June 6, 1984 and before January 1, 1985. The temporary regulations describe four specific and fairly limited circumstances under which such waivers will be granted. There is also a rather tightly drawn "facts and circumstances" exception.

Temp. Regs. §1.367(a)-4T(c)(1) provides that the transitional rule will be waived if: (i) the transferor elects to apply the post-1984 rules of §367(d); (ii) the transferor purchased the intangible property from an unrelated third party, claimed no research and development deductions or credits with respect to the property, and would have received a favorable ruling on the transfer under the Guidelines; (iii) the transfer is required by a foreign government as a necessary condition of doing business in that country or is compelled by a genuine threat of immediate expropriation; or (iv) the transferred intangible property consists of goodwill, going concern value, or similar intangible property that was developed by a foreign branch.

The first exception is not particularly helpful. Any transferor desiring the tax treatment prescribed under §367(d) could simply delay its transfer until 1985, while in the meantime granting a license to the foreign transferee. The second exception is also of limited utility. Unless the transferred intangibles have appreciated in value considerably since their purchase, §367 normally will have only negligible impact on the transfer.

The scope of the third exception is unclear. Does it contemplate absolute legal compulsion under threat of prosecution? Or will a transfer of intangible property be considered "compelled" by a foreign government where the foreign law simply prohibits royalty payments abroad or otherwise exacts a prohibitively high tax on such payments? The alternative provision of the third exception, the expropriation clause, apparently operates on the premise that a taxpayer would be willing to commit still more assets to a country that already has threatened "immediate expropriation" of its business.

Under the fourth exception, a tax-free transfer is permitted of goodwill, going concern value, and "similar intangible property" developed by a foreign branch. One open issue in this connection is whether certain assets (*e.g.*, corporate name, trade names, trademarks, customer lists, contracts and other "non-manufacturing" intangibles) are sufficiently "similar" to goodwill or going concern value to be included in the exception. Since these items are specifically listed in the definition of "intangible property" under Regs. §1.367(a)-4T(a) (which tracks the §936(h)(3)(B) definition incorporated into new §§367(a)(3)(B)(iv) and (d)(1)), the omission of any specific reference to such items in the fourth exception could be considered intentional. On the other hand, it could be argued that the term goodwill, which is not specifically listed in the §936(h)(3)(B) definition, encompasses a variety of discrete intangible assets which are specifically listed in that definition. A second problem area involves distinguishing goodwill and similar items that have been "developed by a foreign branch" from those items that have been developed by the worldwide (non-branch) operations of the home office. It is hoped that whatever goodwill exists in a country where a branch operates will be attributed to the branch for this purpose.

In addition to the four specific exceptions, Temp. Regs. §1.367(a)-4T(c)(3) establishes a "facts and circumstances" exception under which the transitional rule may be waived provided the transfer is not being made during 1984 for the purpose of avoiding application of new §367(d). Circumstances indicating that a transfer is not being timed to avoid §367(d) include (but are not limited to): (i) the existence of a binding commitment that was entered into with an unrelated party or foreign government before June 6, 1984; (ii) the existence prior to March 1, 1984, of a documented plan to transfer the intangible assets before January 1, 1985; and (iii) anticipated use of the transferred intangible assets by the transferee immediately or soon after the transfer. Although Temp. Regs. §1.367(a)-4T(c)(3) states that this last factor, standing alone, generally will not be sufficient to obtain a waiver, it is not clear what further showing will be required. A mere desire to begin operations during 1984, absent some business necessity, apparently would not satisfy the Service.[204] Moreover, even a timely plan or commitment will not necessarily ensure the granting of a waiver; the regulations provide that "the earlier the plan or commitment was made, the greater is the probability that a waiver will be given."

Unless the taxpayer elects to have §367(d) apply, a waiver of the transitional rule in no case will be granted unless the taxpayer satisfies the three tests of Temp. Regs. §1.367(a)-4T(c)(2). First, no waiver will be granted for the transfer of intangible assets which would not have received a favorable ruling under Secs. 3.02(a)(iv) and (b)(i)-(iv) of the Guidelines (which generally withhold favorable clearance where the transferred intangibles will be licensed or sold by the transferee, or where they will be used in connection with a U.S. business). Second, a stricter active business test than that applied under the Guidelines must be satisfied. Adopting a phrase from the Conference Report, the temporary regulations state that a waiver will only be granted if the intangible assets are "essential to the active conduct of a trade or business by the transferee."[205] To be "essential" to the transferee's trade or business it must either be illegal to sell the products or services to which the intangibles relate without access to such intangibles by ownership, license, or otherwise or, in the alternative, it must be impossible without such intangibles to realize a level of earnings reasonable for the transferee's trade or business from sales of such products or services in that country. How to determine a reasonable level of earnings for this purpose is unclear.

Finally, no waiver will be granted for intangible property unless it is "fully developed;" *i.e.*, it has been used in a trade or business or no further significant research and development expenses are required or expected to be incurred prior to its use by the transferee.

Although some flexibility may continue to exist in the rulings process, the temporary regulations generally will make it quite difficult to obtain any meaningful waiver of the transitional rule for pre-1985 transfers of intangible property. Where such a waiver is not obtainable, the avail-

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able options will be limited to either transferring the intangibles pursuant to a taxable sale or exchange or licensing them to the transferee.

J. *Outbound Liquidations*

1. *In General*

Under new §367(e), to the extent provided in regulations, a domestic corporation that makes a distribution of appreciated property to its foreign shareholder(s) in complete liquidation will be required to recognize gain on the distribution (notwithstanding §336) "under principles similar to the principles" of §367. Section 367(e) apparently is not self-executing, but is to become effective "to the extent provided in regulations." If the regulations are issued sometime after the January 1, 1985, effective date of §367(e), they presumably will have effect only prospectively.

Enactment of §367(e) corrects what was perceived to be a deficiency in the provisions of §367. Under pre-1984 Act law, domestic subsidiaries of foreign corporations generally could be liquidated with little or no U.S. tax cost. Although, absent a ruling, §367 would prevent the liquidation from qualifying for tax-free treatment under §332, the foreign parent merely would be viewed as a non-corporate shareholder and the transaction would be converted to a §331 liquidation.[206] Since §336 was not one of the provisions enumerated in §367, that provision would ensure nonrecognition treatment to the liquidating domestic corporation notwithstanding the absence of a §367 ruling. Although the foreign parent theoretically would recognize gain absent §332 protection, the gain would not be subject to U.S. tax if the foreign parent were not engaged in a U.S. trade or business with which such gain could be considered effectively connected.[207] Treatment as a §331 liquidation would cause the domestic corporation to lose, where relevant, the otherwise applicable exemptions from depreciation and investment credit recapture.[208] However, even where recapture applied, its cost often was less than the gain that the distributing corporation would have had to realize under §367 in order to qualify its foreign parent for tax-free treatment under §332.

2. *Application of the "Principles of §367"*

Among the "principles of §367" that likely would be applied to outbound liquidating distributions would be the tainted asset rules of §367(a)(3)(B). Under those rules, gain ordinarily would be required to be recognized by the liquidating corporation to the extent the assets distributed in liquidation included assets falling within any of the defined categories of tainted assets. This result would be consistent with Sec. 3.01(2) of the Guidelines, which tested §332 liquidations under the rules applicable to §351 transfers and required recognition of gain with respect to the distribution of any tainted assets.[209]

Even if no tainted assets are distributed in liquidation, §367(e) possibly still could require that the transaction satisfy the active business test of §367(a)(3)(A) as a condition to the applicability of §336. Although application of the active business requirement may appear anomalous in respect of a liquidating domestic corporation whose business is being wound up rather than relocated offshore (*e.g.*, as a branch of its parent), such an approach is not without precedent.

Although the Guidelines generally applied to outbound §332 liquidations the same standards applicable to outbound §351 transfers, until recently the Guidelines' requirement that the foreign transferee devote the transferred assets to the conduct of an active business outside the United States seemed not to be applied to outbound §332 liquidations.[210] For example, in PLR 8210030, a foreign bank liquidated its domestic subsidiary and continued the subsidiary's operations in U.S. branch form. Although a tainted asset toll charge was imposed on the stock and securities distributed to the foreign parent, the transaction otherwise was accorded tax-free treatment under §332. The foreign parent represented that the transferred assets "will be used in the active conduct of a trade or business." Omitted from the standard representation was the phrase "in a foreign country." Similarly, in PLR 8149038, a domestic corporation was required to pay a toll charge on its tainted assets, but was otherwise permitted to liquidate under §332 even though the foreign parent continued the liquidated subsidiary's U.S. business.[211]

However, in PLR 8334013,[212] the Service reversed this position, holding that the active *foreign* business requirement was applicable to an outbound §332 liquidation and that a favorable §367 ruling would not be issued where a foreign parent would continue the business of its liquidated domestic sales subsidiary in *U.S.* branch form. This result was reached notwithstanding the taxpayer's argument, and willingness to enter into a closing agreement, to the effect that the foreign parent's U.S. tax liability in respect of its effectively connected U.S. branch income would be identical to the U.S. tax liability of the domestic subsidiary prior to the liquidation. Whether the regulations under §367(e) will adhere to the Service's current rulings position, which effectively prohibit "domestic branching" by foreign parents of U.S. subsidiaries on a tax-free basis, remains to be seen. What might be taken into account by the Service in evaluating the regulatory options on this issue is that, to the extent the liquidating corporation recognizes capital gain rather than ordinary income under §367(e), an overall tax benefit might be obtained since the foreign parent presumably will acquire a stepped-up basis in the U.S. branch assets for purposes of future ordinary depreciation and amortization deductions.[213]

The special rules for "intangible property" contained in §367(d) apply only to transfers described in §351 or §361 and should not be applicable for purposes of §367(e). Nevertheless, gain ordinarily will be recognized on any liquidating distribution of "intangible property" by virtue of its tainted asset treatment under §367(a)(3)(B). On the other hand, to the extent goodwill, names, trademarks, and similar intangibles are excluded by regulation from the definition of "intangible property," an outbound liquidating distribution of such items might qualify for nonrecognition treatment, presumably subject, however, to satisfaction of the active business exception as previously discussed.

The loss recapture rules of §367(a)(3)(C) ordinarily should be inapplicable to an outbound liquidation, except perhaps where the liquidating domestic corporation operated a foreign loss branch. As noted earlier, the Conference Report indicates that an outbound transfer of property that has been used in a domestic business will trigger recapture of any depreciation deductions previously claimed in re-

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spect of the transferred property.[214] Absent express statutory authorization, it would seem questionable whether this statement, standing alone, could have the effect of overriding §§1245(b)(3) and 1250(d)(3), which exempt corporations that distribute assets in §332 liquidations from depreciation recapture. Whether the statement nevertheless somehow could be viewed to embody a "principle of §367," such that the IRS by regulation could impose such a recapture rule under §367(e), is somewhat more troublesome. The statement seems gratuitous, but it perhaps could be engrafted onto §367 under the broad regulatory authority granted by the statute.[215]

3. Planning Considerations

Section 367(e) by its terms is not limited to liquidations that would qualify under §332 if §367 were satisfied. It applies to any distribution of appreciated property to which §336 applies, which includes liquidations in which the tax consequences to the shareholders are determined under §331. However, §367(e) should not apply to non-liquidating distributions in respect of which the distributing domestic corporation is taxable (if at all) under §311. Although the general rule under §311(d)(1) is that corporations must recognize gain on distributions of appreciated property, there are several exceptions that, albeit in situations primarily involving non-corporate shareholders, might permit appreciated property to be distributed without recognition of gain to the distributing corporation.[216]

Another approach that could prove advantageous in situations where the tainted asset or active business rules otherwise might present obstacles to tax-free treatment under §367(e) would involve the use of §337, which permits a liquidating domestic corporation to sell its property free of tax provided it is liquidated within 12 months from adoption of the plan of liquidation. By converting its assets on a tax-free basis into cash (which when distributed would not be appreciated property),[217] the domestic corporation should be able to distribute the cash to its foreign shareholders in liquidation without triggering any recognition of gain under §367(e) (although the recapture provisions, previously discussed, would be applicable). The foreign shareholders should not be subject to U.S. tax on the gain recognized under §331 provided the gain is not effectively connected with a U.S. trade or business of the shareholder.[218]

K. Outbound Transfers Subject to §1491

An outbound transfer of property to a foreign corporation as paid-in surplus or as a contribution to capital (except where §367 applies),[219] or an outbound transfer of property to a foreign partnership, trust, or estate, unless excepted under §§1492 or 1494(b) will subject the U.S. transferor to an excise tax equal to 35 percent of the gain not otherwise recognized on the transfer.[220] The tax is due and payable "at the time of the transfer," [221] unless a pre-transfer exemption has been obtained. A Form 926 information return also must be filed at such time, whether or not an exemption has been obtained.[222] In lieu of paying the 35 percent excise tax on a transfer subject to §1491, the transferor may elect under §1057 to recognize gain on the transfer, thereby obtaining an increase in basis for the transferred assets and, except to the extent gain is recaptured as ordinary income, a lower rate of tax on the transfer.[223]

Prior to the 1984 Act, relief was obtainable from the 35 percent excise tax (without making a §1057 election) if the transferor could establish, pursuant to a ruling request filed either before or after the transfer, that tax avoidance was not one of the principal purposes of the transfer.[224] The Service generally applied the same Guidelines' standards in issuing rulings under §1492 (advance rulings) and §1494(b) (requests for abatement of tax) as it applied under §367. The 1984 Act amendments to §367 necessitated complementary changes to the §1491 excise tax provisions.[225]

The 1984 Act has amended §1492 by eliminating the statute's tax avoidance purpose standard and providing that the excise tax will not be imposed on "a transfer . . . with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of §367." Similarly, §1494(b) has been amended to provide that, "Under regulations prescribed by the Secretary, the [excise] tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of §367."

Neither the House Report nor the Senate Report indicates how "the principles of §367" are to be applied to transfers described in §1491.[226] The Conference Report merely reiterates the statutory directive, noting that "all of the principles of Section 367 (including the special rules for intangibles) are applicable for purposes of the excise tax rules." [227]

Applicable "§367 principles" presumably will be considered to encompass the tainted asset and active business rules. If no §1057 election is made, the excise tax apparently will be imposed in respect of any §1491 transfer of property that either constitutes a tainted asset or otherwise will not be devoted by the transferee to an active business abroad.[228]

Other "§367 principles" may prove more difficult to apply in the §1491 context. For example, it is unclear how, or whether, the "useful life" toll charge of §367(d)(2)(A) could be imposed on a transfer of "intangible property" to a foreign partnership. Would the excise tax be imposed on an annual basis in respect of amounts deemed to be received each year as "payments contingent upon the productivity, use or disposition" of the transferred property? [229] If so, would the foreign partnership be entitled to deduct a like amount, by analogy to the "principle" of §367(d)(2)(B) which permits a foreign corporation to reduce its earnings and profits by the amount included in the income of the transferor? A special allocation of such deduction to the transferor could well neutralize the effect of the §1491 tax.[230]

The "principles" of the foreign branch loss recapture rules of §367(a)(3)(C) arguably should not be applied to §1491 transfers to foreign partnerships. Since the transferor will remain taxable on any post-transfer income realized by the partnership from the transferred assets, there will not be the "mismatching" in such a case that the loss recapture rules were designed to prevent. Pending regula-

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tions, however, caution is required in light of the Conference Committee's directive that "all" principles of §367 be applied under §1491.[231]

The procedure under §1492 for obtaining relief from the excise tax by electing the "principles of §367" prior to a §1491 transfer has not been provided by statute. Since §367 contains generally self-executing, objective rules, a taxpayer in the interim should be able simply to send notice to its district director or to the IRS National Office stating its intention to apply the principles of §367. Whether those principles are properly applied should be a matter for determination on audit. However, the Conference Report contains the cryptic statement that: "as under present law, the taxpayer is to make the showing required under §1492 before the transfer." [232] Under "present law," a showing is required that the taxpayer does not have a principal tax avoidance purpose for the transfer, a standard that has been eliminated by the 1984 Act amendments. Hopefully, the Service will clarify this point before the amended provisions take effect.

L. Procedural Changes

1. Ruling Requests and Declaratory Judgments

With the enactment of objective standards, the transferor in an exchange described in §367(a) need no longer satisfy the Commissioner that tax avoidance is not one of its principal purposes in making the transfer. The mandatory ruling requirement has therefore been repealed.[233] Also repealed is §7477, which created a declaratory judgment procedure permitting taxpayers to challenge in the Tax Court the "reasonableness" of an adverse §367 ruling or toll charge.[234]

Although rulings are no longer mandatory, the Committee Reports indicate that taxpayers should continue to have the opportunity to request a ruling.[235] Whether or not to issue a §367 ruling in any particular case will be discretionary with the Service, although the Committee Reports emphasize that rulings generally should be issued upon request.[236] The ability to obtain a ruling could present a problem in those situations where the statutory requirement at issue turns on factual questions, such as whether the foreign transferee will be actively engaged in a trade or business outside the United States. The Service's policy generally has been not to rule on factual matters,[237] and the Service has indicated that it ordinarily will not rule on whether a foreign taxpayer is engaged in a U.S. trade or business.[238] The Service will rule, based on financial information submitted by the taxpayer, that for purposes of §355(b) an active trade or business has been conducted over the past five years.[239] However, it is more difficult to rule on whether an active trade or business *will* be conducted in the future, an issue which in the §355 context is generally covered with a taxpayer representation to that effect.[240]

2. The Notification Requirement

Any U.S. person who makes a transfer of property to a foreign corporation in connection with an exchange described in §367 (*i.e.*, §§332, 351, 354, 355, 356, and 361) is required by new §6038B to file an information return with the Service containing such information regarding the transfer as the Secretary by regulations will prescribe. Information returns also will be required when a liquidating domestic corporation makes a §336/367(e) distribution to a foreign shareholder, whether or not the shareholder's tax liability is tested under §332 or §331.[241] Section 6038B does not apply to transfers described in §1491, but a reporting requirement already exists for such transfers.[242]

Unless the failure to file the information return required by §6038B is "due to reasonable cause and not to willful neglect," a penalty is imposed for nonfiling equal to 25 percent of the amount of gain realized on the exchange.[243] In addition, failure to file the information return tolls the statute of limitations, which will not expire until 3 years after the date on which the Secretary receives the required notification.[244]

The "tolling" effect of not filing a §6038B notice could become a "trap for the unwary" in cases where the applicability of §367 is uncertain; *e.g.*, the transfer of an intangible item that may or may not constitute a "transfer of property" for §367 purposes. In such a case, the Service would be free to challenge the taxpayer's characterization at any time. Whether "reasonable cause" would be found if such a challenge were successful, permitting abatement of the penalty, presumably would depend on the relative strength of the taxpayer's position. As in the case of the Form 926 information return for §1491 transfers, noncompliance with which similarly tolls the applicable limitations period, taxpayers undertaking transactions that arguably must be reported under §6038B may be well advised to file a "protective" §6038B return, reflecting therein the taxpayer's position that no §367 transfer has occurred.

M. Effective Dates

1. In General

The amendments made by §131 of the 1984 Act are generally effective with respect to transfers or exchanges occurring after December 31, 1984.[245] The old rules will continue to apply, however (regardless of when the transfer occurs), to any transfer which was described in a ruling request filed with the Service prior to March 1, 1984.[246]

2. Planning Considerations

Since many of the prior rules governing outbound transfers of property will continue to apply under the amended provisions, there will not necessarily be any advantage to making a §367 transfer prior to January 1, 1985 (the effective date of the amendments). There are several instances, however, where making a transfer during 1984 may be desirable. (It is presumably now too late in the year to obtain a §367 ruling prior to making a transfer before the amendments take effect. A taxpayer must therefore be willing to make the transfer without an advance ruling, resorting if necessary to the Tax Court declaratory judgment procedure (which continues to be effective with respect to pre-1985 transfers, regardless of when the adverse ruling on such transfer is issued) if the Service rules unfavorably.

A taxpayer might consider making a transfer prior to January 1, 1985, if a favorable ruling likely would not be issued by the Service under the objective standards in the Guidelines (which presumably will be the objective standards under the Tax Reform Act of 1984), but a strong

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factual showing could be made that tax avoidance is not one of the principal purposes of the transfer.

A taxpayer confronting a large Rev. Rul. 78-201 toll charge upon the incorporation of a foreign loss branch (and statutory loss recapture under §367(a)(3)(C) if the transaction occurs in 1985) might consider a 1984 transaction as a means to preserve the opportunity for possible declaratory judgment relief on authority of *Hershey Foods*.

A foreign parent contemplating the liquidation and "domestic branching" of its U.S. subsidiary might wish to effect the liquidation (without a ruling) in 1984 before §367(e) becomes effective to preclude §336 treatment.

Although a favorable §367 ruling on a transfer of at least certain types of "intangible property" no longer may be obtainable by virtue of the 1984 Act transitional rule, in some circumstances it still could be advantageous to make such a transfer during 1984, before §367(d) takes effect. Although gain or income likely would be recognized under §367(a) (absent a "waiver" of the transitional rule), the amount of such gain or income would be fixed, its character in certain instances would be capital, and steps could be taken to support characterization of the income (whether ordinary or capital) as foreign source income. (The same result of course also could be achieved even after 1984 by an outright sale of the property rather than a transfer in exchange for stock.)

By contrast to the foregoing, a taxpayer contemplating a transfer of stock under circumstances that would not qualify for tax-free treatment under the Guidelines might consider postponing (rather than accelerating) the transaction until 1985 in order to take advantage of the liberalized standards for securing tax-free treatment of such transactions (including the closing agreement procedure) contemplated in the Committee Reports.

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[1] By Leonard B. Terr, Esq., and Richard J. Safranek, Esq., of Sutherland, Asbill & Brennan, Washington, D.C.

[2] *See, e.g.*, PLR 8329024 (April 15, 1983); PLR 8328066 (April 12, 1983); PLR 8326016 (March 23, 1983).

[3] *See, e.g.*, PLR 8312089 (Dec. 22, 1982) ("D" reorganization), PLR 8311023 (Dec. 10, 1982) ("B" reorganization); PLR 8330059 (April 26, 1983) ("D" reorganization); PLR 8040070 (July 11, 1980) ("F" reorganization).

[4] *See, e.g.*, PLR 8326025 (March 25, 1983); PLR 8309049 (Nov. 29, 1982); PLR 8330012 (Apr. 18, 1983).

[5] Regs. §§1.367(a)-1(b)(2), (3), and (5).

[6] Regs. §1.367(a)-1(b)(3). *See, e.g.*, PLR 8252036 (Sept. 24, 1982).

[7] Regs. §1.367(a)-1(b)(5).

[8] Regs. §1.367(a)-1(b)(2)(i)-(iii); PLR 8303082 (Oct. 21, 1982).

[9] §367(c).

[10] §367(c)(2); Regs. §1.367(a)-1(b)(8). *See, e.g.*, PLR 8311060 (Dec. 14, 1982); PLR 8302077 (Oct. 13, 1982); PLR 8245029 (Aug. 10, 1982).

[11] Regs. §1.367(a)-1(b)(6) and Examples 1 and 2. *See, e.g.*, PLR 8117039 (Jan. 22, 1981); PLR 7833090 (May 19, 1978); PLR 8124135 (March 23, 1981).

[12] Regs. §1.367(a)-1(b)(7). *See, e.g.*, PLR 8304135 (Oct. 28, 1982); PLR 8252036 (Sept. 24, 1982).

[13] *See, e.g.*, PLR 7917125 (Jan. 29, 1979); PLR 8152035 (Sept. 29, 1981); PLR 8139062 (June 30, 1981).

[14] Temp. Regs. §7.367(b)-4(b)(2)(i)(A) ("foreign-to-foreign" "B" reorganization overlap with outbound §351 exchange); See PLR 8325038 (March 17, 1983), but see Regs. §1.367(a)-1(b)(1) and discussion at II, E, 2, b.

[15] *See* Rev. Rul. 68-43, 1968-1 C.B. 146.

[16] *See* Rev. Rul. 79-288, 1979-2 C.B. 79; PLR 8329024 (April 15, 1983); PLR 8309048 (Nov. 29, 1982); PLR 8307034 (Nov. 15, 1982); PLR 8304029 (Oct. 22, 1982).

[17] *See, e.g.*, PLR 8326029 (March 25, 1983); PLR 8109069 (Dec. 8, 1980), supplemented by PLR 8208014 (Nov. 23, 1981) (final determination); *Hospital Corp. of America, Inc.*, 81 T.C. 520 (1983).

[18] *See, e.g.*, PLR 8326031 (March 25, 1983).

[19] H. Rep. No. 708, 72d Cong., 1st Sess. (1932) at page 20; H.R. Rep. No. 658, 94th Cong., 1st Sess. (1975) at page 240.

[20] Rev. Proc. 68-23, 1968-1 C.B. 821. The Guidelines cover some transactions now controlled by the regulations issued under §367(b), but continue to be applicable to outbound transfers under §367(a) until the 1984 Act changes take effect. Rev. Proc. 77-5, 1977-1 C.B. 536.

[21] *Id.*, §3.02(1)(a).

[22] *Id.*, §3.03(1)(d).

[23] *Id.*, §§3.02(1)(d), 3.03(1)(a).

[24] *Id.*, §3.02(1)(a)(iii). *See, e.g.*, PLR 8322052 (Feb. 28, 1983); PLR 8221009 (Feb. 19, 1982).

[25] Rev. Proc. 68-23, *supra*, §3.02(1)(b)(i)-(iv). See, *e.g.*, PLR 8216027 (Jan. 19, 1982) (foreign patent); PLR 8023029 (March 11, 1980) (foreign land on building to be leased); PLR 8321013 (Feb. 11, 1983) and PLR 8321014 (Feb. 11, 1983) (foreign patent rights); PLR 8035100 (June 9, 1980) (trademark); PLR 8035086 (June 9, 1980) (know-how).

[26] Rev. Proc. 68-23, *supra*, §3.02(1)(a)(i) and (ii). See, *e.g.*, PLR 8150082 (Sept. 17, 1981) (inventory); PLR 8109060 (Dec. 5, 1980) (receivables).

[27] 76 T.C. 312 (1981), *gov't appeal dismissed*, No. 81-2096 (3d Cir. Sept. 16, 1981).

[28] Rev. Rul. 78-201, 1978-1 C.B. 91.

[29] Rev. Proc. 68-23, *supra*, §3.02(a).

[30] *Id.*, §2.02.

[31] *See, e.g.*, PLR 8313099.

[32] 76 T.C. 325 (1981), *acq.*, 1982-2 C.B. 1.

[33] 72 T.C. 896 (1979), aff'd mem., 642 F.2d 1211 (5th Cir. 1981).

[34] *Supra*, note 26.

[35] §367(a)(3)(A). Unless otherwise indicated, references are to sections as amended by the 1984 Act.

[36] Rev. Rul. 78-201, 1978-1 C.B. 91.

[37] *See, e.g.*, Rev. Rul 69-156, 1969-1 C.B. 101.

[38] *See, e.g., Hospital Corp. of America v. Comr.*, 81 T.C. 520 (1983); *Shell Oil Co. v. Comr.*, No. 3767-82T (T.C. filed Feb. 19, 1982), judgment entered for taxpayer by stipulation; Rev. Rul. 68-43, 1968-1 C.B. 146.

[39] Such transactions may be subject, however, to the §367(b) regulations and, in the case of non-§367(a) contributions, to §1491. *See* Rev. Rul. 82-112, 1982-1 C.B. 59.

[40] Regs. §7.367(b)-4(b). Compare S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. (1984) at page 365 (§351 to have priority) with Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 955 (§351 priority in certain cases to be considered). *See* discussion at II, E, 2, b, *infra*.

[41] §367(a)(3)(B). The treatment of such "tainted assets" is discussed in II, C, *infra*.

[42] S. Rep. No. 98-169, at p. 365; H.R. Rep. No. 98-432, at p. 1320; Conf. Rep. No. 98-861, at p. 952.

[43] *Id.*

[44] For a brief discussion of the background of the §367 amendments, see Terr and Safranek, "Proposed Amendment to §367(a)," 13 Tax Management International Journal 17 (Jan. 1984).

[45] PLR 8415037 (Jan. 9, 1984); PLR 8406059 (Nov. 9, 1983); PLR 8407012, 13, 14, 16, and 17 (Nov. 9, 1983); PLR 8305036 (Oct. 29, 1982). *See* Terr and Safranek, "IRS Breaks New Ground Defining §367 Active Trade or Business Test," 13 Tax Management International Journal 152 (May, 1984).

[46] Rev. Rul. 73-234, 1973-1 C.B. 180; Rev. Rul. 73-236, 1973-1 C.B. 183; Rev. Rul. 73-237, 1973-1 C.B. 184.

[47] Prop. Regs. §1.355-3(b)(2)(iii).

[48] Following a final adverse determination, PLR 8335022 (May 25, 1983), the taxpayer petitioned the Tax Court for declaratory judgment relief under §7477. *Betty Mayland Ellis*, T.C. Docket No. 24,592-83T (Aug. 23, 1983).

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[49] *Dittler Bros., Inc. v. Comr.*, 72 T.C. 896, 913 (1979). The Committee Reports state that the active trade or business test under the 1984 Act would not be satisfied on the facts in *Dittler Bros.* S. Rep. 98-169, at p. 365; H. Rep. 98-432, at p. 1320.

[50] 1973-1 C.B. 184.

[51] Guidelines, §3.02.

[52] *See* PLR 8210030 (Dec. 9, 1981); PLR 8149038 (Sept. 9, 1981); PLR 8050026 (Sept. 16, 1980); PLR 7907129 (Nov. 20, 1978); PLR 7835095 (June 6, 1978). If property was transferred in a §351 exchange to a foreign corporation owned by U.S. shareholders, however, the U.S. situs of the business was cited as grounds for refusing §367 clearance. PLR 8124107 (Mar. 19, 1981); PLR 8204215 (Nov. 2, 1981); PLR 8334013 (May 18, 1983); PLR 8122083 (Mar. 9, 1981); PLR 8040070 (July 11, 1983).

[53] *See* PLR 8334013 (May 18, 1983); Terr, "IRS Attack on Domestic 'Branching' -PLR 8334013," 83-11 Tax Management International Journal 22 (November, 1983). *See also* the discussion of new §367(e), at II, J, *infra*.

[54] Transfers of stock are discussed at II, E, *infra*.

[55] PLR 8322052 (Feb. 28, 1983); PLR 8213039 (Dec. 29, 1981); PLR 8151124 (Sept. 28, 1981). *See also*, Rev. Rul. 83-34, 1983-1 C.B. 79.

[56] *See* PLR 8425030 (Mar. 19, 1984); PLR 8222012 (Feb. 25, 1982); PLR 7840047 (July 10, 1978); PLR 8040083 (July 14, 1980); PLR 8309019 (Nov. 24, 1982). *Cf.*, §875(1). *See also* Rev. Rul. 83-156, 1983-2 C.B. 66.

[57] S. Rep. No. 98-169, at page 362; H.R. Rep. No. 98-432, at page 1317. *See also* Rev. Rul. 80-323, 1980-2 C.B. 124; PLR 7926118 (Mar. 30, 1979).

[58] *See* PLR 7918104 (Jan. 31, 1979); PLR 8040070 (July 11, 1980).

[59] S. Rep. No. 98-169, at 367; H.R. Rep. No. 98-432, at page 1322.

[60] *See* PLR 8217071 (Jan. 28, 1982); PLR 8021031 (Feb. 27, 1980); PLR 8205079 (Nov. 9, 1981); PLR 8041065 (July 17, 1980).

[61] This would be consistent with the treatment of tiered partnerships under Regs. §1.367(a)-1(b)(3), which for purposes of treating a U.S. person as an indirect transferor, looks through any intervening partnerships. *See* Preamble to Proposed Rules, 47 Fed. Reg. 57504 (Dec. 27, 1982).

[62] S. Rep. No. 98-169, at page 367; H.R. Rep. No. 98-432, at page 1323.

[63] *Id.*

[64] *See, e.g.*, PLR 8319014 (Feb. 7, 1983); PLR 8145034 (Aug. 11, 1981).

[65] In PLR 8022070 (Mar. 7, 1980), a U.S. transferor transferred limited partnership interests in two partnerships. As to one partnership, all partners participated in the transfer, and a favorable §367 ruling was obtained. As to the second, a minority of partners did not join in the transfer and a toll charge was imposed on the transferor. *See also* PLR 8226076 (Mar. 30, 1982); PLR 8252036 (Sept. 24, 1982).

[66] S. Rep. No. 98-169, at page 366; H.R. Rep. No. 98-432, at page 1322.

[67] *See* II, I, *infra*. §367(d) is limited to transfers described in §351 or §361. Intangible property is included in the list of tainted assets subject to §367(a) in order to cover transfers of intangible property in §332 liquidations.

[68] Guidelines, Sec. 3.02(1)(a)(iii).

[69] H.R. Rep. No. 98-432, at page 1322; S. Rep. No. 98-169, at page 364. *See* II, E, *infra*.

[70] H.R. Rep. No. 98-432, at page 1317; S. Rep. No. 98-169, at page 361. *See* II, D, *infra*, for a discussion of how the active business exception applies to property that will be leased by the foreign transferee to third parties. The Guidelines category of property likely to be licensed by the transferee (*i.e.*, intangibles) is covered by new §§367(a)(3)(B) and 367(d).

[71] *See* PLR 8150082 (Sept. 17, 1981).

[72] For rulings involving the transfer of installment obligations and receivables, *see* PLR 8134191 (May 29, 1981); PLR 8242056 (July 20, 1982); PLR 8312089 (Dec. 22, 1982).

[73] Rev. Rul. 81-4, 1981-1 C.B. 126; PLR 8008107 (Nov. 29, 1979); PLR 8204038 (Oct. 27, 1981); PLR 8219033 (Feb. 9, 1982); PLR 8243232 (July 30, 1982). *But see* PLR 8145102 (Aug. 17, 1981), rev'g. an earlier adverse ruling, PLR 8109060 (Dec. 5, 1980).

[74] *See National Standard Co. v. Comr.*, 80 T.C. 551, 555 (1983); *Gillin v. U.S.*, 423 F.2d 309 (Ct. Cl. 1970); *Helburn, Inc. v. Comr.*, 20 T.C. 740 (1953), *aff'd*, 214 F.2d 815 (11th Cir. 1954); *Joyce-Koebel Co. v. Comr.*, 6 B.T.A. 403 (1927). *See generally* Terr & Muller, "Tax Treatment of Foreign Currency Forward Contracts," 25 Tax Management Memorandum 19-39 (Jan. 23, 1984).

[75] S. Rep. No. 98-169, at page 366.

[76] *See* PLR 8139119 (July 2, 1981); PLR 8330059 (Apr. 26, 1983); PLR 8103043 (Oct 21, 1980); PLR 8109060 (Dec. 5, 1980); PLR 8210030 (Dec. 9, 1981).

[77] *See* Rev. Rul 74-7, 1974-1 C.B. 198; PLR 8016004 (Dec. 18, 1979). Absent an explicit statutory provision, such as §367(d)(2)(C) or §367(a)(3)(C), the characterization of an item as ordinary or capital is not affected by §367 but is governed by normally applicable tax principles. Guidelines, §§3.01(2) and 3.02(1)(d); PLR 8413021 (Dec. 22, 1983).

[78] *American Manufacturing Co. v. Comr.*, 55 T.C. 204, 232 (1970); Rev. Rul. 71-433, 1971-2 C.B. 325; Rev. Rul. 76-333, 1976-2 C.B. 104.

[79] H.R. Rep. No. 98-432, at page 1322; S. Rep. No. 98-169, at page 366.

[80] *See Kentucky & Indiana Terminal R.R. Co. v. U.S.*, 330 F.2d 520 (6th Cir. 1964); *Gillin v. U.S.*, *supra* note 74.

[81] *See* PLR 8305036 (Oct. 29, 1982).

[82] *See* PLR 8150129 (Sept. 21, 1981).

[83] *See, e.g.*, PLR 8204038 (Oct. 27. 1981); PLR 8147029 (Aug. 25, 1981); PLR 8323020 (Mar. 4, 1983).

[84] H.R. Rep. No. 98-432, at page 1321; S. Rep. No. 98-169, at page 366.

[85] §367(a)(3)(B)(v). *See* discussion at II, C, 5, *supra*.

[86] 1980-1 C.B. 617. *See, e.g.*, PLR 8340016 (June 27, 1983); PLR 8023029 (Mar. 11, 1980).

[87] H.R. Rep. No. 98-432, at page 1321; S. Rep. No. 98-169, at page 366.

[88] H.R. Rep. No. 98-432, at pages 1320-1321; S. Rep. No. 98-169, at page 365; Conf. Rep., H.R. Rep. No. 98-861, at page 955.

[89] *Id.*

[90] Outbound "C" and "D" reorganizations, involving a domestic corporation's transfer of substantially all of its assets to an acquiring foreign corporation, are the most common examples of reorganizations that have been (and should continue to be) considered transfers of assets for §367 purposes. *See, e.g.*, PLR 8330059 (Apr. 26, 1983); PLR 8312089 (Dec. 22, 1982); PLR 8216027 (Jan. 19, 1982).

[91] *See* Regs. §1.367(a)-1(b)(2)(ii); PLR 8109055 (Dec. 5, 1980); PLR 8316070 (Jan. 17, 1983); PLR 8303082 (Oct. 21, 1982).

[92] *See, e.g.*, PLR 8428018 (Apr. 4, 1984); PLR 7748014 (Aug. 30, 1977). *Cf.* Reg. §1.367(a)-1(b)(2)(i)(B).

[93] *See, e.g.*, PLR 8420032 (Feb. 10, 1984); PLR 8251067 (Sept. 20, 1982); PLR 8209030 (Dec. 4, 1981); PLR 8113123 (Jan. 5, 1981); Rev. Rul. 74-297, 1974-1 C.B. 84. Regs. §1.367(a)-1(b)(i)(A), which seemed literally to recharacterize a forward triangular merger as an outbound transfer of assets for §367 purposes, has not been so interpreted by the IRS. GCM 39231 (Jan. 23, 1984), issued in connection with PLR 8420032, states that such reorganizations will continue to be tested under the rules applicable to reorganizations involving transfers of stock.

[94] *See* PLR 8143019 (July 28, 1981). Regs. §1.367(a)-1(b)(iii) seems literally to treat such reorganizations as transfers of assets for §367 purposes, but GCM 39231 logically should apply to triangular "C" reorganizations to the same extent as it applies to forward triangular mergers.

[95] Guidelines Sec. 3.03(1)(d). Even if the 50% test were satisfied, a favorable ruling ordinarily would not be issued if the assets of the acquired corporation consisted primarily of stock or securities. *But see* PLR 8126126 (Apr. 6, 1981), where the stock or securities prohibition was held not to apply to a holding company which held stock in operating subsidiaries rather than portfolio investments.

[96] Guidelines Sec. 3.02(1)(a)(iii). A "facts and circumstances" test was applied (and favorable consideration was generally denied) where post-reorganization ownership of the acquiring foreign corporation fell between 50 percent and 80 percent.

[97] It is hoped that the Treasury and the Service will take the opportunity in drafting regulations to alter the present practice of including foreign as well as domestic share holders of the domestic corporation in applying the 50 percent test. *See* PLR 8334017 (May 19, 1983); PLR 8121093 (Feb. 27, 1981), *supp. by* PLR 8235071 (June 3, 1982). But see, *contra*, PLR 8241057 (July 14, 1982). Foreign shareholders not engaged in U.S. business ordinarily should have no incentive to reorganize prior to a sale of stock in a domestic corporation, since they normally can escape U.S. tax on any gain realized without need of such a pre-sale reorganization. §§871(a)(2) and 881.

[98] *See also* PLR 8426049 (Mar. 27, 1984).

[99] Guidelines, Sec. 3.02(1)(a)(iii)(B). The holding company must be a "controlled foreign corporation" as defined in §957. PLR 8401032 (Sept. 30, 1983).

[100] *See* PLR 8413035 (May 2, 1984), where a §367(c) contribution of stock was treated as not being in exchange for "voting stock" and, thus, as an outbound §351 transfer rather than a "B"-§351 "overlap."

[101] S. Rep. No. 98-169, at page 365. The House Report does not contain this language.

[102] H.R. Rep. No. 98-861, at page 955.

[103] PLR 8325038 (Mar. 17, 1983).

[104] §954(c). The statutory "same country" exception of §954(c)(4)(A), which excludes from foreign personal holding company income dividends

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received from a same country subsidiary, is in some case inapplicable to distributions of earnings and profits accumulated prior to establishing the "same country" structure. Regs. §1.954-2(e).

[105] 76 T.C. 325 (1981), *acq. in result*, 1982-2 C.B. 1.

[106] *See also* PLR 8313099 (Dec. 29, 1982), where the IRS issued a favorable ruling with respect to the transfer of stock in a corporation owning an oil refinery where the stockholder was required to furnish crude oil to the refinery and market certain of the refinery's products. For unsuccessful attempts to invoke the *Kaiser Aluminum* exception, *see* PLR 8150082 (Sept. 17, 1981) and PLR 8429048 (Apr. 18, 1984).

[107] H.R. Rep. No. 98-432, at pages 1320-1321; S. Rep. No. 98-169, at page 365.

[108] *See* Rev. Rul. 80-247, 1980-2 C.B. 127; Rev. Rul. 81-82, 1981-1 C.B. 127; Rev. Rul. 81-89, 1981-1 C.B. 129; discussed at II, F, 6, *infra*.

[109] *See Container Corp. of America v. Franchise Tax Board*, 108 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm.*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dept.*, 458 U.S. 354 (1982); *Mobil Oil Corp. v. Comr. of Taxes*, 445 U.S. 425 (1980).

[110] H.R. Rep. No. 98-432, at pages 1320-21; S. Rep. No. 98-169, at page 365. Authority to enter into closing agremeents is contained in §7121.

[111] H.R. Rep. No. 98-432, at page 1321.

[112] 76 T.C. 325, at 337 and 349.

[113] PLR 8313099 (Dec. 29, 1982), supplementing PLR 8129072 (Apr. 23, 1981) *supra*, note 106.

[114] Between 1968 and 1977 the Service regularly entered into §367 closing agreements in connection with certain foreign-to-foreign reorganizations. *See* Rev. Proc. 75-29, 1975-1 C.B. 754 (first announced in T.I.R. No. 978 (May 24, 1968)); T.I.R. No. 1354 (March 26, 1975), as modified by Rev. Procs. 76-4, 1976-1 C.B. 543; 76-24, 1976-1 C.B. 563; and 77-4, 1977-1 C.B. 536. This practice was halted upon the issuance of the §367(b) regulations.

[115] For a full exposition of the Service's position, see PLR 7924028 (Mar. 14, 1974), *amending* PLR 7917119 (Jan. 19, 1974). *See also* PLR 8204134 (Oct. 29, 1981); PLR 8023029 (March 11, 1980), supp. by PLR 8052084 (Oct. 1, 1980); PLR 8334013 (May 18, 1983).

[116] For examples of closing agreements serving a comparable function in the §1491 context, *see* PLR 8226147 (Apr. 2, 1982) and PLR 8123129 (Mar. 16, 1981).

[117] H.R. Rep. No. 98-432, at page 1321; S. Rep. No. 98-169, at page 365.

[118] 1978-1 C.B. 201.

[119] The ruling also indicated that P's basis in the transferee stock could be increased by the amount of losses recaptured (§358(a)(1)(B)(ii)), and that the transferee could increase its basis in the transferred assets by the same amount (§362(a)).

[120] 76 T.C. 312 (1981), *gov't appeal dismissed*, No. 81-2096 (3d Cir., Sept. 16, 1981).

[121] 72 T.C. 896 (1979).

[122] *See, e.g.*, PLR 8252036 (Sept. 24, 1982); PLR 8427066 (Apr. 3, 1984).

[123] 457 U.S. 1103 (1983).

[124] 1974-2 C.B. 106.

[125] 583 F.2d 378 (6th Cir. 1978). *Cf. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) (requiring an actual recovery as a predicate to invocation of the tax benefit rule).

[126] April 3, 1984.

[127] *See, e.g.*, Rev. Rul. 73-472, 1973-2 C.B. 114.

[128] *Cf.* Rev. Rul. 80-198, 1980-2 C.B. 113, with *Long v. U.S.*, 652 F.2d 675 (6th Cir. 1981).

[129] 1972-2 C.B. 481.

[130] 1980-2 C.B. 125, discussed at II, G, 5, *infra*.

[131] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956.

[132] 1980-1 C.B. 78.

[133] *See, e.g.*, PLR 8001024 (Oct. 9, 1979).

[134] 1982-2 C.B. 84.

[135] *See, e.g.*, PLR 8251073 (Sept. 26, 1982).

[136] *See, e.g.*, PLR 8205079 (Nov. 9, 1981).

[137] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), at page 1324.

[138] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 956.

[139] *Id.*

[140] Another possible interpretation would be that priority was granted to §367(d) in order to ensure U.S. source treatment of the resulting toll charge. However, this result would require a special priority rule only if, in the normal case, §367(a)(3)(C) were to have general priority over the tainted asset (and §367(d)) toll charges, a premise that is inconsistent with existing rulings practice. Under that practice, as noted, tainted asset toll charges generally have been applied prior to application of Rev. Rul. 78-201 (as reduced by such toll charges).

[141] §367(a)(3)(C)(ii)(II).

[142] Under §904(f)(1), recapture is accomplished by requiring the taxpayer to treat as U.S. source income in a profitable year or years subsequent to the loss year the lesser of (1) the previously unrecaptured foreign loss, or (2) at least 50 percent of its foreign source taxable income for such year. The effect of this rule is to reduce the amount of foreign source income includible in the numerator of the §904(a) foreign tax credit limitation fraction, thus reducing the amount of foreign tax credits that may be claimed against the taxpayer's U.S. tax liability for such year.

[143] There is some uncertainty as to whether §904(f)(1) applies if the transferor's overall foreign loss arises in the same year in which the asset transfer occurs. Compare the language of §904(f)(1) ("for each succeeding taxable year") with that of §904(f)(3) ("the remaining amount of the overall foreign losses . . . for such taxable year or any prior taxable year").

[144] 1980-2 C.B. 125.

[145] S. Rep. No. 169, 98th Cong., 2d Sess. (1984) at page 369.

[146] *See, e.g.*, Rev. Rul. 75-107, 1975-1 C.B. 32; *American Pad & Textile Co.*, 16 T.C. 1304 (1951), *acq.*, 1951-2 C.B. 1. *Cf.* Rev. Rul. 75-109, 1975-1 C.B. 69, and TAM 7818009 (specific transaction method).

[147] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956.

[148] 1980-2 C.B. 127.

[149] 1981-1 C.B. 127.

[150] 1981-1 C.B. 129.

[151] 1980-2 C.B. 128.

[152] *See* Rev. Rul. 78-201, at II, G, 2, a, *supra*.

[153] The Service previously had characterized the Rev. Rul. 78-201 toll charge as FORI for §907(b)(1) purposes to the extent the deductions previously claimed had reduced FORI and as FOGEI to the extent the deductions had reduced FOGEI. *See* PLR 8216022 (Jan. 19, 1982); PLR 8252036 (Sept. 24, 1982); PLR 8323020 (March 4, 1983). However, in recognition of the fact that a Rev. Rul. 78-201 toll charge imposed on the incorporation of a foreign branch engaged in extraction operations ordinarily will be subject to §907(c)(4), the current rulings position appears to be that the toll charge will be treated as FOGEI without regard to whether the prior losses reduced FOGEI. §367(a)(3)(C) appears to adopt the current position, although this point should be clarified in the regulations.

[154] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956.

[155] *See* §904(b)(2); PLR 8221009 (Feb. 19, 1982).

[156] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956; Rev. Rul. 78-201, *supra*. The toll charge presumably will correspondingly increase the transferor's basis in the stock of the transferee pursuant to §358(a)(1)(B)(ii).

[157] Regs. §1.312-6(b); PLR 8017043 (Jan. 29, 1980).

[158] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), at page 1318.

[159] S. Rep. No. 169, 98th Cong., 2d Sess. (1984), at page 358.

[160] Such an exception, although representing a major departure from the Service's historic unwillingness to consider the implications of foreign taxes in determining the existence of a tax avoidance purpose, would derive some support from the *Gerli* decision (73 T.C. 1019 (1980), rev'd, 668 F.2d 691 (2d Cir. 1982)). *Cf.* §954(b)(4).

[161] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 955.

[162] §§367(d)(1)(A) and (B).

[163] §367(d)(2)(A)(i).

[164] §367(d)(2)(A)(ii)(I).

[165] §367(d)(2)(A)(ii)(II).

[166] §367(d)(2)(C).

[167] §367(d)(2)(B).

[168] *See* II, I, 6, *infra*.

[169] *See* Rev. Proc. 81-57, 1981-2 C.B. 674; Rev. Rul. 69-156, 1969-1 C.B. 101; Rev. Rul. 71-564, 1971-2 C.B. 179; Regs. §§1.1235-2(b)(1)-(3). Similar criteria have been applied to transfers of film and broadcast copyrights. Rev. Rul. 75-202, 1975-1 C.B. 170; Rev. Rul. 54-409, 1954-2 C.B. 174; PLR 8020001 (Tech. Adv. Dec. 18, 1979).

[170] 471 F.2d 1211 (Ct. Cl. 1973).

[171] *Id.* at 1219, n. 21.

[172] Rev. Rul. 64-56, 1964-1 C.B. (Part 1) 133. *See also* Rev. Proc. 69-19, 1969-2 C.B. 301. These criteria also have been applied to transfers of computer software. Rev. Proc. 74-36, 1974-2 C.B. 491.

[173] To the extent goodwill, corporate names and similar "marketing" intangibles are determined to be covered by §367(d), the developed criteria applicable to determining the "property" status of these items also would need to be clarified. *See* Rev. Rul. 79-288, 1979-2 C.B. 139, articulating the Service's current position as to when the transfer of a corporate name will constitute a property transfer for §367 purposes.

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[174] Contract rights have long been considered "property" subject to the §367 ruling requirement, but no consistent policy was developed concerning whether or not a toll charge should be imposed. Compare PLR 8129072 (Apr. 23, 1981); PLR 7938011 (June 19, 1979); PLR 8150082 (Sept. 17, 1982); and PLR 8326029 (Mar. 25, 1983) (toll charge imposed), with PLR 8043131 (Aug. 4, 1980), *supp. by* PLR 8104050 (Oct. 28, 1980); PLR 8140093 (July 13, 1981); PLR 8237012 (June 9, 1982); PLR 8326029 (Mar. 25, 1983); and PLR 8303085 (Oct. 21, 1982) (no toll charge imposed).

[175] 81 T.C. 520 (1983).

[176] No. 3767-82T (T.C. filed Feb. 19, 1982), judgement entered for taxpayer by stipulation.

[177] 727 F.2d 1043 (11th Cir. 1984), rev'g. 552 F. Supp. 311 (M.D. Ga. 1982).

[178] The *Shell* case was a declaratory judgment action in respect of an adverse determination, PLR 8109096 (Dec. 8, 1980); PLR 8208014 (Nov. 23, 1981).

[179] §367(a)(3)(B)(iv). See II, J, *infra.*

[180] Regs. §§1.482-2(d)(2)(ii) and (iii).

[181] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 955.

[182] By virtue of Sec. 63 of the 1984 Act, §368(a)(1)(C) now requires that the transferor corporation be liquidated pursuant to the reorganization. A "D" reorganization ordinarily requires liquidation of the transferor in order to satisfy the requirements of §354(b)(1)(B).

[183] S. Rep. No. 169, 98th Cong., 2d Sess. (1984), at page 368; H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 955.

[184] The character and source of the income, however, may be different under §367(d) (*i.e.*, U.S. source ordinary income).

[185] Consistent with GCM 39231 (Jan. 23, 1984), issued in connection with PLR 8420032 (Feb. 10, 1984), a foreign corporation's acquisition of a domestic target corporation pursuant to a forward triangular merger or triangular "C" reorganization presumably will be treated as an outbound transfer of stock, rather than assets, and will not be subject to §367(d) (notwithstanding the contrary indication contained in Regs. §1.367(a)-1(b)(i)(A)).

[186] §§861(a)(4) and 862(a)(4).

[187] Regs. §1.861-7.

[188] Guidelines, §§3.01(2) and 3.02(1)(c).

[189] §§358(a)(1)(B)(ii) and 362(a).

[190] §1012.

[191] The Service's position under §482, notwithstanding *First Security Bank of Utah,* 405 U.S. 394 (1981), generally has been that such local law restrictions will not preclude reallocation of income under §482 if less than the required arm's length royalty is included in income by the licensor. *See* Rev. Rul. 82-45, 1982-1 C.B. 89.

[192] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), at page 1320.

[193] S. Rep. No. 169, 98th Cong., 2d Sess. (1984), at page at 365.

[194] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 955.

[195] Guidelines, §3.02(1)(b)(iii). *See* PLR 8326017 (March 23, 1983) (customer lists and goodwill); PLR 8220053 (Feb. 17, 1982) (computer software).

[196] Guidelines, §3.02(1)(b)(iv). *See* PLR 8017059 (Jan. 30, 1980) (name and know-how); PLR 8035100 (June 9, 1980) (same). A de minimis exception has been permitted allowing limited use of foreign intangibles in connection with sales of U.S. manufactured goods to cover start-up and periodic inventory shortfall situations. PLR 8035086 (June 9, 1980), and PLR 8035100 (June 9, 1980), supp. by PLR 8128049 (Apr. 15, 1981). *See also* PLR 8309050 (Nov. 29, 1982).

[197] Guidelines, §§3.02(1)(b)(i) and (ii).

[198] Favorable rulings previously were granted on a routine basis with respect to outbound transfers of intangibles pursuant to the incorporation abroad of service businesses. *See, e.g.,* PLR 8146098 (Aug. 24, 1981); PLR 8208013 (Nov. 23, 1981); PLR 8249057 (Sept. 8, 1982) (insurance companies and banks); PLR 8301004 (Sept. 30, 1980) (computer services); PLR 8304016 (Oct. 20, 1982) (engineering); PLR 8122050 (Mar. 4, 1981) (living and galley services on offshore oil rigs); and PLR 7938011 (June 19, 1979) (advertising).

[199] But see S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. (1984), at page 368, which suggests §482 should be used in such situations rather than §367(d).

[200] Section 131(g)(2).

[201] Section 131(g)(2)(B). Prior to the 1984 Act, provided intangible assets were not to be used in connection with the manufacture or sale of goods in the United States, they could generally be transferred tax-free to a foreign corporation. Guidelines, §3.02(1)(b)(iii) and 3.02(1)(b)(iv).

[202] 130 Cong. Rec. 8410 (June 27, 1984) (Statement of Senator Chafee).

[203] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 957.

[204] The "reasonableness" of the Service's ruling on a request for a waiver of the interim rule could presumably be challenged in a Tax Court declaratory judgement preceeding under §7477.

[205] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 957.

[206] *See Gerli & Co., Inc. v. Comr.,* 73 T.C. 1019 (1980), *rev'd.,* 668 F.2d 691 (3d Cir. 1982).

[207] §§881 and 882. See PLR 8020003 (Jan. 21, 1980); GCM 39231 (Jan. 23, 1984).

[208] §§1245(b)(3), 1250(d)(3), and 47(b)(2). H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 952.

[209] *See, e.g.,* PLR 8149038 (Sept. 9, 1981).

[210] Guidelines, §3.02.

[211] *See also,* to the same effect, PLR 8149038 (Sept. 9, 1981); PLR 8050026 (Sept. 16, 1980); PLR 7907129 (Nov. 20, 1978); PLR 7835095 (June 6, 1978).

[212] May 18, 1983. *See* Terr, "IRS Attack on Domestic 'Branching' - PLR 8334013," 83-11 Tax Management International Journal 22 (Nov. 1983).

[213] *See* GCM 39231 (Jan. 23, 1984), which discusses this issue in a different context.

[214] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 955.

[215] Virtually every provision of §367 is prefaced with the phrase "except as provided in regulations."

[216] Section 311(d)(2)(A) exempts corporations from tax on "partial liquidations" and certain other distributions to non-corporate shareholders who own at least 10 percent of the value of the distributing corporation's stock. It would be preferable, of course, for the foreign shareholder to recognize gain on the distribution under §302 rather than dividend income under §301. Dividend distributions will be subject to U.S. withholding tax at the 30 percent statutory rate under §871(a) unless a tax treaty provides for a lower rate of tax, whereas capital gains should escape U.S. tax entirely. §871(a)(2). To the extent any U.S. withholding taxes on dividends could provide a useable credit against the shareholder's tax in his home country, however, even a 30 percent withholding tax might not necessarily make the §311 route less attractive than §367(e).

[217] Rev. Rul. 68-43, 1968-1 C.B. 146.

[218] §871(a)(2). §337(c)(3) limits the availability of a §337 sale followed by a §332 liquidation to situations where all members of the affiliated group (including for this purpose foreign corporations) that are in the same chain of ownership as the domestic corporation are also liquidated within 12 months. It may in some cases be desirable to preserve the benefits of §337 by intentionally breaking affiliation by failing the 80% stock ownership tests of §1504(a), causing §332 not to apply either to the liquidating domestic corporation or to an intervening foreign corporation. In this regard, see *Granite Trust Co. v. U.S.,* 238 F.2d 670 (1st Cir. 1956), and GCM 34820 (Mar. 24, 1972).

[219] Where the transferor "controls" a corporate transferee, so that §351 applies to the capital contribution, §367 applies rather than §1491. §§1492(1). Cf. §367(c), which treats a contribution of capital to a controlled corporation as an exchange, whether or not stock is received by the transferor.

[220] §1491.

[221] §1494(a).

[222] Regs. §1.1494-1(a).

[223] §1492(3), formerly §1492(4).

[224] §1492(2) and §1494(b).

[225] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. (1984), at page 369; H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984), at page 1324; H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 952.

[226] *Id.*

[227] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956.

[228] §367(a)(3).

[229] §367(d)(2)(A). Such a continuing toll charge would presumably not apply if an election were made under §1057 to recognize gain on the transfer.

[230] Such a special allocation might be viewed as the reverse side of the Service's practice prior to the 1984 Act of permitting the tax-free transfer of appreciated property to a foreign partnership provided the transferor entered into a closing agreement stating that, if the transferred property were sold, he would recognize 100 percent of the gain inherent in the property at the time of transfer (rather than an amount reflecting his interest in the partnership). PLR 8226147 (Apr. 2, 1982); PLR 8123129 (Mar. 16, 1981); PLR 8030133 (May 5, 1980) (transfer to foreign trust).

[231] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984), at page 956.

[232] *Id.*

[233] §367(a); S. Rep. No. 169 at page 369; H.R. Rep. No. 432 (Part 2), at page 1324.

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[234] Section 131(e). The repeal of §7477, like §131 of the 1984 Act generally, is effective for transfers or exchanges beginning after December 31, 1984, unless a ruling request with respect to the transfer or exchange was filed before March 1, 1984.

[235] S. Rep. No. 169 (Vol. 1), at page 364; H.R. Rep. No. 432 (Part 2), at page 1324.

[236] *Id.*

[237] *See* Rev. Proc. 84-1, Sec. 8.01, I.R.B. 1984-1, 10. For §367 rulings currently, the transferor generally represents that the transferee will be actively engaged in a trade or business, with final resolution of this issue left for audit.

[238] Rev. Proc. 84-12, I.R.B. 1984-9, 15.

[239] *See, e.g.*, PLR 8429071 (Apr. 18, 1984); PLR 8428040 (Apr. 9, 1984); PLR 8428014 (Mar. 30, 1984); PLR 8427074 (Apr. 3, 1984).

[240] *Id.*

[241] §6038B(a)(2).

[242] See IRS Form 926 and Regs. §1.1494-1(a).

[243] §6038B(b).

[244] §6603(c)(8).

[245] Section 131(g). As previously discussed, a special transitional rule is provided for transfers of "intangible property" occurring after June 6, 1984 and before January 1, 1985. In addition, as noted earlier, new §367(e), although effective with respect to §336 distributions occurring after December 31, 1984, is not self-executing but requires implementing regulations, which presumably will have only prospective effect.

[246] Section 131(g)(3).

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Chapter 66

MODIFICATIONS TO THE CHARACTER AND SOURCE OF INCOME RULES

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I. The Source of Transportation Income Rules Modified

A. Introduction

Section 124 of the Tax Reform Act of 1984 (P.L. 98-369) modifies the source rules for income derived in coastwise (*i.e.*, from one point in the United States to another point in the United States) transportation from the rental of vessels and aircraft and transportation services.

1. Current Source Rules for Rental Income

Income derived from the rental of property located within the United States,[1] or from the use of property within the United States, is United States source income.[2] On the other hand, income derived from the rental of property located outside the United States, or from the use of property outside the United States is foreign source income.[3] Thus, rental income derived from the lease of a vessel (*i.e.*, bareboat charter hire) is U.S. or foreign source income depending upon whether the vessel is located within or without the United States.

The rules governing the source of income derived in coastwise transportation from the rental of a vessel are illustrated in Rev. Rul. 75-483.[4] In Rev. Rul. 75-483, M, a domestic corporation, purchased a vessel and leased it to R, an unrelated ship operator, under a 20-year bareboat charter. The vessel was documented under the laws of the United States. R used the ship primarily in transporting property from Alaska to various points in the United States. The vessel frequently travelled outside the territorial waters of the United States while engaged in coastwise trade. The Service ruled that the location of rental property both within and without the United States is determined by its actual physical presence within and without the United States. When the vessel travelled from one port in the United States to another port in the United States and when it was used in international trade, the vessel travelled outside the United States territorial waters. Therefore, the vessel was located within the United States and without the United States at various times. Accordingly, charter hire paid by R to M was U.S. source income to the extent that the income was allocable to: (i) periods when the vessel was in a U.S. port between voyages, and (ii) periods during which the vessel was engaged in a voyage which began in a U.S. port and ended in a U.S. port provided the vessel did not travel outside the U.S. territorial waters. The charter hire was foreign source income to the extent allocable to period when the vessel travelled outside U.S. territorial waters.

2. Current Source Rules for Transportation Services Income

Income from services performed within the United States is U.S. source income.[5] On the other hand, income from services performed without the United States is foreign source income.[6] Income from transportation or other services performed partly within and partly without the United States is treated as income derived partly from sources within the United States and partly from sources without the United States.[7] Thus, the source of income derived from transportation services (*e.g.*, time or voyage charter hire, towing or barging services) depends upon the place where such services are carried on.

The issue in coastwise transportation services is whether such services are considered performed wholly within the United States or partly within and partly without the United States. In Technical Advice Memorandum 8229005, the taxpayer claimed that income derived from the performance of towing and barging services was foreign source income to the extent attributable to the travel time within Canadian waters and on the high seas. TAM 8229005 agreed:

> "With respect to transportation services between points in the United States and points without the United States, section 863(b) of the Code and section 1.863-4(b) of the regulations provide that income from such services is from sources partly within and partly without the United States. The determination of the source of income is based on th place where the transportation service is being carried on by the taxpayer. Implicit in section 1.863-4(b) is the fact that income earned in international waters or abroad is from sources without the United States. The theory behind section 1.863-4(b) is applicable to this case even though the transportation service is being carried on from points in the United States to points in the United States. Thus, transportation services performed outside the United States territorial limits should be sourced without the United States."

3. Reasons for Change

Under Rev. Rul. 75-483 and TAM 8229005, the rental as well as services income from coastwise transportation activities is predominantly foreign source income if the transport route lies primarily beyond the U.S. territorial limits. For example, U.S. persons engaged in the business of transporting crude oil from Alaska to West Coast points or, by way of the Panamanian pipeline to East Coast points, can treat income derived from such activities as foreign source income to the extent allocable to periods when the transporting vessel was outside the U.S. territorial limit. Congress considered this to be an undesirable result. The House Ways and Means Committee Report observes:

> "The committee believes that all transportation income attributable to transportation which begins and ends in the United States (or any of its possessions)

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should be U.S. source income. That is, the committee believes that the United States should retain the primary right to tax this income. Under the present sourcing rules, carriers operating between points in the United States can obtain predominantly foreign sourcing for transportation income earned from their U.S. routes by routing their vessels or aircraft outside the three-mile limit. The transaction rarely has any connection with any country other than the United States.

"Treating transportation income attributable to transportation beginning and ending in the United States as foreign source income increases the foreign tax credit limitation of the carrier and affiliates. If the carrier or affiliates have excess foreign tax credits as a result of unrelated foreign operations, this increase in the foreign tax credit limitation effectively enables the carrier to use the excess credits to offset all or part of any U.S. tax that should be imposed on the transportation income. Thus, the carrier or its affiliates may pay little or no U.S. tax on the transportation income. The committee does not believe that such income should escape U.S. tax." [8]

B. Overview

Section 124 of the Tax Reform Act of 1984 (P.L. 98-369) adds subsection (c) to §863, which provides new source rules for income derived from coastwise transportation.

Under §863(c), all transportation income attributable to transportation which begins in the United States and ends in the United States shall be treated as United States source income. Similarly, income derived from the lease of an aircraft to an unrelated regularly scheduled air carrier shall be treated as United States source income if the aircraft is operated between the United States and a possession of the United States. Transportation income attributable to transportation which begins in the United States and ends in a possession of the United States, or vice versa, shall be apportioned between the United States and the possession on a 50-50 basis.

Transportation income includes any income derived from or in connection with the use (or hiring or leasing for use) of a vessel or aircraft, or the performance of services directly related to the use of such vessel or aircraft.

Section 863(c) is effective for transportation beginning after July 18, 1984, in taxable years ending after that date.

C. Detailed Analysis

1. General Rule

Section 863(c)(1) provides that all transportation income attributable to transportation which begins and ends in the United States shall be treated as United States source income.

This general rule does not apply to transportation income attributable to transportation between the United States and a possession of the United States. Section 863(c)(2) provides an allocation formula for income derived from such transportation.

2. Transportation Income

The term "transportation income" encompasses two separate categories of income. First, it includes any income derived from or in connection with the use, (or hiring or leasing for use) of a vessel or aircraft.[9] Thus, rental income from the bareboat charter hire of a vessel is transportation income. Also included in this category of transportation income are rentals from the leasing of containers used in connection with a vessel or an aircraft.[10]

Second, it includes any income derived from, or in connection with, the performance of services directly related to the use of a vessel or an aircraft.[11] This category includes income from a time or voyage charter hire of a vessel or an aircraft, and income from the transportation of cargo as well as persons.[12] It is important to note that the term "transportation income" includes income derived from transportation services only to the extent such services are directly related to the use of a vessel or an aircraft. The statute does not define what transportation services are considered directly related to the use of a vessel or an aircraft. The Conference Committee Report, however, does contain a few examples of transportation services which are not considered directly related to the use of a vessel or an aircraft:

"The new source rule also does not apply to income for services performed in a foreign country that are connected indirectly with transportation beginning and ending in the United States. For example, income from the operation of the Panamanian pipeline (through which oil extracted in Alaska and bound for East Coast points may pass) will not be treated as U.S. source income under the new sourcing rule. Income from the operation of foreign storage facilities used to store cargo transported between U.S. points will not be subject to new source rule. Income from services, such as refueling, performed outside the United States in connection with a trip beginning and ending in the United States also will not be treated as U.S. source income under the new provision." [13]

3. Transportation Beginning and Ending in the United States

Transportation is considered to begin and end in the United States when it begins in one of the 50 States or the District of Columbia and ends in one of the 50 States or the District of Columbia.

The House Ways and Means Committee Report and the Conference Committee Report clarify the circumstances under which the transportation of cargo and persons is considered to begin and end in the United States when the transporting vessel or aircraft makes an intermediate stop.

a. Transportation of Cargo to an Intermediate U.S. Point

Transportation of cargo will not be considered to begin and end in the United States when it involves transportation from one U.S. point to another intermediate U.S. point for purposes of refueling, maintenance, loading or unloading of other cargo, or for other business reason (*e.g.*, repackaging or recontainerization) provided the cargo is bound for ultimate delivery to a point in a foreign country.[14] Transportation of cargo in this situation, will not be considered to begin and end in the United States even where the cargo is transported on a different vessel or aircraft from the intermediate U.S. point to its ultimate destination in a

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foreign country provided: (i) the vessel or the aircraft belongs to the same taxpayer; and (ii) the cargo does not pass through U.S. customs at the intermediate U.S. point.[15] However, transportation of cargo will be considered to begin and end in the United States if (after stopping at the intermediate U.S. point prior to the cargo's ultimate delivery to a point in a foreign country): (i) a different taxpayer transports the cargo on the second leg of the trip; or (ii) the cargo passes through U.S. customs at the intermediate U.S. point.

Example 1: Pan Am airlines takes on certain cargo at Washington, D.C. for transportation to Tel Aviv. The plane carrying the cargo lands at New York where the cargo is transferred to another aircraft belonging to El Al Israel Airlines, which carries the cargo to Tel Aviv. Transportation of cargo from Washington, D.C. to New York by Pan Am is considered to begin and end in the United States because the cargo is transported from the intermediate point (*i.e.*, New York) to the foreign destination in a different aircraft belonging to a different taxpayer. Pan Am's income attributable to the transportation of this cargo will, therefore, be U.S. source income.[16]

Example 2: British Airways takes on certain cargo in Houston for transportation to London. The cargo is carried in a plane owned by British Airways from Houston to New York. At New York the cargo is transferred to another plane belonging to British Airways, which carries the cargo to London. The cargo does not pass through customs at New York. Transportation of cargo from Houston to New York is not considered transportation of cargo that begins and ends in the United States.

The same rules apply when cargo is loaded at a point in a foreign country for transportation to a point in the United States and the vessel or aircraft makes a stop at an intermediate point in the United States. Thus, if the intermediate stop is made for purposes of refueling, maintenance, loading or unloading of other cargo, or for another business reason (*e.g.*, repackaging or recontainerization), the transportation of the cargo will not be considered to begin and end in the United States. However, if the cargo is reloaded in another vessel or aircraft belonging to another taxpayer or if the cargo goes through customs at the intermediate U.S. point, the transportation of such cargo from the intermediate point to the final destination will be considered as transportation of cargo which begins and ends in the United States.[17]

b. Transportation of Persons to an Intermediate U.S. Point

Transportation of persons will not be considered to begin and end in the United States when, en route to a destination elsewhere in the United States, a stop is made at a U.S. intermediate point for refueling, maintenance, or other business reasons, if the persons begin the trip in a foreign country and do not change aircraft or vessels at the U.S. intermediate point. Similarly, transportation of persons will not be considered to begin and end in the United States when it involves transportation from one U.S. point to an intermediate U.S. point like that just noted en route to the persons' destination in a foreign country provided the persons do not change aircraft or vessels at the intermediate U.S. point.[18]

Round-trip travel from the United States to a foreign country (whether by air or a cruise ship whch calls only on foreign ports) is not transportation which begins and ends in the United States.[19]

4. Transportation Involving the Possessions of the United States

Income from transportation which begins in the United States and ends in a possession of the United States is 50-percent U.S. source income and 50-percent foreign source income.[20] Also, from the standpoint of the possession's tax laws which mirrors the Internal Revenue Code (*e.g.*, Guam), such income will be 50-percent possession source income and 50-percent foreign source income.[21] Similarly, income from transportation which begins in a possession of the United States and ends in the United States is 50-percent U.S. source income.[22]

The general rule pertaining to transportation income attributable to transportation which begins in a possession and ends in the United States (or vice versa), as described above, has one exception.[23] Section 863(c)(2)(B) provides that transportation income attributable to transportation between the United States and its possessions is 100 percent U.S. source income if the following conditions are met:

(i) The income is derived from the lease of an aircraft;

(ii) The lessor owns the aircraft;

(iii) The aircraft is §38 property;

(iv) The aircraft is leased to a regularly scheduled air carrier which qualifies as a U.S. person; and

(v) The lessee and the lessor are not members of the same controlled group (as defined in §1563).[24]

Finally, transportation income attributable to transportation between two possessions or between two points within a possession is wholly foreign source income.[25]

5. Effective Date

The source rules of §863(c) apply with respect to transportation beginning after July 18, 1984, in taxable years ending after that date.[26]

II. Certain Foreign Source Income Recharacterized as U.S. Source Income for §904 Purposes

A. Introduction

As discussed under III, A, *infra*, under §904, the amount of direct or indirect foreign tax credit available to a U.S. taxpayer against its U.S. tax liability is limited by a fraction; the numerator is the taxpayer's aggregate foreign source taxable income for the year and the denominator is the taxpayer's worldwide taxable income for the year. The greater the numerator of the fraction (*i.e.*, the foreign source taxable income) the greater the foreign tax credit limitation. A taxpayer with excess foreign tax credits may, therefore, absorb the excess credits by generating additional foreign source income. It should be noted, however, that the additional foreign source income must bear foreign taxes at an effective tax rate which is lower than the top U.S. tax rate (assuming the taxpayer is in the top tax

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bracket). If the additional foreign source income bears foreign taxes at or near the maximum U.S. tax rate, the additional foreign tax credit limitation generated by the additional foreign taxes will be absorbed by the additional foreign taxes and the taxpayer will not derive any benefit with respect to its excess foreign tax credits.

Over the years, U.S. taxpayers with excess foreign tax credits have devised a number of techniques for absorbing the excess credits. One popular technique is the conversion of U.S. source income into low-taxed foreign source dividend income by utilizing a foreign tax haven corporation.

The dividend source of income rules are contained in Code §§861 and 862. As a general rule, the source of dividend income is governed by the payor's place of incorporation. Thus, dividends paid by a corporation incorporated in the United States (excluding the possessions) is U.S. source income,[27] and dividends paid by a corporation incorporated outside the 50 states and the District of Columbia are foreign source income.[28] These are, however, a number of exceptions to this general rule. For example, dividends paid by a domestic corporation are foreign source income if less than 20 percent of such corporation's gross income over a 3-year base period is derived from U.S. sources.[29] Similarly, a portion (or all) of the dividends paid by a foreign corporation may be U.S. source income if 50 percent or more of such corporation's gross income over a 3-year base period is effectively connected with the conduct of a U.S. trade or business.[30] Thus, under the normal Code rules, the source of the dividend distributing corporation's income is relevant to determine the source of dividend income in the hands of the recipient. However, when a U.S. corporation is deemed to have received a Subpart F distribution that carries with it foreign taxes under the rules of §960, no such tracing is utilized. Under Regs. §1.960-1(h)(1), the Subpart F income is deemed to be derived from sources within the country of incorporation of the controlled foreign corporation.

Utilizing the Subpart F rules, U.S. taxpayers have been able to absorb their excess foreign tax credits by converting U.S. source income into low-taxed foreign source income. These source converting techniques are utilized particularly in two types of transactions: Netherlands Antilles finance subsidiaries and captive foreign insurance companies.

In the case of the Netherlands Antilles finance subsidiary, U.S. corporations may raise funds in the Eurodollar Market by forming a wholly-owned Netherlands Antilles subsidiary, contributing equity capital to the N.A. company, and using such company to borrow money from foreign lenders. The N.A. company, in turn, lends the borrowed funds (and in some cases the equity capital) back to the U.S. affiliates at an interest rate higher than the rate charged by the foreign lenders. Assuming that the back-to-back loan obligations are considered bona fide debt obligations, the interest paid by the U.S. parent (or its affiliates) is considered to be exempt from the 30 percent U.S. withholding tax under Article VIII of the Income Tax Convention between the United States and the Netherlands Antilles. Further, since the finance subsidiary is not considered as engaged in a U.S. trade or business, interest paid by it to foreign lenders is not subject to the second-tier U.S. withholding tax. The difference (or "spread") between U.S. source income received by the N.A. corporation and the interest expense paid to foreign lenders, however, is subject to tax in the Netherlands Antilles at the full 30 percent rate because the N.A. corporation may not elect to be taxed at the lower 2.4% - 3% rate in order to obtain the benefit under Article VIII.

Since the "spread" (which is essentially the net U.S. source interest income of the N.A. company) is Subpart F income currently taxable to the U.S. parent, it carries with it the Netherlands Antilles tax as a potential credit against the U.S. parent's U.S. tax liability. The U.S. parent's U.S. tax liability on the Subpart F income, on the other hand, is not particularly significant because it is also entitled to a deduction for the corresponding interest expense which far exceeds the Subpart F income. However, the Subpart F income increases the U.S. parent's §904 limitation (because of the rule under Regs. §1.960-1(h)(1) which treats Subpart F income as foreign source income) and enables it to absorb excess foreign tax credits. Thus, by utilizing a single-purpose financing subsidiary in the Netherlands Antilles, a U.S. corporate borrower is simultaneously able to avoid the 30 percent U.S. withholding tax on interest paid to foreign lenders, obtain a U.S. foreign tax credit for the taxes paid to the Antilles, and absorb its excess foreign tax credits.

In the case of captive insurance companies, a U.S. company creates a foreign subsidiary in a low or zero-tax foreign jurisdiction (*e.g.*, Cayman Islands, Bermuda, or Bahamas). The foreign subsidiary insures the casualty risks of its U.S. parent and/or its U.S. affiliates. Assuming the validity of the arrangement,[31] the U.S. parent and the affiliates are entitled to a deduction under §162 for the insurance premiums paid to the captive insurance company. The foreign captive insurance company's net premium income (which is U.S. source income) and investment income (which may be either U.S. or foreign source income), on the other hand, is includible in the gross income of its U.S. shareholders as Subpart F income under §953. However, under Regs. §1.960-1(h)(1), the Subpart F income is treated as dividend income derived from foreign sources. This low-taxed Subpart F income enables the captive's U.S. parent to absorb excess foreign tax credits.

Similarly, U.S. taxpayers may set up a personal holding company in a foreign tax treaty jurisdiction which has a favorable tax regime for holding companies. The foreign personal holding company may invest in U.S. stocks and securities and earn U.S. source dividend, interest, or capital gain income at reduced withholding rates under the treaty. The undistributed foreign personal holding company income is included in the gross income of the U.S. shareholders as a dividend under §551(b). Since the dividend income is considered foreign source and bears foreign tax at a low rate, it enables the U.S. shareholders to absorb the excess foreign tax credits.

It is apparent that in each of the above cases, U.S. source income is converted into foreign source income by simply passing it through a foreign tax haven company. The House Ways and Means Committee Report, in disapproving of these source converting techniques, observes:[32]

> "The committee continues to believe that U.S. taxpayers should not pay both full U.S. tax and foreign tax on foreign income. Such double taxation could effectively prohibit U.S. taxpayers from conducting foreign

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operations. The committee continues to believe that the foreign tax credit, which can offset U.S. tax on foreign income, is the appropriate mechanism to prevent double taxation.

"The United States, however, should receive full U.S. tax (unreduced by foreign tax credits) on income of U.S. persons that arises within the United States. The committee intends to proscribe devices that artificially convert U.S. income to foreign income, or other devices that create artificial foreign income. Such devices circumvent the foreign tax credit limitation and erode the U.S. tax base. They could have the result of making U.S. taxpayers indifferent to high foreign taxes on income that is truly foreign. Such devices for conversion of U.S. income to foreign income pass the cost of high foreign taxes from the U.S. taxpayer to the U.S. Government."

Accordingly, Congress added §121 to the Tax Reform Act of 1984, which prescribes U.S. source treatment for certain amounts (but only for purposes of §904) regardless of the fact that such amounts would be treated as foreign source income under the Code's source of income rules.

B. Overview

Section 121 of the Tax Reform Act of 1984 (P.L. 98-369) redesignates subsections (g) and (h) of §904 as subsections (h) and (i), respectively, and adds a new subsection (g).

New §904(g) recharacterizes the Subpart F income, the undistributed foreign personal holding company income, the foreign source dividend income, and the foreign source interest income derived from a U.S.-owned foreign corporation as U.S. source income to the extent such inclusions in the income of U.S. shareholders are attributable or allocable to U.S. source income of the foreign corporation. The recharacterization rule applies for purposes of §904 only.

A U.S.-owned foreign corporation is defined as any foreign corporation 50 percent or more of whose total combined voting power or the total value of all classes of stock is owned by U.S. persons.

In the case of dividends or interest income derived from a U.S.-owned foreign corporation, §904(g)(5) provides a de minimus exception. According to this exception, foreign source dividends or interest derived from a U.S.-owned foreign corporation are not recharacterized as U.S. source income if: (i) the foreign corporation has earnings and profits for the relevant taxable year, and (ii) less than 10 percent of such earnings and profits is attributable to U.S. sources.

C. Detailed Analysis

1. General Rule

Under the general rule of §904(g), the Subpart F and the foreign personal holding company inclusions with respect to a U.S.-owned foreign corporation as well as certain foreign source dividend and interest income derived from a U.S.-owned foreign corporation are recharacterized as U.S. source income to the extent such inclusions or such payments are attributable or allocable to U.S. source income of the U.S.-owned foreign corporation.

It should be noted, however, that the recharacterization rule applies only for purposes of computing the §904 limitation of the U.S. taxpayer and, for all other purposes of the Code, the income retains its foreign source character. Also, the recharacterization rule applies only to that dividend and interest income which is foreign source income to the recipient under the normal Code rules.

Example: A, a calendar-year basis U.S.-owned foreign corporation, is engaged in a U.S. trade or business. Sixty percent of A's total gross income over a 3-year period ending with the close of calendar year 1984 is effectively connected with a U.S. trade or business. On March 15, 1985, A pays $1,000 of interest to B, a U.S. corporation owning 15 percent of voting stock in A. Since, under §861(a)(1)(C), $600 of the $1,000 interest paid to B is treated as U.S. source income, only $400 of interest paid to B is subject to recharacterization as U.S. source income under §904(g).

Finally, the recharacterization rule of §904(g) applies on a year-to-year basis.

2. U.S.-Owned Foreign Corporation Defined

Section 904(g) recharacterizes certain amounts as U.S. source income only if such amounts are received from a U.S.-owned foreign corporation.

The term "U.S.-owned foreign corporation" is defined in §904(g)(6) to mean any foreign corporation in which 50 percent or more of the total combined voting power of all classes of stock or 50 percent or more of the total value of all classes of stock is held, directly or indirectly (under the constructive ownership rules of §§958(a)(2), 958(a)(3) and 318(a)(4)), by any combination of the following persons:

(i) A citizen or resident of the United States;

(ii) A domestic partnership;

(iii) A domestic corporation;

(iv) Any estate or trust (other than a foreign estate or trust, within the meaning of §7701 (a)(31)).

3. Categories of Income Subject to Recharacterization as U.S. Source Income

Only four categories of income are subject to recharacterization as U.S. source income.[33]

(i) Subpart F income with respect to a U.S.-owned foreign corporation;

(ii) Undistributed foreign personal holding company income of a U.S.-owned foreign corporation;

(iii) Interest payments made by a U.S.-owned foreign corporation; and

(iv) Dividend payments (including gain treated as dividend income under §§1246 and 1248) made by a U.S.-owned foreign corporation.

a. Subpart F and Foreign Personal Holding Company Inclusions

Section 904(g)(2) provides that the Subpart F income and the foreign personal holding company income included in the gross income of a U.S. person with respect to a U.S.-owned foreign corporation is recharacterized as U.S. source income but only to the extent the inclusions in the

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gross income of a U.S. person are attributable to the foreign corporation's U.S. source income.

This rule may be illustrated by means of an example.

Example: A foreign corporation wholly-owned by a U.S. corporation earns $100 of net income and pays a $20 dividend. Ninety dollars of the net income is attributable to the insurance of U.S. risks and $10 is attributable to the insurance of foreign risks of related parties located in other foreign countries. All of the income is Subpart F income to the U.S. parent corporation (under §953, and §954(e) as amended by the TRA 1984). Since $90 of this $100 Subpart F inclusion is attributable to U.S. source income of the foreign corporation (the $90 of net income attributable to the insurance of U.S. risks), $90 of the inclusion will be treated as U.S. source income of the parent corporation under §904(g)(2).

As a result of the $100 Subpart F inclusion, the $20 dividend is considered to be paid from previously taxed earnings and profits and is excluded from the parent corporation's gross income under §959. Section 904(g)(2), therefore, has no application to the tax-free $20 dividend.[34]

b. Interest Income Received from a Foreign Corporation

Under the general rule of §862(a)(1), interest received from a foreign corporation is foreign source income. However, such interest will be recharacterized as U.S. source income for purposes of §904 provided the following conditions are met:[35]

(i) The interest is paid or accrued by a U.S.-owned foreign corporation;

(ii) The interest is paid or accrued to a U.S. shareholder (within the meaning of §951(b)) of the U.S.-owned foreign corporation, or to any person related to a U.S. shareholder within the meanings of §267(b); and

Note: Section 904(g)(9)(B) authorizes the Secretary to promulgate regulations providing that interest paid or accrued to any person, whether or not a U.S. shareholder, will be subject to the recharacterization rule of §904(g). Such regulations may be necessary in the case of some U.S.-owned foreign corporations where only some of whose stockholders are U.S. shareholders.

(iii) The interest is properly allocable, under Regs. §1.861-8, to U.S. source income of the foreign corporation for the taxable year.

c. Dividends Received from a Foreign Corporation

Under the general rule of §862(a)(2), dividends paid by a foreign corporation are foreign source income. However, a portion of such dividends is recharacterized as U.S. source income if paid by a U.S.-owned foreign corporation. The portion of the recharacterized dividend payment is equal to the U.S. source ratio of the entire payment.[36]

The "United States source ratio" of a dividend payment equals the earnings and profits of the U.S.-owned foreign corporation derived from U.S. sources for the taxable year out of whose earnings and profits the dividend was paid or accrued, divided by the total earnings and profits of that taxable year.[37] Thus, if a dividend is paid out of the earnings and profits of a prior year, the source of earnings and profits in such prior year will control the recharacterization.

For purposes of the dividend recharacterization rule, the term "dividend" includes any gain derived from the sale or exchange of stock in a U.S.-owned foreign corporation that is treated as ordinary income under §1246 or as a dividend under §1248.[38]

The Conference Report provides the following example to illustrate the recharacterization of foreign source interest and dividend income:[39]

Example: A foreign corporation wholly owned by a U.S. corporation earns $85 of gross income, consisting of $60 of gross income from manufacturing operations in its country of incorporation, $10 of gross U.S. bank interest, and $15 of gross interest on a loan to a U.S. affiliate. The foreign corporation incurs total expenses of $115, consisting of $85 of manufacturing expenses and $30 of interest payments to its U.S. parent. The foreign corporation, thus, has a net loss of $30 for the taxable year. Assuming, for simplicity, that earnings and profits equal net income, the foreign corporation also has a deficit in earnings and profits of $30 for the taxable year. The foreign corporation pays a $20 dividend out of earnings and profits for an earlier taxable year. One hundred percent of the earlier year's earnings and profits were from foreign sources and no interest was paid to U.S. affiliates in the earlier year. The foreign corporation owns assets with a total fair market value of $500, consisting of assets used in its manufacturing operations worth $300, a $100 U.S. bank deposit, and a $100 loan to a U.S. affiliate.

To determine whether the 10-percent exception applies to the $30 of interest paid to the U.S. parent, the foreign corporation's earnings and profits for the current year must first be recomputed without any reduction for this interest paid to a U.S. shareholder. Earnings and profits recomputed in this manner equal zero ($-30 + $30). The 10-percent exception, therefore, does not apply since a requirement of the exception — that the foreign corporation have earnings and profits for the year — is not satisfied.

To determine how much of the $30 of interest payments will be treated as U.S. source income of the U.S. parent under the provision, the payments must be allocated to gross income of the foreign corporation from U.S. and foreign sources respectively. The U.S. parent corporation uses the asset method (Regs. §1.861-8(e)2)(v)) to allocate interest under the provision. Thus, it allocates $18 of the interest paid ($30 X ($300/$500)) against the foreign corporation's $60 of gross manufacturing income, $6 ($30 X ($100/$500)) against the foreign corporation's $10 of gross U.S. bank interest, and $6 ($30 X $100/$500)) against the foreign corporation's $15 of gross interest on its U.S. affiliate loan. Since all of the manufacturing income is from foreign sources and of all the interest income from U.S. sources, a total of $12 ($6 + $6) of the interest paid is properly allocable under the provision to U.S. source income of the foreign corporation. Therefore, $12 of the $30 of interest paid by the foreign corporation to its U.S. parent will be treated as U.S. source income of the U.S. parent under the provision.

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Because the foreign corporation has no earnings and profits for the current year, the U.S. parent corporation has no Subpart F inclusion with respect to any separately computed net U.S. interest income earned by the foreign corporation. Any such income would otherwise be Subpart F income and, because wholly attributable to U.S. source income of the foreign corporation in this case, would be treated as U.S. source income of the parent under the provision.

Because the $20 dividend paid to the U.S. parent corporation is paid out of earnings and profits for a year for which all earnings and profits were from foreign sources, no portion of the dividend will be treated as U.S. source income of the U.S. parent under the provision.

4. De Minimis Exception

Section 904(g)(5) provides a de minimis exception for interest and dividends received from a U.S.-owned foreign corporation. Under this exception, interest and/or dividends paid or accrued by a U.S.-owned foreign corporation are not recharacterized if:

(i) The U.S.-owned foreign corporation has earnings and profits for the taxable year; and

(ii) Less than 10 percent of such earnings and profits is attributable to U.S. sources.

For purposes of the de minimis exception, the earnings and profits of a U.S.-owned foreign corporation are not reduced by any interest paid by such corporation to: (i) a U.S. person who qualifies as a U.S. shareholder within the meanings of §951(b); or (ii) any person who is related to a U.S. shareholder within the meanings of §267(b).[40]

Note: The de minimis exception does not apply to the recharacterization of the Subpart F and the Foreign Personal Holding Company inclusions.

The Conference Report contains the following example illustrating the application of the de minimus exception:[41]

> *Example:* A foreign corporation, 90 percent of the total combined voting power in which is held by a U.S. corporation, earns net income of $95 from the sale of personal property in a second foreign country. The foreign corporation also earns net dividend income (after allocation of expenses) of $5 from a U.S. money market account. All of the foreign corporation's $100 of net income is foreign base company income.
>
> Among the foreign corporation's expenses (deductions from net income) is a $20 interest payment to its U.S. parent. The foreign corporation's $95 of net sales income is from foreign sources. Its $5 of net dividend income is from U.S. sources. Assume, for purposes of this example only, that earnings and profits equal net income and that $19 of the $20 interest payment was allocated to gross foreign sales income and the remaining $1 to gross U.S. dividend income in computing the respective amounts of net income from foreign and U.S. sources.
>
> Under Subpart F, the U.S. parent corporation must include its pro rata share of the foreign corporation's $100 of foreign base company income in its gross income for the taxable year. Assume, because the U.S. parent controls 90 percent of the voting power in the foreign corporation, that its pro rata Subpart F inclusion is $90.
>
> To determine whether the 10-percent exception from resourcing may apply (*i.e.*, whether less than 10 percent of the foreign corporation's earnings and profits for the year are attributable to U.S. sources), the foreign corporation's earnings and profits are first recomputed without any reduction for the $20 interest payment to its U.S. parent. Earnings and profits recomputed in this manner equal $120. Of this amount, $6, or five percent, is attributable to U.S. sources (the $5 of net U.S. dividend income plus the $1 of the $20 interest payment previously allocated to gross U.S. dividend income in computing the amount of net income from U.S. sources).
>
> While less than 10 percent of the foreign corporation's recomputed earnings and profits for the year are, thus, attributable to U.S. sources, the 10-percent exception does not apply to Subpart F income. The portion of the U.S. corporation's $90 Subpart F inclusion attributable to U.S. source income of the foreign corporation is 5/100ths of $90, or $4.50. Therefore, $4.50 of the Subpart F inclusion will be treated as U.S. source income of the U.S. parent under the provision.
>
> The 10-percent exception does, however, apply to interest payments. Because less than 10 percent of the foreign corporation's recomputed earnings and profits are attributable to U.S. sources, the $20 interest payment made by the foreign corporation to its U.S. parent is not subject to resourcing under the provision.

5. Coordination with Section 904(f)

In case a U.S. taxpayer has an overall loss from foreign sources in a particular taxable year which is used to reduce or eliminate U.S. tax liability attributable to U.S. source income, §904(f) provides two separate rules for the recharacterization of foreign source income earned by such taxpayer in a subsequent taxable year(s) as U.S. source income:

(i) The lesser of either the amount of such prior year's loss (to the extent not recaptured in earlier years) or 50 percent of foreign source income derived in the subsequent taxable year is recharacterized as U.S. source income for which a foreign tax credit is, therefore, not available; and

(ii) If, prior to a full recapture of the overall foreign source loss, the taxpayer disposes of trade or business property which is used predominantly outside the United States, then the lesser of the amount of the unrecaptured loss or 100 percent of the gain realized on the disposition is treated as U.S. source income currently taxable to the U.S. taxpayer.

In certain cases, therefore, a U.S. taxpayer's foreign source income may be subject to recharacterization as U.S. source income under both §§904(f) and 904(g). To resolve this overlap, §904(g)(8) provides a coordinating rule: the foreign source income of a U.S. taxpayer will be recharacterized as U.S. source income first under §904(g) and then under §904(f).

6. Payments Through Intermediate Entities

Some taxpayers may attempt to circumvent the recharacterization rule of §904(g) by making interest or dividend payments through one or more entities. For example, a

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U.S.-owned foreign corporation earning U.S. source gross income might reduce the amount of income subject to recharacterization by making interest payments to a related foreign entity. In order to prevent this, §904(g)(9) authorizes the Secretary to promulgate regulations providing rules for tracing interest or dividend payments made through one or more entities. Thus, where income subject to recharacterization is reduced through payments of interest or dividend to related foreign parties, the inclusions in income of the U.S. persons on account of the related foreign parties will be subject to recharacterization. Types of inclusions in the income of U.S. persons which will trigger recharacterization include: (i) inclusions under the Subpart F rules, (ii) interest, (iii) dividends, and (iv) inclusions under §956.[42]

Example: A foreign corporation wholly owned by a U.S. corporation ("CFC-1") earns $100 of gross U.S. source dividends (that is foreign personal holding company income subject to Subpart F) but reduces its current year earnings and profits to zero by a $100 interest payment to another foreign corporation wholly owned by the same U.S. corporation ("CFC-2"). Because of the interest payment, there is no Subpart F inclusion by the U.S. parent corporation on account of CFC-1 and no dividend payable for the year by CFC-1. Thus, the U.S. parent has no current income with respect to CFC-1 that could be subjected to resourcing. Absent the special rule under discussion, the $100 of U.S. source dividends received by CFC-1 would not give rise to any resourcing of income from CFC-1 or CFC-2 that is included in the U.S. parent's gross income. To prevent this result, the regulations to be prescribed by the Secretary will, for example, subject to resourcing a Subpart F inclusion on account of CFC-2 determined with respect to its current year earnings and profits regardless of whether the 10-percent exception from resourcing would otherwise apply. The regulations will treat as U.S. source income CFC-1's $100 interest payment to CFC-2. The U.S. parent's Subpart F inclusion on account of CFC-2 consequently will be resourced to the extent of the $100 interest payment (and any other U.S. source Subpart F income of CFC-2).

7. Effective Date and Transitional Rules

a. General

Generally, §904(g) takes effect on July 18, 1984. But, for purposes of recharacterizing the income of a U.S.-owned foreign corporation for a taxable year which begins prior to July 18, 1984, and includes July 18, 1984, only such income earned by the foreign corporation after July 18, 1984 will be taken into account.[43] However, for purposes of applying the de minimus exception discussed under II, C, 4, *supra*, the earnings and profits for the entire taxable year will be taken into account.[44]

b. Transitional Rules

Section 121(b)(2) of the Tax Reform Act of 1984 provides two transitional rules which are discussed below.

(1) Exemption for Interest Paid to International Finance Subsidiaries

The first transitional rule exempts from recharacterization under §904(g) certain interest payments made to international finance subsidiaries.

Section 121(b)(2)(A) of P.L. 98-369 provides that "qualified interest" shall not be taken into account under §904(g) and, hence, will escape recharacterization as U.S. source income if received or accrued by an applicable CFC [45] before January 1, 1992.

Caveat: For purposes of applying the de minimus exception discussed under II, C, 4, *supra*, qualified interest received from an applicable CFC will be taken into account.[46]

Qualified interest [47] is defined to include interest received or accrued by an applicable CFC during any taxable year on United States affiliate obligations [48] held by an applicable CFC multiplied by a limiting fraction. The limiting fraction is equal to the aggregate principal amount of U.S. affiliate obligations held by the CFC on March 31, 1984 (but not in excess of the applicable limit, *i.e.*, the CFC's capitalization on March 31, 1984) [49] divided by the average daily principal amount of U.S. affiliate obligations held by the applicable CFC during the taxable year. In no event may the limiting fraction exceed one.

Note: Section 121(b)(2)(H) of P.L. 98-369 provides that, with respect to obligations with original issue discount (OID), the principal amount of OID-type CFC and U.S. affiliate obligations include as of any day the aggregate amount of all OID on such obligations previously includible in gross income as of that day.

The numerator of the fraction is adjusted downwards to reflect: (i) retirement of any CFC obligations [50] included in its March 31, 1984, capitalization, and (ii) a pro rata portion of the CFC's equity allocable to these retired obligations.[51]

Adjustments in the numerator are also required for OID accruing after March 31, 1984, on CFC obligations and U.S. affiliate obligations.[52] This means that the numerator will be adjusted upwards for the OID accrued after March 31, 1984, on OID-type CFC obligations. However, to the extent that the proceeds of OID-type CFC obligations included in a CFC's March 31, 1984 capitalization were used, as of March 31, 1984, to finance non-U.S. affiliate obligations, no special adjustment in the numerator will be permitted.[53]

(2) Exemption for Interest on Certain Term Obligations

The recharacterization rule of §904(g) does not apply to interest earned on term obligations held on March 7, 1984, by U.S.-owned foreign corporations that do not qualify as applicable CFCs. Also, the recharacterization rule of §904(g) does not apply to interest earned on term obligations of U.S. persons who do not qualify as U.S. affiliates (within the meaning of §121(b)(2)(E)(ii) of P.L. 98-369) that are held by an applicable CFC on March 7, 1984.[54]

(3) Separate §904 Limitation on Amounts Benefiting from Transitional Rules

The §904 limitation is required to be computed separately (as, for example, in the case of interest) with respect to any amounts derived from a U.S.-owned foreign corpora-

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tion which are not recharacterized as U.S. source income under either of the two transitional rules described above.[55] Thus, foreign taxes paid by the recipient of such income on other income will not be creditable against the U.S. tax on the income that benefits from a transitional rule.

If the income in question is also subject to separate limitation under §904(d), the separate limitation rule of §121(b)(5) of P.L. 98-369 will be applied first.[56]

The application of the separate §904 limitation rule of §121(b)(5) of P.L. 98-369 is delayed until January 1, 1986, in one special interest case. The exception relates to the foreign subsidiary of a U.S. corporation engaged in manufacturing for over 50 years which issued certificates with respect to obligations on: (i) September 24, 1979, denominated in French Francs; (ii) September 10, 1981, denominated in Swiss Francs; (iii) July 14, 1982, denominated in Swiss Francs; and (iv) December 1, 1982, denominated in U.S. dollars, with a total amount not exceeding $200 million.[57]

III. Certain Amounts Characterized as Interest for §904 Purposes

A. Introduction

The United States taxes domestic corporations and individual citizens and residents on their worldwide income. This worldwide taxation may result in double taxation of the foreign source income; *i.e.*, once in the country of source and again by the United States. With a view to avoid or at least mitigate this potential double taxation of U.S. corporations and individual citizens and residents, the U.S. Congress enacted a dollar-for-dollar credit against U.S. tax for income taxes paid to foreign countries. The foreign tax credit provisions are contained in Code §§901-908 and 960.

Since the basic function of the foreign tax credit is to prevent double taxation of the foreign source income and not to reduce U.S. tax on U.S. source income, §904 provides a limitation on the foreign tax credit to ensure that the credit is not greater than the U.S. tax attributable to foreign source income. The §904 limitation is expressed in the form of a formula as follows:

$$\text{Tentative U.S. Tax Liability} \times \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

This §904 foreign tax credit limitation applies to most taxpayers on an overall basis: the taxpayers combine income and losses from all foreign operations in all foreign countries in the §904 formula. Because of this overall method of computing §904 limitation, taxes paid to foreign countries that exceed the top U.S. tax rate become creditable to the extent the taxpayer also has foreign source taxable income bearing a foreign tax rate lower than the top U.S. tax rate. Thus, in essence, a U.S. taxpayer with excess foreign tax credits (*i.e.* credits for foreign taxes imposed by foreign countries at a rate higher than the top U.S. tax rate which are not available in the current year and which must be carried back or carried forward) can, by generating foreign source income in a low tax foreign jurisdiction, offset U.S. tax that would otherwise apply to such low-taxed foreign source income.

Since many foreign countries do not impose any income tax on interest income earned by foreigners, a U.S. taxpayer could easily utilize its excess foreign tax credits by exporting cash to such a foreign country and earning interest income on it. This possibility, however, is foreclosed by §904(d), which provides for a separate §904 limitation on all foreign source interest income. Because of §904(d), foreign taxes imposed on non-interest income do not offset U.S. tax that applies to low-taxed foreign source interest income.

A U.S. person, however, may circumvent the §904(d) separate limitation on interest income in at least two ways. First, a U.S. person may create a foreign corporation and lend money through such a corporation to borrowers resident in countries which impose little or no income tax on interest paid to foreigners. The interest income earned by the foreign corporation is generally included in the gross income of the U.S. shareholders currently as a dividend under either the foreign personal holding company provisions (§§551-558) or the Subpart F provisions (§§951-964) of the Code. This simple technique, therefore, enables a U.S. taxpayer to convert potential interest income into dividend income. Second, a U.S. person may buy shares in a U.S. corporation (*i.e.*, a mutual fund) which invests in foreign securities the interest income from which bears little or no foreign tax. If the U.S. corporation earns more than 80 percent of its gross income from foreign sources, the dividends received by the U.S. person from such a corporation are characterized as foreign source income.[58]

Cognizant of this manipulation of the character of income, the Congress enacted §122 of the Tax Reform Act of 1984 (P.L. 98-369). The Senate Finance Committee Report observes that:[59]

> "In 1962, Congress enacted the separate foreign tax credit limitation for interest to prevent taxpayers from artificially converting U.S. source income to foreign source low taxed interest income and thus inflating the foreign tax credit limitation. It has come to the attention of the committee that under the current Treasury interpretation of the separate foreign tax credit limitation, the same result can be achieved by having interest paid to a foreign subsidiary rather than directly to the taxpayer and then by distributing that interest as a dividend. In either case, there is artificial inflation of the foreign tax credit limitation, as a result of an easily manipulable financial transaction. The committee seeks to insure the integrity of the separate foreign tax credit limitation for interest income, and to prevent U.S. taxpayers from using artificial devices to convert interest income into non-interest income.
>
> "Current law, by encouraging U.S. taxpayers to invest capital outside the United States, erodes the U.S. tax base. If taxpayers can convert low-taxed foreign interest income to non-interest income, they circumvent the foreign tax credit limitation. Then, the U.S. Treasury, and not the U.S. taxpayer, bears the burden of foreign taxes on non-interest income."

B. Overview

Section 122 of the Tax Reform Act of 1984 (P.L. 98-369) adds a new paragraph (3) to subsection (d) of §904. The new §904(d)(3) provides for the maintenance of

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the character of income as interest (which is subject to a separate limitation under §904(d)(2)) when such income is earned through a foreign corporation or a regulated investment company and distributed (whether actually or constructively) to the U.S. shareholders as dividends or interest. Under the general rule of §904(d)(3), when a U.S.-owned foreign corporation, a regulated investment company, or a foreign corporation in which the taxpayer is a U.S. shareholder (within the meanings of §951(b)) pays or accrues dividends or interest, such payments are treated as interest (subject to the §904(d)(2) separate limitation) in the hands of the U.S. recipients but only to the extent the payor corporation's earnings and profits for the relevant taxable year include separate limitation interest. Under a de minimus exception, however, if the payor corporation has earnings and profits for a particular taxable year and the separate limitation interest is less than 10 percent of such earnings and profits, dividends and interest paid or accrued by such a corporation are not recharacterized as interest which is subject to the separate §904(d)(2) limitation.

C. *Detailed Analysis*

1. *The General Rule*

Section 904(d)(3), as added by P.L. 98-369, provides that certain types of payments (*i.e.*, dividends and interest) paid or accrued by a "designated payor corporation" and attributable to any taxable year of such corporation are treated as interest income (within the meanings of §904(d)(2)) in the hands of the recipient but only to the extent that the aggregate amount of such payments does not exceed the "separate limitation interest" of the payor for such taxable year.[60]

Comment: Actual dividend or constructive dividend payments under Subpart F made or accrued by a designated payor corporation retain their character as such for purposes of determining whether the taypayer is entitled to a deemed paid foreign tax credit under §§902 or 960, respectively.

2. *Types of Payments Subject to Recharacterization*

The types of payments made or accrued by a designated payor corporation which are recharacterized as interest (within the meaning of §904(d)(2)) are enumerated below:

(i) *Interest.*[61] At first blush, it appears redundant to state that interest paid by a designated payor corporation is characterized as interest in the hands of the recipient. However, the inclusion of interest in the types of payments which are recharacterized serves an important function: it decreases the separate limitation interest of the designated payor corporation.

(ii) *Constructive dividends under §551.*[62] Sections 551(a) and 551 (b) require U.S. shareholders in a FPHC to include in their gross incomes as a constructive dividends "the UFPHC1" of the FPHC for its taxable year.

(iii) *Constructive dividends under §951.*[63] Under §951, if a foreign corporation is a "controlled foreign corporation" for an uninterrupted period of 30 days during any taxable year, then every person who is a "United States Shareholder" of such corporation is required to include in gross income as a "constructive dividend" his pro rata share of the CFC's "Subpart F income" and certain other income.

(iv) *Section 1246 gain.*[64] Under §1246, any gain derived by a U.S. stockholder from the sale or exchange of stock in a Foreign Investment Company is treated as ordinary income.

(v) *Section 1248 dividend.*[65] Under §1248, the gain recognized on the sale or exchange of stock of a controlled foreign corporation by a United States person, who is a 10-percent owner, is included in the gross income of the United States person as a dividend to the extent of the CFC's post-1962 earnings and profits accumulated during the period the stock was held by the U.S. person.

3. *Designated Payor Corporation*

Payments of the types described above paid or accrued by a "designated payor corporation" are subject to recharacterization as interest. The term "designated payor corporation" is defined to include the following:[66]

(i) A United States-owned foreign corporation. A foreign corporation is U.S.-owned if 50 percent or more of the total combined voting power of all classes of stock or the total value of all shares of stock in such corporation is held directly or indirectly by United States persons.[67] For purposes of this 50-percent test, the constructive ownership rules of §§958(a)(2), 958(a)(3) and 318(a)(4) apply.

(ii) Any foreign corporation in which a U.S. person is a "U.S. shareholder" at any time during the taxable year of the foreign corporation.[68] The term "U.S. shareholder" is defined in §951(b) to include any U.S. person who owns, directly or indirectly (under the constructive ownership rules of §958), 10 percent or more of the total combined voting power of all classes of stock in the foreign corporation.

(iii) Any regulated investment company.

4. *Separate Limitation Interest*

Section 904(d)(3) recharacterizes certain payments paid or accrued by a designated payor corporation as interest (subject to the separate limitation of §904(d)(2)) only to the extent that the aggregate amount of such payments does not exceed the "separate limitation interest" of the designated payor corporation for the taxable year.

The term "separate limitation interest" is defined to mean the aggregate amount of interest income described in §904(d)(2) which is received or accrued by the designated payor corporation during the relevant taxable year reduced by the properly allocable deductions as determined under the regulations prescribed by the IRS.[69]

Note: Interest received by a designated payor corporation from another corporation (whether domestic or foreign, which is a member of the same affiliated group within the meaning of §1504), is not separate limitation interest unless such interest is attributable, directly or indirectly, to the separate limitation interest of the payor corporation.[70]

Interest described in §904(d)(2) includes all interest except the following four categories of income:

(i) Interest generated from any transaction which is directly related to the active conduct of a trade or business in a foreign country;[71]

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(ii) Interest generated from the conduct of an active banking, financing, or similar business;[72]

(iii) Interest paid by a corporation in which the taxpayer owns, directly or indirectly, at least 10 percent of the voting stock;[73]

(iv) Interest earned from obligations that were acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country, or as a result of the disposition of stock or obligations in a 10-percent owned corporation.[74]

Once the total interest income (as described in §904(d)(2)) of the designated payor corporation is determined, it is reduced by the deductions that are properly allocated to such income in order to arrive at the separate limitation interest. The taxpayer may use any method of allocation prescribed in Regs. §1.861-8, provided such method is used consistently by the taxpayer for all purposes.[75] It should be observed, however, that no deduction is allowed against the interest income of a designated payor corporation for any interest paid to: (i) a U.S. person who qualifies as a U.S. shareholder (within the meanings of §951(b)) in such corporation, or (ii) any person who is related to the U.S. shareholder within the meanings of §267(b).[76]

5. De Minimis Exception

Dividends and interest paid by a designated payor corporation are not recharacterized as interest income in the hands of the recipient if the following two requirements are met:

(i) The designated payor corporation has earnings and profits for the relevant taxable year; and

(ii) Less than 10 percent of these earnings and profits are attributable to separate limitation interest.[77]

For purposes of this de minimis exception, the earnings and profits of the designated payor corporation are not reduced by any interest payments made to: (i) a U.S. person who is a "U.S. shareholder" (within the meaning of §951(b)) in such corporation, or (ii) any other person who is related to a "U.S. shareholder" within the meaning of §267(b).[78]

6. The Rules of Application

Since dividends and/or interest paid or accrued by a designated payor corporation for any taxable year are recharacterized only to the extent of such corporation's separate limitation interest for such taxable year, it is crucial to determine:

(i) To which taxable year of the designated payor corporation are the dividends and/or interest paid by such corporation attributable; and

(ii) What is the amount of separate limitation interest of the designated payor corporation for such taxable year.

The computation of the separate limitation interest amount is discussed under III, C, 4, *supra*. The rules for determining to which taxable year of the designated payor corporation are the dividends and/or interest paid or accrued by such corporation attributable are provided in §904(d)(3)(F). These rules are as follows:

(i) If any amounts are included in the gross income of a U.S. person under the FPHC or the Subpart F provisions of the Code as constructive dividends, such amounts are attributable to the taxable year of inclusion;[79]

(ii) If the designated payor corporation pays or accrues interest, such amount is attributable to the taxable year in which the interest is paid or accrued;[80]

(iii) If the designated payor corporation pays dividends, such dividends are attributable to the taxable year out of which earnings and profits are paid.[81]

If more than one type of payment is attributable to a taxable year of the designated payor corporation, §904(d)(3)(G) provides the following ordering rules. First, the FPHC and the Subpart F inclusions on account of a designated payor corporation are recharacterized as interest subject to the separate §904(d)(2) limitation. Second, if the aggregate of the FPHC and the Subpart F inclusions are less than the separate limitation interest amount of the designated payor corporation for the taxable year, any interest paid or accrued by such corporation reduces the separate limitation interest amount. Finally, if the aggregate of the FPHC, the Subpart F, and the interest amounts is less than the separate limitation interest amount of the designated payor corporation for the taxable year, any dividends paid by such corporation during the taxable year are recharacterized as interest subject to the separate §904(d)(2) limitation.

7. Distributions Through Intermediate Entities

Section 904(d)(3)(I) provides the Secretary with the authority to prescribe regulations necessary to achieve the purposes of §904(d)(3) in cases where distributions or payments are made through one or more entities. The Conference Report explains the reasons for delegating this statutory authority to the Secretary as follows:[82]

"The conference agreement retains the rule of the Senate amendment requiring the Secretary to prescribe such regulations as may be necessary to carry out the purposes of this provision in the case of distributions or payments through one or more entities. For example, a U.S. owned foreign corporation that earns separate limitation interest but that pays interest to a related foreign party would reduce the amount of income subject to characterization as separate limitation interest. The income of the related foreign corporation might not be subject to U.S. tax, so the foreign tax credit limitation would not affect the related foreign person. The Secretary is to prescribe rules so that an inclusion in income of a U.S. taxpayer on account of the related foreign corporation will be subject to recharacterization as separate limitation interest. Such an inclusion could occur, for example, under the rules of Subpart F, on a dividend or interest payment, by the related foreign corporation, or on an investment by the related foreign corporation in U.S. property.

"For example, if a controlled foreign corporation ("CFC-1") earns $100 of gross separate limitation interest (that is foreign personal holding company income subject to Subpart F) but reduces its current year earnings and profits to zero by a $100 interest payment to a related foreign party ("CFC-2"), there would be no Subpart F inclusion for the year on account of CFC-1. If there were no Subpart F inclusion on account of CFC-2 (for instance, because

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foreign base company income made up less than 10 percent of the gross income of CFC-2), later dividends from CFC-2 would be subject to recharacterization, whether or not 10 percent of the earnings and profits of CFC-2 for the year at issue were attributable to the separate limitation interest that it received from CFC-1 or to other separate limitation interest."

8. The Effective Date

Section 904(d)(3) is generally effective as of July 18, 1984.[83] However, for purposes of computing the separate limitation interest of a designated payor corporation, interest income received or accrued by such a corporation shall be taken into account only in taxable years beginning after July 18, 1984.[84] There are two exceptions to this rule:

(i) Interest income earned by a regulated investment company with respect to investments made by a taxpayer after June 22, 1984, shall be treated as separate limitation interest;[85] and

(ii) Interest received or accrued by a designated payor corporation (which is not an "applicable CFC" as defined in §121(b)(2)(D) of P.L. 98-369) on a term obligation held by such corporation on March 7, 1984, shall not be treated as separate limitation interest.[86] An "applicable CFC" is defined in §121(b)(2)(D) to mean a controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on such date was to issue and to hold the short-term obligations of affiliates and to lend the proceeds of such obligations to the affiliates.

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[1] The term "United States" does not include possessions (§7701(a)(9)).
[2] §861(a)(4); Regs. §1.861-5. Unless otherwise indicated, all references herein are to the Internal Revenue Code of 1954, as amended.
[3] §862(a)(4); Regs. §1.862-1(a)(iv).
[4] 1975-2 C.B. 286.
[5] §861(a)(3).
[6] §862(a)(3).
[7] §863(b).
[8] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1339.
[9] §863(c)(3)(A).
[10] §863(c)(3).
[11] §863(c)(3)(B).
[12] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1340.
[13] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 935.
[14] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1340; H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at pages 934-935.
[15] *Id.*
[16] Although there is no guidance in the statute or the legislative history, it appears that only that portion of the total air freight paid to Pan Am which is attributable to Washington, D.C.-New York route will be considered as U.S. source income.
[17] *Supra*, note 14.
[18] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1340.
[19] *Id.* at pp. 1340-1341.
[20] §863(c)(2)(A)(i).
[21] H.R. Rep. No. 861, 98th Cong., 2d Sess., (1984) at page 934.
[22] §863(c)(2)(A)(ii).
[23] §863(c)(2)(B).
[24] *Id.*
[25] H.R. Rep. No. 861, 98th Cong., 2d Sess., (1984) at page 934.
[26] §124(b) of the Tax Reform Act of 1984 (P.L. 98-369).
[27] §861(a)(2).
[28] §862(a)(2).
[29] §861(a)(2)(A).
[30] §861(a)(2)(B).
[31] *See* Rev. Rul. 77-316, 1977-2 C.B. 53; *Carnation Co. v. Comr.*, 640 F.2d 1010 (9th Cir. 1981); and *Stearns-Rogers Corp. Inc. v. U.S.*, 84-1 USTC ¶9165 (D.C. Colo. 1984), which cast a shadow of doubt on such arrangements.
[32] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984) at page 1347.
[33] §904(g)(1).
[34] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 921.
[35] §904(g)(3).
[36] §904(g)(4)(A).
[37] §904(g)(4)(B).
[38] §904(g)(7).
[39] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 922.
[40] §904(g)(5).
[41] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at pages 921-922.
[42] *Id.* at p. 920.
[43] Section 121(b)(1)(A) of the Tax Reform Act of 1984 (P.L. 98-369).
[44] Section 121(b)(1)(B) of P.L. 98-369.
[45] §121(b)(2)(D) of P.L. 98-369 defines the term "applicable CFC" to mean a controlled foreign corporation (within the meaning of §957) which was in existence on March 31, 1984, and the principal purpose of which on that date consisted of issuing obligations (whether long-term or short-term) and lending proceeds to affiliates. A CFC satisfies this principal purpose test if at least half of its liabilities on March 31, 1984, were CFC obligations and if at least half of its assets on that date were loans to affiliates. The term "affiliate" is defined in §121(b)(2)(E)(i) of P.L. 98-369 to include any person who is related to the applicable CFC within the meaning of §482.
[46] Section 121(b)(2)(A)(ii) of P.L. 98-369.
[47] Section 121(b)(2)(B) of P.L. 98-369.
[48] Section 121(b)(2)(F) of P.L. 98-369 defines the term "United States affiliate obligations" to include any obligation of and payable by a U.S. affiliate.
[49] With respect to the numerator of the limiting fraction, the term "applicable limit" means the sum of: (i) the equity of the applicable CFC on March 31, 1984, and (ii) the aggregate principal amount of the CFC obligations outstanding on March 31, 1984, which were issued by an applicable CFC before March 8, 1984, or after March 7, 1984, pursuant to a binding commitment in effect on March 7, 1984 (see §121(b)(2)(I) of P.L. 98-369).
[50] A CFC obligation is defined in §121(b)(2)(G) to mean any obligation of and issued by a CFC which is described in clause (i) of §163(f)(2)(B), or clause (ii) of such subsection if issued after December 31, 1982.
[51] §121(b)(2)(C) of P.L. 98-369.
[52] §121(b)(2)(H) of P.L. 98-369.
[53] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 924.
[54] §121(b)(3) of P.L. 98-369.
[55] §121(b)(5) of P.L. 98-369.
[56] *Id.*
[57] §121(b)(6) of P.L. 98-369.
[58] §861(a)(2)(A).
[59] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. (1984) at page 392.
[60] §904(d)(3)(A).
[61] *Id.*
[62] §904(d)(3)(H)(i).
[63] *Id.*
[64] §904(d)(3)(H)(ii).
[65] *Id.*
[66] §904(d)(3)(E).
[67] §904(g)(6).
[68] §904(d)(3)(E)(ii).
[69] §904(d)(3)(B).
[70] §904(d)(3)(J).
[71] §904(d)(2)(A).
[72] §904(d)(2)(B).
[73] §904(d)(2)(C).
[74] §904(d)(2)(D).
[75] H.R. Rep. No. 861, 98th Cong., 2nd Sess. (1984) at page 929.
[76] §904(d)(3)(D).
[77] §904(d)(3)(C).
[78] §904(d)(3)(D).
[79] §904(d)(3)(F)(i).
[80] §904(d)(3)(F)(ii).
[81] §904(d)(3)(F)(iii).
[82] H.R. Rep. No. 861, 98th Cong., 2d Sess. (1984) at page 928.
[83] §122(b)(1) of P.L. 98-369.
[84] §122(b)(2)(A) of P.L. 98-369.
[85] §122(b)(2)(B) of P.L. 98-369.
[86] §122(b)(2)(C) of P.L. 98-369.

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Chapter 67

THE DEMISE OF RELATED PARTY INTERNATIONAL FACTORING OPERATIONS?

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I. Introduction

When goods or services are sold on credit, the seller generally takes from the purchaser a receivable, which is a transferable promise to pay cash in the future. The seller may cash the receivable prior to its maturity date by selling it to a third party, a "factor" (*i.e.*, a finance company), at a discount. The seller's income realized from the sale of goods or services in such a case is reduced by the amount of the discount. When the receivable is paid, the factor realizes income in the amount of the discount.

At the time the Tax Reform Act of 1984 (P.L. 98-369) was enacted, the practice of factoring by foreign subsidiaries of trade accounts receivable of U.S. parent companies (and of U.S. and foreign affiliates) was ever so popular. In employing this technique, the U.S. multinational companies hoped to achieve, among others, the following tax advantages:

(i) To repatriate untaxed foreign earnings accumulated abroad by a controlled foreign corporation tax-free (*i.e.*, free of dividend tax) and, at the same time, to meet the short-term financing needs of the U.S. parent; [1]

(ii) To shift a portion of the income (*i.e.*, equal to the discount income) earned by the U.S. parent (or a foreign affiliate) from the sale of goods or services out of the United States (or high-tax foreign) taxing jurisdiction to a low or zero-tax foreign jurisdiction; [2]

(iii) To absorb the U.S. parent corporation's excess foreign tax credits by repatriating the low-taxed discount income accumulated by the factoring subsidiary as a dividend;

(iv) To shift funds among brother-sister foreign affiliates and to maximize the net after-tax yields on investments within the controlled group; and

(v) To accomplish the important non-tax objectives of centralized currency management and the hedging of foreign currency risks inherent in the foreign trade receivables of foreign affiliates.

A. *Typical Related Party International Factoring Arrangement*

In order to achieve the desired tax results it was imperative that the factoring arrangement be properly structured. The outlines of a successful structure were illustrated in PLR 8338043.

In PLR 8338043, P, a domestic corporation, was engaged in manufacturing and sales. P's wholly-owned subsidiary S, incorporated in foreign country A, operated manufacturing facilities and produced and distributed products to the parent's affiliates outside the United States. P and its domestic subsidiaries, X, Y, and Z, sold to S certain trade accounts receivable arising from their sale of goods to unrelated domestic and foreign customers.[3] Other pertinent facts were as follows:

(i) S purchased the trade receivables without recourse. It bore all risk and expense of collection, attorney fees, accounting fees, litigation expenses, and taxes on any account receivable.

(ii) The purchase price was a percentage of the face amount of the receivable designed to compensate S in accordance with the customary practice of factors operating at arm's length.

(iii) The transferors represented to S that the accounts sold arose from the bona fide sale and delivery of goods in the ordinary course of business and provided S with bills of sale.

(iv) Upon acquisition of the accounts, S forwarded the entire purchase price to the transferors.

(v) Obligors on the purchased receivables were notified on the invoices representing the purchased receivables to make payments directly to S.

(vi) The accounts sold were clearly identified as the property of S and segregated in the accounts of the transferors.

(vii) The factoring operations were conducted in foreign country A, where S was incorporated, under the direction of an executive officer of S. In certain cases, an unrelated agent in the United States was used where follow-up activity was necessary.

(viii) It was anticipated that S would make recurring purchases of receivables under a contract with an initial term of one year and subject to renewal for additional one-year periods.

(ix) Neither P nor any of its other subsidiaries repurchased any of the trade receivables sold to S.

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B. The Major Tax Issues Involved

Although the broad outlines of a typical factoring arrangement were clear and simple, a successful implementation required navigation around a variety of Code provisions.[4] The first major issue related to the characterization of the factoring transaction: was it a pledge of collateral for a loan or a bona fide sale?

If the sale of trade accounts receivable was characterized as a pledge of collateral for a loan from the factoring subsidiary to the transferor, the discount income was clearly interest. Under this characterization, therefore, the discount income would be subject to 30 percent withholding tax[5] and it would be currently taxable as a constructive dividend in the hands of the U.S. parent (either as foreign personal holding company income or as Subpart F foreign personal holding company income).[6]

On the other hand, if the sale of trade accounts receivable was characterized as a bona fide sale, it gave rise to two further issues: (i) was the discount income subject to U.S. withholding tax under §1442; and (ii) was the discount income taxable in the hands of the U.S. parent currently as Subpart F income.

The second major tax issue related to the treatment of the purchase by the foreign factoring company of the trade accounts receivable of its U.S. parent and other U.S. affiliates as investment in U.S. property under §956.

1. Loan v. Sale Issue

In PLR 8338043, the Service held that in evaluating whether the sale of trade accounts receivable constituted a loan or a sale, the following factors were to be considered:

(i) Which party bore the risk of loss inherent in owning the receivables;

(ii) Who had the absolute power of disposition;

(iii) Was the transferee entitled to any interest accruing on the receivables;

(iv) Who was obligated to make collections on the receivables and incur collection expenses;

(v) Who was obligated with respect to all property, excise, sales, or similar taxes;

(vi) Was the transferor entitled to hold the transferee harmless from and against any action brought against the transferee arising out of the transferor's acting as an agent for the transferee in making collections;

(vii) Were the customers notified of the transfers of their obligations;

(viii) Did the transferee retain the right to inspect the records and books of the transferor at any time;

(ix) Was the servicing of the receivables performed by the transferor and, if so, did the transferee supervise the operation;

(x) Did the transferor receive the entire face amount of the receivables transferred;

(xi) Were all receivables transferred to the transferee; and

(xii) Were any other forms of collateral pledged, such as guarantees, insurance assignments, and limitations on payment of dividends.

After enumerating these factors the Service went on to conclude that the sale of trade accounts receivables by P, X, Y, and Z to S was a bona fide sale rather than a pledge of collateral to secure a loan because: (i) S purchased the receivables without recourse; (ii) S bore all risk and expense of collection, attorney fees, accounting fees, litigation expenses, and taxes on accounts receivables; (iii) P and other transferors forwarded the invoices representing the purchased receivables to S; and (iv) the obligors on the accounts receivables were notified to make payments directly to S.

It is apparent, therefore, that a "bona fide sale"[7] characterization could be obtained for a transfer of trade accounts receivable by surrendering substantial incidents of ownership in the receivables to the factoring subsidiary.

2. The Withholding Tax Issue

In order to determine whether discount income was subject to withholding of U.S. tax under §1442, the following issues had to be resolved: (i) the characterization of the discount income; (ii) the source of the discount income; and (iii) whether the discount income was effectively connected with a U.S. trade or business.

As to the characterization issue, given the absence of any specific provisions in the Code dealing with discount income, there were three possibilities:

(i) The discount income could be characterized as interest income;[8]

(ii) The discount income could be characterized as income from the purchase and sale of personal property;[9] or

(iii) The discount income could be characterized as income from the performance of personal services.

Comment: Since the source of income rules vary depending upon the character of income, (*e.g.*, interest, income from personal services, income from the purchase and sale of personal property), the answer to the second issue would vary according to the characterization given the discount income.

PLR 8338043 as well as GCM 39220 concluded that, in the normal factoring situation, the amount of income (other than any stated interest) derived by the factor consists of a commission, which is a charge for the service of passing on credits, assuming all credit risks, and keeping the accounts. Thus, when a factoring company factors the trade accounts receivable of the transferors, it is considered to be performing a service for the transferors and the discount income generated by it is income from the performance of personal services.

With respect to the source of income issue, §§861(a)(3) and 862(a)(3) provide that income derived from the performance of personal services is sourced to the place where the services are rendered. Thus, if the U.S. parent (or another party), acting as an agent of the foreign factoring subsidiary, performed the collection activities in the United States, the discount income was U.S. source income. On the other hand, if the foreign factoring subsidiary performed

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the collection activities itself outside the United States, the discount income was foreign source income. If the factoring services were performed partly within and partly without the United States, the discount income was partly U.S. source and partly foreign source income to the foreign factoring subsidiary.[10]

As to the trade or business issue, GCM 39220 concluded that if the foreign factoring subsidiary's activities included substantial and recurring purchases of trade accounts receivable, it was engaged in the trade or business of factoring. Since the term trade or business includes the performance of personal services,[11] the discount income earned by the foreign factoring subsidiary from the factoring services performed within the United States (whether by the U.S. parent or any other agent of the factoring subsidiary) constituted income effectively connected with a U.S. trade or business. The effectively connected income, even though subject to U.S. tax at graduated rates under §11, is not subject to U.S. withholding tax provided, the taxpayer furnishes a statement referred to in Regs. §1.1441-4(a)(2).[12] If, however, the factoring services were performed outside the United States, the discount income was not treated as income effectively connected with a U.S. trade or business [13] and, hence, was free of U.S. withholding or §11 tax.

It is apparent, therefore, that discount income of the foreign factoring subsidiary could be sheltered from U.S. withholding and §11 income taxes by structuring the factoring arrangement so that all factoring services were performed outside the United States.

3. The Subpart F Income Issue

Theoretically, the discount income could be subjected to current tax in the hands of U.S. shareholders of the foreign factoring subsidiary as a constructive dividend under three different provisions of Subpart F:

(i) If the receivables qualified as "securities" within the meaning of §553(a), the discount income earned upon collection of such receivables could qualify as Subpart F foreign personal holding company income and taxed to U.S. shareholders under §§951(a)(1), 952(a)(2), 954(a)(1) and 954(c); [14]

(ii) If the foreign factoring subsidiary sold the trade accounts receivable prior to maturity, it could give rise to Subpart F foreign base company sales income which would be taxed to U.S. shareholders under §§951(a)(1), 952(a)(2), 954(a)(2), and 954(d); and

(iii) The discount income could also be subject to current tax in the hands of U.S. shareholders as Subpart F foreign base company services income under §§951(a)(1), 952(a)(2), 954(a)(3) and 954(e).

However, since trade accounts receivable never qualified as securities and since such receivables were rarely, if ever, sold prior to maturity, the only real issue was whether the discount income qualified as foreign base company services income.

Foreign base company services income is income of a controlled foreign corporation which arises in connection with the performance of technical, managerial, engineering, architectural, skilled, industrial, commercial, or similar services, but only if, those services are (i) performed by a controlled foreign corporation for or on behalf of a related person, and (ii) performed outside the controlled foreign corporation's country of incorporation.[15] GCM 39220 concluded that when a factoring company factored the trade accounts receivable of a related party it was considered to perform services for that related party. Consequently, if the factoring services were performed outside the foreign factoring subsidiary's country of incorporation (*e.g.*, in the United States by the U.S. parent or other agent of the factoring subsidiary), the discount income attributable to such services qualified as foreign base company services income.

In a typical factoring arrangement, the U.S. parent could guarantee that the discount income was not taxed to it under Subpart F by ensuring that the trade accounts receivable were not sold by the factoring subsidiary prior to maturity and that the factoring services were performed in the subsidiary's country of incorporation.

4. Section 956 Issue

Although neither PLR 8338043 nor GCM 39220 passed on the §956 issue, it was reasonably clear that §956 did not pose any serious problems in a typical related party international factoring arrangement.

Under §956, any U.S. shareholder of a controlled foreign corporation is taxed currently on its pro-rata share of the increase in the taxable year of the controlled foreign corporation's earnings invested in "United States property." The term "United States property," as defined in §956(b)(1), includes "an obligation of a U.S. person." Section 956(b)(2)(F), however, provides that the term "United States property" does not include the obligation of an unrelated U.S. corporation. Since, in a typical factoring arrangement, the foreign factoring subsidiary factored the obligations of unrelated U.S. (and foreign) corporations, the U.S. parent of the subsidiary had no potential exposure under §956.

In summary, therefore, if the factoring arrangement was patterned after PLR 8338043 and if all the factoring services were performed in the factoring subsidiary's country of incorporation, the U.S. multinational corporation could achieve the tax and non-tax advantages outlined above.

C. Reasons for Change

Concerned by the shifting of income to tax haven jurisdictions and a tax-free repatriation of untaxed foreign earnings involved in the related party international factoring operations, the U.S. Congress enacted §123 as part of the Tax Reform Act of 1984. The reasons for enacting §123 are stated in the House Ways and Means Committee Report as follows: [16]

"The committee will not condone artificial devices that shift income out of U.S. taxing jurisdiction and into tax havens. Some factoring transactions involve credit sales by U.S. sellers to U.S. buyers. There is no justification for allowing the U.S. seller to shift part of the income from this wholly domestic transaction outside the United States to a passive, related party in a tax haven.

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"Similarly, if a foreign corporation controlled by U.S. shareholders sells a receivable to a related foreign corporation, profits may be shifted from a high-tax foreign country to a tax haven. As a result, there could be deferral of current tax on that income, or generation of low-taxed foreign-source income available to absorb otherwise unusable foreign tax credits. If the bill did not apply to this situation, the factoring of receivables from one foreign subsidiary to a related foreign corporation where the discount income is not taxed by the United States or any country would give an advantage to foreign operations of a U.S. business over the U.S. operations of the same business. The committee believes, however, because there is no shifting of income into tax havens when a controlled foreign corporation factors receivables of related corporations that operate in the same country, that it is appropriate to provide an exception for such transactions.

"Furthermore, multinational corporations based in the United States are using foreign subsidiaries to factor receivables as a device for repatriating foreign earnings tax-free. The committee is concerned about the recent growth in this offshore factoring and consequent tax-free repatriation of foreign earnings. The committee believes, therefore, that taxpayers should pay tax on foreign earnings repatriated through factoring subsidiaries."

II. Overview

Section 123 of the Tax Reform Act of 1984 (P.L. 98-369) spells the demise of related party international factoring operations as such operations were known prior to the Act. It adds a new subsection (d) to §864 and a new paragraph (3) to subsection (b) of §956. These new provisions take away all the tax advantages that a U.S. taxpayer obtained under a typical factoring arrangement.

Section 864(d) ensures that the discount income earned by the foreign factoring subsidiary is taxed currently to the U.S. shareholders of the subsidiary under either the foreign personal holding company provisions of the Code (§§551-558) or under the Subpart F provisions of the Code (§§951(a)(1), 952(a)(2), and 954(c)). The factoring arrangements (where the factoring company qualifies as a controlled foreign corporation) would, therefore, no longer succeed in shifting a portion of the income attributable to the sale of goods or services from the U.S. and foreign high-tax jurisdictions to low or zero-tax foreign tax-haven jurisdictions. Section 864(d) also ensures that U.S. taxpayers cannot utilize factoring arrangements to absorb their excess foreign tax credits.

Additionally, §956(b)(3) provides a strict rule that treats the trade accounts receivables acquired from related U.S. parties under which the obligor is a U.S. person as "United States property" for purposes of §956(a). Consequently, U.S. taxpayers would no longer be able to repatriate untaxed foreign earnings tax-free.

The new provisions are effective for accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date.

III. Detailed Analysis

Section 123 of the Tax Reform Act of 1984 (P.L. 98-369) launches a two-pronged attack on related party international factoring operations: (i) it subjects the U.S. shareholders of the foreign factoring corporation to current U.S. income tax, and (ii) it treats the trade accounts receivable of U.S. obligors acquired from a related U.S. person as "United States property" for §956 purposes.

A. Current Income Taxation of U.S. Shareholders

Section 864(d), as added by §123 of P.L. 98-369, ensures current taxation of the income earned by the foreign factoring corporation (*e.g.*, the discount income or stated interest) upon the collection of trade accounts receivable purchased, directly or indirectly, from a related U.S. person in the hands of its U.S. shareholders. Such taxation is accomplished by characterizing the income as interest for purposes of the foreign personal holding company (FPHC) rules and the Subpart F rules. Section 864(d) also characterizes the factoring income as interest for purposes of the §904 foreign tax credit limitation, which guarantees that the current U.S. income tax attributable to the factoring income is not reduced by the taxpayer's excess foreign tax credits.

Section 864(d) is analyzed in detail below.

1. The General Rule

The general rule of §864(d), in essence, recasts a related party factoring arrangement as if the factoring company made a loan to the obligor under the trade or service receivable who, in turn, used the money to pay for the goods or services supplied by the transferor of the trade or service receivable. Thus, if:

(i) A trade or service receivable is acquired, whether directly or indirectly,

(ii) From a related person,

(iii) Any income derived by the acquiring person from such trade or service receivable is treated as interest income.[17]

However, the interest characterization does not apply for all purposes of the Code. It applies only for purposes of the Foreign Personal Holding Company (FPHC) rules, the Subpart F rules, and the §904 foreign tax credit limitation rules.[18]

a. Acquisition of a Trade or Service Receivable

The interest characterization applies only if there was a direct or indirect "acquisition" of a "trade or service receivable."

(1) "Acquisition" Defined

Note that the statute uses the word "acquisition" rather than the word "purchase." Thus, it is not necessary that the factoring company *purchase* the trade or service receivable from a related person in order to trigger the rules of §864(d). An *acquisition* of a trade or service receivable (in whatever manner or form) is enough for §864(d) to apply.

The Conference Committee Report explains the significance of the word *"acquisition"* as follows:

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"Income from a receivable will be subject to the rules of the conference agreement whenever the receivable or an interest in the receivable is assigned to a foreign corporation by a related party. There will be an acquisition of a receivable, for the purpose of the rule contained in the conference agreement, whether or not the person earning the income from the receivable takes title to or physical possession of the receivable, and whether the related party that transfers the rights to income from a receivable does so with or without recourse." [19]

(2) Indirect Acquisition

The recharacterization rule of §864(d) applies to a direct as well as an indirect acquisition of a trade or service receivable of a related party.

An indirect acquisition occurs, for example, where a controlled foreign corporation loans funds to another foreign corporation which, in turn, uses the funds to acquire the trade or service receivables of a related party. In such a case the interest income earned by the lending controlled foreign corporation is treated as interest within the meaning of §864(d).[20] That is, the interest income will be taxable to the U.S. shareholders of the controlled foreign corporation as Subpart F foreign personal holding company income and it will be subject to separate §904(d) limitation. The impact of this indirect acquisition rule is illustrated by the following examples:

Example 1: Controlled foreign corporation A, which is engaged in an active business in foreign country X, has accumulated sizeable cash reserves. A's U.S. parent P is in need of cash. A loans funds to an unrelated foreign corporation Y at an arm's length interest rate. Y uses these funds to purchase P's trade and service receivables, which supply P with much-needed cash. Assuming Y is unrelated to P, its factoring income is not subject to the rules of §864(d). However, interest paid by Y to A is interest within the meaning of §864(d).

Example 2: Controlled foreign corporation A, which is engaged in an active business in foreign country X, has accumulated sizeable cash reserves. A desires to make these cash reserves available to its cash-strapped U.S. parent P. Towards this end, A makes a small equity contribution and a large loan to P's newly-organized wholly-owned foreign subsidiary M. The new subsidiary M purchases the trade and service receivables of P. The factoring income earned by M is subject to the rules of §864(d). In addition, interest paid by M to A is also subject to the rules of §864(d).

(3) The Term "Trade or Service Receivable" Defined

The term "trade or service receivable" is defined to mean any account receivable or evidence of indebtedness arising out of:

(i) The disposition by a related person of property defined in §1221(1) (*i.e.*, inventory); or

(ii) The performance of services by a related person.[21]

b. The Term "Related Person" Defined

Section 864(d) applies only if a trade or service receivable is acquired from a "related person." The term related person is broadly defined. It includes:

(i) Any person who is a related person within the meaning of §267(b);

(ii) Any person who is a U.S. shareholder within the meaning of §951(b); and

(iii) Any person who is related to a "U.S. shareholder" within the meaning of §267(b).[22]

A "United States shareholder" is defined by §951(b) to mean any United States person who, either actually or constructively (within the meaning of §958), owns 10 percent or more of total combined voting power of all classes of stock entitled to vote in a foreign corporation.

Comment: The inclusion of a 10-percent U.S. owner of a foreign factoring company within the definition of a "related person" is aimed at preventing tax-free related party factoring by foreign corporations owned by several U.S. persons.

It should also be noted that the term "related person" is not restricted to U.S. persons alone. Consequently, foreign-to-foreign related party factoring is within the ambit of §864(d).

c. The Applicable Source of Income Rules

The statute itself does not specify how the factoring income, which is characterized as interest income, is to be sourced. However, guidance is provided in the Conference Report, which states:

"In applying [the general rule of §§864(d)(1) and 864(d)(2)], the conferees intend that the source rules (Code sec. 861-863) be applied as though the income from a trade or service receivable were interest on a loan to the obligor under the receivable."

"The application of the rule treating related person factoring income as interest income also will apply to determine the source of that income upon eventual inclusion of the income in the gross income of a U.S. person pursuant to the provision of the conference agreement that maintains the source of U.S. source income that flows through a foreign corporation (Code sec. 904(g))." [23]

Since under §§861-863, as a general rule, interest income is sourced at the place where the obligor is resident, factoring income earned by a foreign factoring company is U.S. or foreign source income depending upon whether the obligor under the trade or service receivable is resident in the United States or a foreign country. Also, factoring income earned by a foreign factoring company from a trade or service receivable is foreign source income if the obligor under the receivable is a U.S. corporation which is an "80-20" corporation within the meaning of §861(a)(1)(B). Similarly, factoring income earned by a foreign factoring company from a trade or service receivable is U.S. source income (at least partially), even if the obligor under the receivable is a foreign corporation, provided such corporation is a 50-50 corporation within the meaning of §861(a)(1)(C).

Finally, §904(g), which was added to the Code by §121

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of the Tax Reform Act of 1984 (P.L. 98-369), provides that factoring income which is treated as U.S. source interest income in the hands of the foreign factoring company will retain its character as U.S. source interest income when it is included in the gross income of a U.S. shareholder of the foreign factoring company, but only for §904 purposes.

2. Factoring Income as Foreign Personal Holding Company Income (FPHCI)

a. The FPHC Provisions

The FPHC provisions (§§551-558) were enacted in 1937 to prevent U.S. shareholders from deferring or avoiding U.S. taxation through the use of foreign corporations to receive passive or personal services income. Unlike the Personal Holding Company provisions of the Code, FPHC provisions do not penalize the foreign corporation. Rather, the FPHC provisions require the U.S. shareholders to include in income their proportionate share of the foreign corporation's Undistributed Foreign Personal Holding Company Income (UFPHCI).

The term FPHC is defined in §552 as a foreign corporation which meets both a gross income test and a stock ownership test. Once a foreign corporation is determined to qualify as a FPHC, its UFPHCI must be included in the gross income of its shareholders in the manner described in §551(b).

The gross income test is met if at least 60 percent of the gross income of a foreign corporation for the relevant taxable year is FPHCI as defined in §553 (*e.g.*, interest, dividends, royalties, annuities, gain from sales or exchanges of securities, certain personal services income, certain lease payments, and rents).[24] Once a foreign corporation has qualified as a FPHC, the 60 percent test is reduced to 50 percent for subsequent years. "Gross income" for purposes of this test is computed in accordance with §555. Under the general rule of that section, the gross income of a FPHC is computed in the same manner as a domestic PHC. Thus, a FPHC includes in gross income all of its income from U.S. and foreign sources.

A foreign corporation meets the stock ownership test if, at any time during the relevant taxable year, more than 50 percent in value of its stock is owned, directly or indirectly, by (or for) not more than 5 individuals who are citizens or residents of the United States.[25] These individuals are collectively referred to as "the United States group." In determining whether the stock ownership test is met, the constructive ownership rules of §554 apply.

Once it is determined that a foreign corporation is a FPHC because it meets the gross income and stock ownership tests, each shareholder of the corporation (who is a U.S. citizen or resident) is required to include in his gross income, as a dividend, the amount he would have received if the UFPHCI were distributed on the last day of the taxable year of the company when a U.S. group existed.

b. Factoring Income as FPHCI

Under §§864(d)(1) and 864(d)(2), income earned by a foreign factoring company from trade or service receivables acquired from a related party is treated as interest income for purposes of §§551-558. Thus, this rule causes the foreign corporation to meet the gross income test of §552(a)(1). For example, if a foreign factoring company has no other type of income, it will certainly meet the gross income test of §552(a)(1). Additionally, if such a corporation also meets the stock ownership test of §552(a)(2), it will qualify as a FPHC and its UFPHCI (which will include the factoring as well as non-factoring income) will be taxed currently in the hands of its U.S. shareholders as a dividend.

Comment: The fact that factoring income is characterized as interest income for §553 purposes does not mean that it would inevitably be taxed to the foreign factoring company's U.S. shareholders currently as FPHCI. For example, if the factoring operations are conducted by an active foreign corporation which earns substantial non-factoring income, such corporation may not meet the gross income test of §552(a)(1). Alternatively, the foreign factoring company may not meet the stock ownership test of §552(a)(2). In these cases, the factoring income of the foreign factoring corporation will not be subject to current U.S. taxation as FPHCI.

Finally, note that although UFPHCI is usually included in the gross income of U.S. shareholders as foreign source dividend income, the factoring income which is U.S. source interest income in the hands of the foreign factoring corporation will retain its character as such when included in the gross income of U.S. shareholders, but only for §904 purposes.[26]

3. Factoring Income as Subpart F Income

a. Outline of Subpart F

To put the §864(d) provisions treating the related party factoring income as Subpart F income in proper perspective, a summary of the Subpart F provisions is presented below.

If a foreign corporation is a "controlled foreign corporation" for an uninterrupted period of 30 days during any taxable year, then every person who is a "United States shareholder" of such corporation must include in his gross income for the taxable year his pro rata share of the controlled foreign corporation's "Subpart F income" (and certain other income),[27] even if such income is not distributed to the shareholder.[28]

Thus, the Subpart F provisions apply only to those persons who qualify as "U.S. shareholders" of "controlled foreign corporations." Those persons who own stock in a "controlled foreign corporation" but do not qualify as "U.S. shareholders" are beyond the reach of Subpart F. Similarly persons who qualify as U.S. shareholders in a foreign corporation which is not a "controlled foreign corporation" are also beyond the reach of Subpart F.

The effect of the Subpart F provisions is to treat the U.S. shareholder's pro rata share of the "Subpart F income" (and certain other kinds of income) earned by the "controlled foreign corporation" during the taxable year as a constructive dividend taxable to the U.S. shareholder currently even though the U.S. shareholder receives no actual distribution from the controlled foreign corporation during the taxable year.

Any U.S. person may qualify as a U.S. shareholder. The term "U.S. person" includes:[29]

(i) A U.S. resident or citizen;

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(ii) A U.S. partnership;

(iii) A U.S. corporation; and

(iv) Any estate or trust (other than a foreign estate or trust as defined in §7701(a)(31)).

A U.S. person qualifies as a "U.S. shareholder" of a foreign corporation if the person:

(i) Actually owns,

(ii) Or is considered as owning,[30]

(iii) Ten percent or more,

(iv) Of the total combined voting power,

(v) Of all classes of stock entitled to vote of the foreign corporation in question.[31]

The term "controlled foreign corporation" means any foreign corporation of which more than 50 percent [32] of the total combined voting power of all classes of stock entitled to vote is either actually owned, or is considered owned,[33] by U.S. shareholders on any day of the taxable year of such foreign corporation.[34] Consequently, a foreign corporation that is owned equally by more than 10 shareholders will not qualify as a controlled foreign corporation because it will have no "U.S. shareholders". Also, certain corporations organized in the possessions of the United States are excluded from the definition of a controlled foreign corporation.[35]

Subpart F income of a controlled foreign corporation includes the following:[36]

(i) Income derived from the insurance of United States risks as determined under §953;

(ii) The foreign base company income as determined under §954;

(iii) Some international boycott income as defined in §952(a)(3); and

(iv) The amounts paid as illegal bribes or kickbacks to foreign government officials.

Excluded from the Subpart F income is income of the controlled foreign corporation which is U.S. source income effectively connected with a U.S. trade or business carried on by such corporation (unless such item is exempt from taxation (or is subject to a reduced tax rate) pursuant to a treaty obligation of the United States).

Foreign base company income, as defined in §954, includes the following:

(i) Foreign personal holding company income;

(ii) Foreign base company sales income;

(iii) Foreign base company services income;

(iv) Foreign base company shipping income; and

(v) Foreign base company oil and gas related income.

There are certain exclusions from foreign base company income which are enumerated below:

(i) Foreign base company income does not include foreign base company shipping income to the extent such income does not exceed the increase for the taxable year in qualified investments in foreign base company shipping operations of the controlled foreign corporation.[37]

(ii) If foreign base company income is less than 10 percent of gross income, no part of the gross income for the taxable year is treated as foreign base company income.[38]

(iii) Foreign base company income of a controlled foreign corporation does not include any item of income received by it if it is established to the satisfaction of the Secretary that neither the creation or acquisition of the controlled foreign corporation, nor the effecting of the transaction by the corporation giving rise to the potentially "tainted" income, had as one of its principal purposes a reduction of taxes.[39]

(iv) Foreign base company income does not include a controlled foreign corporation's income derived from the use of a vessel or an aircraft in foreign commerce between two points within the foreign jurisdiction in which the controlled foreign corporation was organized and in which the vessel or aircraft is registered.[40]

b. Subpart F Foreign Personal Holding Company Income

For purposes of Subpart F, the concept of foreign personal holding company income draws generally on the foreign personal holding company provisions of §553, with certain modifications which give effect to the anti-tax haven idea.

According to §553, FPHCI includes dividends, interest, income from stock and securities transactions, gains from commodities transactions, some items dealing with estates and trusts, personal service contract income, deemed income from the use of corporate property by a shareholder, and certain rents.

Modifications made to §553 by §954(c) include the following:

(i) Rents are included in Subpart F income without regard to the 50-percent limitation;[41]

(ii) Certain dividend, interest, and capital gain income derived from the active conduct of a trade or business is not included in FPHCI;[42] and

(iii) Certain dividend, interest, rents, and royalties income received from related persons is not included in FPHCI.[43]

The modifications that are relevant to the present discussion are discussed in more detail below.

(1) Active Trade or Business Modification

Section 954(c)(3) excludes from the Subpart F foreign personal holding company income category certain income, normally of a passive nature, which arises in the course of the active conduct of a foreign trade or business. The excluded income falls into three categories: (i) rents and royalties;[44] (ii) dividends, interest, and gains associated with banking and financing business;[45] and (iii) certain passive income associcated with the insurance business.[46]

With respect to the exclusion for investment income of

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banks and financial institutions, §954(c)(3)(B) provides that Subpart F FPHCI does not include interest, dividends, or securities gains derived from the conduct of a banking, financing, or similar business provided such income does not arise out of transactions with a related party. A controlled foreign corporation is treated as being engaged in the banking or financing business if its business consists of receiving deposits from the public, making loans to the public, dealing with the public as to bills and notes, issuing letters of credit, performing trust services, financing foreign exchange transactions, and conducting securities offerings.[47]

(2) Related Person Modification

Section 954(c)(4) excludes from the Subpart F FPHCI category certain income derived from related persons. Such income falls into three categories: (i) dividends and interest from a related person,[48] provided certain conditions are met; (ii) interest received in the active conduct of a banking or financing business from a related person engaged in a similar business, provided both parties do business predominantly with other parties;[49] and (iii) rents or royalties derived from a related person, provided the related person uses the property in the controlled foreign corporation's country of incorporation.[50]

Under §954(c)(4)(A), dividends or interest received from a related person is not Subpart F FPHCI if the following two conditions are met:

(i) The related person is organized under the laws of the same foreign country in which the controlled foreign corporation is organized; and

(ii) The related person has a substantial part of its trade or business assets located in its country of organization.

This exclusion is consistent with the tax haven base company concept that underlies Subpart F — income generated from related persons within the country of the CFC's incorporation is not foreign base company income.

Under §954(c)(4)(B), interest received by a bank, a financial institution, or a similar business entity engaged in the active conduct of a banking, financing, or similar business from a related party, which is also engaged in a similar business, is excluded from Subpart F foreign personal holding company income provided both the recipient and the payor do business predominantly with other parties.

c. Factoring Income as Subpart F Foreign Personal Holding Company Income

Sections 864(d)(1) and 864(d)(2) provide that if any person acquires a receivable from a related person any income derived from such receivable is treated as interest income for purposes of the Subpart F foreign personal holding company provisions.

Thus, if the foreign factoring company qualifies as a controlled foreign corporation, its income from factoring trade or service receivables of related parties will qualify as Subpart F foreign personal holding company income. Consequently, all "U.S. shareholders" of the foreign factoring company will be required to currently include in gross income their pro rata share of the factoring income of such company. For purposes of applying this rule, certain exclusions that are normally available from foreign base company income and Subpart F foreign personal holding company income do not apply. The exclusions that are not available to the foreign factoring company are as follows:

(i) Under §954(b)(3)(A), if foreign base company income of a controlled foreign corporation is less than 10 percent of gross income, no part of the gross income for the taxable year is treated as foreign base company income. This exclusion does not apply to related party factoring income earned by a controlled foreign corporation.[51] As a result, even if 90 percent or more of a controlled foreign corporation's gross income for a taxable year is non-foreign base company income, its related party factoring income will still be taxed currently to its U.S. shareholders as foreign base company income.

(ii) As discussed above, under §954(c)(3), interest and certain other income derived from the active conduct of a banking, financing or similar business is excluded from Subpart F foreign personal holding company income provided such income is received from a person who is not a related person within the meaning of §954(d)(3).[52] Also, under §954(c)(4)(B), interest and dividend income received in the active conduct of a banking, financing, or similar business from a related person (as defined in §954(d)(3)), which is also engaged in a similar business, is excluded from Subpart F foreign personal holding company income. Both of these exclusions do not apply to related party factoring income earned by a controlled foreign corporation engaged in a banking, financing, or similar business.[53]

Consequently, as a strict rule, any related party factoring income earned by a controlled foreign corporation engaged in a banking, financing, or similar business will be currently taxed to its U.S. shareholders as Subpart F foreign personal holding company.

(iii) As discussed above, under §954(c)(4)(A), interest and dividends received from a related person organized in and having substantial business assets in the recipient's country of organization are excluded from Subpart F foreign personal holding company income. This exclusion also does not apply to related party factoring income.[54] Consequently, if a controlled foreign corporation earns income from factoring the receivables of a foreign affiliate organized in and having substantial assets in the factoring company's country of organization, such income will be taxed currently to the factoring company's U.S. shareholders as Subpart F foreign personal holding company income.

Comment: The key to avoiding current taxation of related party factoring income as Subpart F income is to avoid the controlled foreign corporation status for the foreign factoring company.

4. Coordination of FPHC and Subpart F Provisions

Since the regular FPHC provisions and the Subpart F provisions overlap to a considerable extent, the income of a controlled foreign corporation, which also qualifies as a FPHC, is exposed to potential double taxation. Specifically, a foreign factoring company may qualify both as a FPHC and a controlled foreign corporation. In such a case, the question that must be faced is whether the related party

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factoring income must bear a current U.S. tax both as foreign personal holding company income and as Subpart F foreign personal holding company income.

Prior to the Tax Reform Act of 1984, §951(d) resolved this overlap issue by providing that a U.S. shareholder who, for his taxable year, was subject to tax under §551(b) on the income of a controlled foreign corporation was not required to include in gross income any amount under §951(a). In other words, the regular FPHC provisions took precedence over the Subpart F provisions.

For taxable years of U.S. shareholders beginning after July 18, 1984, however, the Tax Reform Act of 1984 has changed the coordinating rules of §951(d). Under the amended §951(d), if certain income is subject to tax both under the FPHC provisions and the Subpart F provisions, such income will be taxed under the Subpart F provisions only. Hence, if related party factoring income is taxable both as foreign personal holding company income and as Subpart F foreign personal holding company income, it will be taxed only as Subpart F foreign personal holding company income.

5. Special Separate §904 Limitation for Factoring Income

a. Section 904 Limitation in General

Since the basic purpose of the foreign tax credit is to prevent double taxation and not to reduce U.S. tax, §904 provides a limitation on the amount of foreign taxes that may be claimed as a credit against U.S. tax. The structure of §904 is designed to insure that the credit is not greater than the amount of U.S. tax attributable to the foreign source income generating the foreign tax. For example, A, a U.S. corporate taxpayer in the top tax bracket (*i.e.*, 46%), pays 50x dollars in income taxes to a foreign country Y on 100x dollars of taxable income from Y; §904 will limit the foreign tax credit to 46x dollars. A, however, is allowed to carry back the excess foreign tax credits (*i.e.*, 4x dollars) for two years and forward for five years. The U.S. multinationals doing business primarily in high-tax foreign jurisdictions, therefore, are normally in an excess foreign tax credit position. The §904 limitation is expressed in the form of a formula as follows:

$$\text{U.S. tax liability} \times \frac{\text{foreign source taxable income}}{\text{worldwide taxable income}}$$

The limitation is computed on an overall basis. That is, taxable income and losses from all foreign countries are aggregated in the numerator of the fraction of the §904 limitation formula, and the limitation is then applied to all taxes paid to foreign countries on an aggregate basis. Because of this overall method of computing the §904 limitation, taxes paid to foreign countries that exceed the top U.S. tax rate become creditable to the extent the taxpayer also has foreign source taxable income bearing a foreign tax rate lower than the top U.S. tax rate. Thus, one technique for absorbing the excess foreign tax credits is to generate foreign source taxable income in a low-tax foreign jurisdiction.

A U.S. taxpayer with excess foreign tax credits and large amounts of cash on hand could easily utilize its excess credits by exporting the cash to a low-tax foreign jurisdiction and earning foreign source interest income. This possibility, however, is foreclosed by §904(d) which provides for a separate §904 limitation on all foreign source interest income.[55] Thus, low-taxed foreign source interest income does not increase the §904 limitation on foreign taxes paid on non-interest foreign source income.

The separate limitation on interest income provision of §904(d), however, does not apply in the following four cases:

(i) Interest generated from any transaction which is directly related to the active conduct of a trade or business in a foreign country;[56]

(ii) Interest generated from the conduct of an active banking, financing, or similar business;[57]

(iii) Interest paid by a corporation in which the taxpayer owns, directly or indirectly, at least 10 percent of the voting stock;[58] and

(iv) Interest earned from obligations that were acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country, or as a result of the disposition of stock or obligations in a 10-percent owned corporation.[59]

b. Separate Limitation for Factoring Income

Sections 864(d)(1) and 864(d)(2) provide that income earned by any person from factoring the trade or service receivables of a related party is interest income to the factoring company for purposes of the §904 limitation. In addition, §864(d)(5)(A)(i) provides that the four exceptions (discussed above) to the separate §904 limitation on interest provided in §§904(d)(2)(A) - §904(d)(2)(D) do not apply to income recharacterized as interest under §864(d).

Since the factoring income, when taxed to the U.S. parent as foreign personal holding company income or Subpart F foreign personal holding company income, will retain its character as interest income under §904(g), the U.S. parent will be subject to the separate §904(d) limitation on such income but without the benefit of exceptions contained in §§904(d)(2)(A) - §904(d)(2)(D). Thus, the efficacy of the factoring technique for purposes of utilizing the excess foreign tax credits of U.S. companies has been effectively eliminated.

6. Special Rule for Possessions and Virgin Islands Corporations

Section 864(d)(5)(B) provides that the benefits of §§934 and 936 will not be available to related party factoring income of Virgin Islands and Possessions corporations, respectively.

a. Possessions Corporations

(1) Puerto Rico and Possessions Tax Credit

Section 936 of the Code provides a domestic corporation with a special credit if the domestic corporation elects to be treated as a possessions corporation. This credit is equal to the U.S. tax attributable to the possessions corporation's "qualifying income."[60] The "qualifying income" consists of foreign source income derived from the active conduct of a trade or business within a possession and the

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qualified possession's source investment income.[61] All nonqualifying income is taxed in the United States at regular corporate tax rates with the allowance of normal foreign tax credit.

In order to be eligible for a §936 election, a domestic corporation must meet the following two tests: [62]

(i) It must have derived 80 percent or more of its gross income for the three-year period immediately preceding the close of the current taxable year from sources within a possession; and

(ii) It must have derived 65 percent of its gross income for the same 3-year period from the active conduct of a trade or business within a possession. The 65 percent test applies for taxable years beginning in 1985 and later. The percentage is 60 percent for taxable years beginning in 1984.

Thus, an eligible U.S. corporation, which makes a §936 election, is effectively exempt from U.S. tax on its possessions source qualifying income under the credit mechanism.

(2) The Special Rule for Possessions Corporations

Concerned that a U.S. corporation, which otherwise qualifies for a §936 election, could base its factoring operations in a possession (*e.g.*, Puerto Rico) and earn related party factoring income free of U.S. tax under the §936 credit mechanism, Congress provided a special rule in §864(d)(5)(B)(i). This concern was expressed in the Senate Finance Committee Report as follows:

"In certain cases, if the bulk of a taxpayer's income is derived from the conduct of a trade or business in a U.S. possession, and if the bulk of the taxpayer's income arises within a possession, favorable U.S. tax rules apply. For example, in the case of a U.S. corporation, foreign source business income earned in the possessions generally (most notably Puerto Rico) may be effectively exempt from U.S. tax under the possessions tax credit (sec. 936). Similarly, in the case of a Virgin Islands corporation or a U.S. corporate inhabitant of Virgin Islands, the United States may impose no tax on its income, and the Virgin Islands may reduce its tax on the corporation's income (sec. 934(b)). Under present law, it is not clear if income from factoring is derived from the active conduct of a trade or business for the purpose of these rules. Similarly, it is unclear whether factoring income arises where the factor has its place of business, where the obligor of the receivable resides or does business, or where the seller of the receivable resides or does business. If income from factoring constitutes income from the active conduct of a trade or business at the place where the factor does business, income from a factoring business in a U.S. possession may be eligible for these favorable tax rules." [63]

Section 864(d)(5)(B)(i) provides that related party factoring income (which is recharacterized as interest under §864(d)(1) for limited purposes) shall not be treated as "qualifying income" [64] eligible for the §936 credit. This denial of "qualifying income" status, however, does not apply to that portion of related party factoring income which is considered possessions source income after applying §864(d)(1). Thus, income from factoring a receivable of an obligor who is a possessions resident will not be denied the "qualifying income" status.

Comment: The special rule of §864(d)(5)(B)(i) is needed because the recharacterization of the related party factoring income as interest under §864(d)(1), together with its concomitant sourcing rules, applies only for the limited purposes of the FPHC, Subpart F, and §904 provisions. In the absence of this rule, if an electing §936 corporation were to base its factoring operations in a possession and perform all factoring services in the possession, then, under GCM 39220, its factoring income would be considered derived from the active conduct of a trade or business in a possession. Such income, therefore, would qualify for §936 credit and escape U.S. taxation.

The impact of the special rule in §864(d)(5)(B)(i) is to deny a §936 credit for related party factoring income to the extent that such income is derived from factoring the receivables of obligors who are not residents of a possession. It should be noted, however, that to the extent related party factoring income is considered derived from the active conduct of a trade or business in a possession under GCM 39220, it may enable a U.S. corporation to meet the 80 percent and the 65 percent tests of §936(a)(2).

b. The Virgin Islands Corporations

(1) Section 934

Section 934(a) limits the Virgin Islands government's power to make grants or subsidies (by way of incentives or otherwise) that reduce, directly or indirectly, income taxes payable to it. Section 934(b) excepts subsidies for Virgin Islands or U.S. corporations which meet certain requirements. Specifically, §934(b) provides that §934(a) does not apply to a U.S. or a Virgin Islands corporation's non-U.S. source income, provided the corporation meets the following two tests:

(i) It derived 80 percent or more of its gross income for the 3-year period immediately preceding the close of the current taxable year from sources within the Virgin Islands; and

(ii) It derived 65 percent or more of its gross income over the same 3-year period from the active conduct of a trade or business within the Virgin Islands.

(2) Special Rule for the Virgin Islands Corporations

Section 864(d)(5)(B)(ii) contains a special rule for Virgin Islands corporations. It provides that the exception in §934(b) does not apply to any related party factoring income which is recharacterized as interest under §864(d)(1). The exception in §934(b), however, remains available for that portion of the related party factoring income which, after applying §864(d)(1), is considered derived from the Virgin Islands sources; *i.e.*, income from factoring receivables of obligors who are resident in the Virgin Islands.

The impact of §864(d)(5)(B)(ii) is to forestall any action on the part of the Virgin Islands government to provide tax incentives with a view to attract factoring companies to the Virgin Islands.

B. U.S. Taxation of the Foreign Factoring Subsidiary

Section 864(d) is silent as to the U.S. tax treatment of

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the foreign factoring subsidiary. The Conference Committee Report, however, does state that:

> "A foreign corporation earning income from a trade or service receivable of a U.S. obligor will not be taxable currently on that income (under Code sec. 881)." [65]

This statement implies that the related party factoring income recharacterized as interest under §864(d)(1) is not subject to U.S. withholding tax even where such interest is sourced to the United States. A foreign factoring subsidiary, therefore, remains subject to U.S. income tax on related party factoring income to the extent that such income is considered effectively connected with a U.S. trade or business under GCM 39220. Thus, for example, a foreign factoring subsidiary of a U.S. parent, which factors the parent's receivables on a regular basis and engages a U.S. agent for collection activities in the United States, may be subject to U.S. tax under §11 on that portion of its factoring income which is attributable to U.S. collection activities of its agent.

C. Receivables of U.S. Obligors Treated as "United States Property" Under §956

1. Section 956 Generally

Prior to 1962, U.S. shareholders of foreign corporations (which did not qualify as foreign personal holding companies) were not subject to U.S. income tax on the earnings of such corporations until the earnings were repatriated to the United States as dividend, redemptions, or liquidating distributions. United States taxpayers could, therefore, incorporate foreign entities and accumulate and multiply the earnings of these corporations free of U.S. income tax and often of foreign income taxes as well.

The U.S. Congress's concern that certain U.S. persons in control of foreign corporations were abusing the "deferral" privilege led to the enactment of the Subpart F provisions (§§951 - 971) in the Revenue Act of 1962. These provisions eliminated the deferral privilege for certain specific types of income (designated as Subpart F income) by subjecting the "U.S. shareholders" of "controlled foreign corporations" to current U.S. income tax on such income.[66] This is accomplished by treating the Subpart F income as a constructive dividend to the U.S. shareholders in the current taxable year.

As part of the Subpart F legislation, the Revenue Act of 1962 also enacted §956. Under §956, to the extent a controlled foreign corporation invests its current or accumulated earnings in the "United States property," such earnings are taxed to the "United States shareholders" of the controlled foreign corporation in the year in which the investment occurred. In enacting §956, Congress in effect provided that, when a controlled foreign corporation acquired U.S. property, the U.S. shareholders of the foreign corporation would be treated as if they received a cash dividend equal to the purchase price of the property and then contributed the cash back to the foreign corporation which purchased the property. The rationale for this treatment is described in the Senate Finance Committee Report:

> "earnings brought back to the United States . . . are substantially the equivalent of a dividend." [67]

Section 951(a)(1)(B) requires a United States shareholder of a controlled foreign corporation to include in his gross income as a constructive dividend his pro rata share (as determined under §956(a)(2)) of the foreign corporation's increase in earnings invested in United States property for such year. The calculation of the amount of the CFC's increase in earnings invested in "United States property" for a given year is made by comparing the earnings invested in U.S. property at the end of the year in question with the amount of earnings so invested at the end of the preceding year. The amount of a CFC's investment in U.S. property on a given date is the adjusted basis of the property less any liabilities. This amount is then subject to the dividend limitation. Thus, the computation of a CFC's increase in investments in U.S. property involves the following steps:

> (i) The CFC's adjusted basis (less liabilities) in all "United States property" owned by it at the end of current taxable year is compared with the CFC's current or accumulated earnings and profits in order to determine the portion of such earnings "which would have constituted a dividend had it been distributed;"
>
> (ii) The same calculation is made for the CFC as of the end of the preceding taxable year; and
>
> (iii) The result in step (ii) is subtracted from the result in step (i) in order to arrive at the CFC's increase in the United States property.

Section 956(b)(1) defines the term "United States property" to include:

> (i) Tangible property located in the United States;
>
> (ii) Stock of a domestic corporation;
>
> (iii) An obligation of a United States person; and
>
> (iv) Any right to use in the United States of a patent, a copyright, a secret process or formula, or any other similar property right.

In addition to property which it owns directly, a CFC is also considered to hold indirectly any other investments in United States property held on its behalf by a trustee, a nominee, or a second CFC controlled by the first CFC, provided the second CFC is created or availed of by the first CFC principally for the purpose of holding United States property.[68] This rule was applied by the Service in Rev. Rul. 76-192, 1976-1 C.B. 205, where a wholly-owned CFC (X) of a domestic parent (Y) sold debt obligations to underwriters for resale outside the United States. The proceeds of the sale were deposited, in the form of a demand deposit, with an unrelated foreign financial institution. Subsequently, Z, a newly formed wholly-owned subsidiary of Y, borrowed from the financial institution an amount equal to X's deposit for two years at an arm's length rate. Z then reloaned the proceeds of the loan to Y for the same term at a substantially similar interest rate. The Service ruled that an overall plan existed by which Z was availed of by X principally for the purpose of holding Y's obligations on X's behalf. Consequently, there was an investment of the earnings of X in United States property in an amount equal to Z's loan to Y to the extent of X's earnings and profits available for distribution as a dividend.

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Section 956(b)(2) provides a list of investments which are not regarded "United States property":

(i) U.S. Government obligations, money, and bank deposits;

(ii) Certain export property;

(iii) Certain obligations arising out of the sale or processing of property;

(iv) Aircraft, vessels, and other property used in international transportation;

(v) The investment by an insurance company of its unearned premiums or reserves from the insurance of foreign risks;

(vi) The stock or debt obligations of unrelated U.S. corporations;

(vii) Movable property used in exploring on the U.S. continental shelf; and

(viii) Assets equal to the earnings of the CFC that have been taxed as effectively connected income.

In addition, Regs. §1.956-2(d)(2) provides that the term "obligation of a United States person" does not include: (i) any indebtedness arising out of the involuntary conversion of property which is not United States property; or (ii) any indebtedness (other than an indebtedness arising in connection with sale or processing of property) which is collected within one year from the time incurred, or which matures within one year but is not collected by reason of inability or unwillingness of the debtor to make the payment.

Finally, under §956(c), a CFC is considered holding an obligation of a United States person if it is a pledgor or guarantor of such obligation.

2. Receivables of U.S. Persons Treated as United States Property

Section 138(b) of the Tax Reform Act of 1984 adds a new paragraph (3) to subsection (b) of §956. It provides that, notwithstanding the exceptions contained in §956(b)(2), the term "United States property" includes any trade or service receivable provided:

(i) Such receivable is acquired (directly or indirectly) from a related person who is a U.S. person; and

(ii) The obligor under the receivable is a United States person.

Comment: Since the purpose of new §956(b)(3) is to prevent a tax-free repatriation of untaxed foreign earnings, it makes sense to include the receivables within the United States property net only if such receivables are acquired from a related U.S. person. Foreign-to-foreign factoring, therefore, would not result in §956 consequences.

Comment: The requirement in §956(b)(3)(A)(ii) that the obligor under the receivable be a U.S. person leaves a gap in the statutory provision because it apparently excepts from the definition of "United States property" receivables acquired from a related U.S. person if the obligor is a foreign person. One of the objectives of a related party factoring arrangement is to place the untaxed foreign earnings at the disposal of a U.S. parent without attracting a U.S. dividend tax. To the extent a foreign factoring subsidiary factors the receivables of its U.S. parent or affiliates generated from sales to foreign customers, such objective could still be achieved.

The terms "related person" [69] and "trade or service receivable",[70] as used in §956(b)(3)(A), have the same meanings as in §864(d).[71]

The Conference Report enumerates certain techniques involving the avoidance of §956(b)(3) and directs the Secretary to promulgate regulations bringing these as well as other avoidance techniques within the §956(b)(3) net.[72] These techniques and their treatment are described below:

(i) For purposes of applying §956(b)(3), the substitution of any party for the obligor will be disregarded. For example, if a U.S. purchaser of goods pays for the goods by establishing a line of credit with a foreign bank whose note the seller of the goods takes and sells at a discount to its foreign subsidiary, the income from the bank's obligation in the hands of the foreign subsidiary will be U.S. source income and the acquisition of the bank's obligation will constitute an investment in U.S. property.

(ii) The principles of Rev. Rul. 76-192 (discussed above) will apply to §956(b)(3).

Example: A, a controlled foreign corporation, has accumulated substantial earnings and profits. It organizes a wholly-owned foreign corporation B with a small equity contribution. A deposits $10 million with a foreign financial institution. Soon thereafter, B borrows $10 million from the same financial institution and uses these funds to purchase the receivables of U.S. obligors from A's U.S. parent, P. Under the rationale of Regs. §1.956-1(b)(4) and Rev. Rul. 76-192, there is an investment of the earnings of A in United States property equal to $10 million for purposes of §956(b)(3). The same result will obtain if A, instead of depositing $10 million with the foreign financial institution, contributes this amount to the capital of B.

(iii) Section 956(b)(3) will apply to treat the purchase by a CFC of an obligation of an unrelated U.S. person as an investment in U.S. property where a related U.S. person guarantees such obligation. Thus, for example, a loan by a CFC to a purchaser of goods or services of a related party will be treated as an acquisition by the CFC of the borrower's receivable if the seller (a related party) guarantees or otherwise secures payment to the CFC.

Section 864(d)(7) contains the statutory authority for the Secretary to issue regulations under §956(b)(3) foreclosing the use of avoidance techniques enumerated above (as well as any other avoidance techniques).

D. Effective Date

The provisions of §§864(d) and 956(b)(3) apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date.[73]

Section 123(c)(2) of the Tax Reform Act of 1984, however, provides a transitional rule for a certain Belgian corporation in existence on March 1, 1984. Under this

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transitional rule, the U.S. shareholders of this Belgian corporation are not required, by reason of §956(b)(3), to include in gross income an amount equal to the Belgian corporation's adjusted basis on March 1, 1984, in stock of another foreign corporation (up to a maximum of $15,000,000) formed to issue bonds outside the United States to the public.

E. Related Party International Factoring Arrangements — Dead or Alive?

Section 123 of the Tax Reform Act of 1984 may have dealt a death-blow to related party international factoring arrangements as such arrangements were known prior to the Act. But related party international factoring may not be dead and buried. It is possible that related party international factoring will re-emerge in another shape or form. The application of anti-factoring rules enacted by the Act is predicated upon the foreign factoring company qualifying as a controlled foreign corporation under §957(a). Consequently, if the factoring company can avoid the CFC status, it will avoid the major impact of new §§864(d) and 956(b)(3). For example, a foreign factoring company organized in a tax haven jurisdiction and equally owned by 11 U.S. shareholders will not qualify as either a foreign personal holding company or a controlled foreign corporation. If such a factoring company performs all of the factoring activities in its country of incorporation, it will avoid all current U.S. tax both at the corporate and the shareholder level.

Section 957(c) also provides that a corporation organized or created under the laws of Puerto Rico or a possession does not qualify as a "controlled foreign corporation" if: (i) 80 percent of its gross income for the 3-year period immediately preceding the close of current taxable year was Puerto Rico or possession source income; and (ii) 50 percent or more of its gross income over the same period was derived from certain active trades or businesses conducted within Puerto Rico or a possession. Consequently, a Puerto Rican or a possession's corporation, which meets the 80-percent and the 50-percent tests of §957(c), may be used to factor the receivables of related parties.

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[1] This could be accomplished by an injection of cash in the form of a loan or equity contribution by the cash-rich controlled foreign corporation to an existing or a newly-organized foreign factoring subsidiary, which, in turn, used the cash to purchase the U.S. parents' trade receivables.

[2] A properly structured factoring operation avoided all U.S. tax on the discount income both in the hands of the foreign factoring subsidiary and in the hands of the U.S. parent as Subpart F income.

[3] Although in this case S itself acted as a factor, the factoring operations could be performed by a separate single-purpose foreign subsidiary of the U.S. parent; *see* footnote 1, *supra*.

[4] Roin and Rosenbloom, "Bringing Foreign Profits Back to the U.S. by Factoring: How to Use This Technique," 58 J. of Tax. 164 (1983).

[5] §1442(a). Unless otherwise indicated, all references herein are to the Internal Code of 1954, as amended.

[6] §§553(a) and 954(c).

[7] Note that a "bona fide sale" characterization was not affected if the U.S. parent of the foreign factoring subsidiary performed the collection activities in its capacity as an agent of the subsidiary. GCM 39220, the background document for PLR 8338043, observes, in relevant part, that "Although the finance company had the right, under the contract with the taxpayer, to collect the accounts, it in fact did not do so. The taxpayer did not notify the customers that their accounts had been sold and, as agent for the finance company, the taxpayer collected the accounts. In the instant case, P intends to collect the accounts for [S]. We do not believe this fact indicates that the transaction is a loan."

[8] Since factoring of trade accounts receivable is basically a financing activity requiring an investment of substantial capital, the discount income, at least partially, is interest.

[9] §863(b).

[10] §863(b)(1).

[11] §864(b).

[12] §§1441(c)(1) and 1442(a).

[13] §§864(c)(3) and 864(c)(4).

[14] Subpart F foreign personal holding company income also includes interest, but since the discount income was characterized as services income it avoided categorization as Subpart F foreign personal holding company income.

[15] §954(e); Regs. §1.954-4(a).

[16] H.R. Rep. No. 432 (Part 2), 98th Cong. 2d Sess. p. 1305 (1984).

[17] §864(d)(1).

[18] §864(d)(2).

[19] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 932 (1984).

[20] §864(d)(6).

[21] §864(d)(3).

[22] §864(d)(4).

[23] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 931 (1984).

[24] §552(a)(1).

[25] §552(a)(2).

[26] §904(g).

[27] §§951(a)(1)(A), and 951(a)(1)(B).

[28] §951(a)(1)(A)(i); Regs. §1.951-1(a).

[29] §7701(a)(30). For a more detailed discussion of this concept, see 432 T.M., *Subpart F — Background, Basic Concepts and Terminology*.

[30] The constructive ownership rules of §958 apply for this purpose.

[31] §951(b). *See* also *432 T.M., Subpart F — Background, Basic Concepts and Terminology*.

[32] This requirement is 25 percent in the case of foreign corporations which derive income from the insurance or reinsurance of U.S. risks (*See* Regs. §1.957-2 and §957(b)).

[33] The constructive ownership rules of §958 apply for this purpose.

[34] §957(a); Regs. §1.957-1.

[35] §957(c).

[36] §952(a).

[37] §954(b)(2).

[38] §954(b)(3)(A).

[39] §954(b)(4).

[40] §954(b)(7).

[41] §954(c)(2).

[42] §954(c)(3).

[43] §954(c)(4).

[44] §954(c)(3)(A).

[45] §954(c)(3)(B).

[46] §954(c)(3)(C).

[47] Regs. §1.954-2(d)(2)(ii).

[48] §954(c)(4)(A).

[49] §954(c)(4)(B).

[50] §954(c)(4)(C).

[51] §864(d)(5)(A)(ii).

[52] Note that factoring income (characterized as interest by §864(d)) received from a U.S. person controlling, directly or indirectly, less than 50 percent of the total combined voting power of the foreign banking or financial institution will qualify as interest received from an unrelated party under §954(d)(3).

[53] §§854(d)(5)(A)(iii) and (iv).

[54] §864(d)(5)(A)(iv).

[55] §904(d)(1)(B) also requires that the §904 limitation be computed separately for dividends from a DISC or former DISC.

[56] §904(d)(2)(A).

[57] §904(d)(2)(B).

[58] §904(d)(2)(C).

[59] §904(d)(2)(D).

[60] §936(a)(1).

[61] The qualifying possessions source investment income is defined in §936(d)(2) to include investment income from sources within a possession

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in which an active trade or business is conducted, provided the taxpayer establishes that such income is attributable to the investment in such possesson of funds derived from the active business or such investment.

[62] §936(a)(2).

[63] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess., p. 348 (1984).

[64] As stated earlier, the term "qualifying income" is defined in §936(a)(1) to include foreign source income derived from the active conduct of a trade or business within a possession and the qualified possessions source investment income.

[65] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 931 (1984).

[66] For an outline of the Subpart F provisions, *see* III, A, 3, a, supra.

[67] S. Rep. No. 1881, 87th Cong. 2d Sess. p. 88 (1962).

[68] Regs. §1.956-1(b)(4).

[69] *See* III, A, 1, a, (4), *supra.*

[70] *See* III, A, 1, a, (3), *supra.*

[71] §956(b)(3)(B).

[72] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 933 (1984). *See* §864(d)(7), which specifically authorizes the Secretary to issue regulations in order to prevent the avoidance of §956(b)(3).

[73] Section 123(c)(1) of the Tax Reform Act of 1984 (P.L. 98-369).

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CHAPTER 68

AMENDMENTS TO SECTION 1248 RULES

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I. Elimination of Double Taxation of Earnings and Profits of Certain CFCs

A. Introduction

Under §1248(a), gain recognized upon the sale or exchange of stock in a controlled foreign corporation ("CFC") by a United States shareholder (a U.S. person who owns directly, indirectly, or constructively at least 10 percent of the total combined voting power of all voting stock) is included in the gross income of such U.S. shareholder as a dividend to the extent of the earnings and profits of the CFC accumulated in post-1962 years during the period the stock was held by the U.S. shareholder. This basic rule also applies to deemed exchanges under §302 or §331. The Tax Reform Act of 1976 added §1248(f) to the Code, which applied a similar rule to the sale or exchange of CFC stock by a U.S. corporation in a §311, §336, or §337 transaction.

For purposes of determining the extent to which the U.S. shareholder's gain from the sale or exchange of CFC stock is characterized as ordinary dividend income under §1248, the determination of the CFC's post-1962 earnings and profits accumulated during the U.S. shareholder's period of ownership is crucial. The Code, therefore, provides extensive rules for determining the CFC's earnings and profits for §1248 purposes. The starting point is the earnings and profits used to determine whether a distribution is taxable as a dividend. However, there are several adjustments which must be made.

Section 1248(c)(1) makes inapplicable the special rule of §312(k)(4), which provides special depreciation rules for foreign corporations which have less than 20 percent U.S. income. Section 1248(c)(2) includes in the earnings and profits of the foreign corporation the earnings and profits of its subsidiaries. Section 1248(d) provides five specific exclusions from earnings and profits: amounts taxed under Subpart F, amounts excluded under §337 (12-month liquidations), earnings and profits of less developed country corporations, effectively connected income, and amounts subject to tax under §1247 (foreign investment companies). In addition, Regs. §1.1248-3(e)(3) provides an exclusion for amounts taxed as undistributed foreign personal holding company income.

Since the basic thrust of §1248 is to impose U.S. tax at ordinary income rates when untaxed foreign income is repatriated, one might conclude that the CFC's post-1962 accumulated earnings and profits should be subject to dividend tax only once. The structure of §1248 in fact achieves this result because successive owners of stock in a CFC are taxed at ordinary income rates under §1248 only with respect to those earnings and profits which were accumulated while they held the stock. The problem, however, arises when subsequent to a §1248 disposition, the CFC distributes a dividend. Unless the CFC's earnings and profits are reduced by the amount treated as a dividend under §1248, the subsequent distribution by the CFC would again cause dividend treatment on account of the same earnings and profits. In addition, if the earning and profits adjustment is not made, the new stockholder may claim a deemed paid foreign tax credit for taxes paid by the CFC which already have been credited by the previous owner.

Prior to the Tax Reform Act of 1984, both the statute and the regulations were silent on this issue. In Rev. Rul. 71-388, 1971-2 C.B. 314, however, the Service ruled that the earnings and profits of a CFC were not affected by the amount of gain (realized from the sale or exchange of the CFC stock) that was treated as a dividend under §1248. Subsequently, in Rev. Rul. 83-182, I.R.B. 1983-51, 12, the Service announced that it was reconsidering the issue and that, accordingly, the relevant part of Rev. Rul. 71-388 (holding that no earnings and profits adjustment was required for the amounts treated as dividends upon the sale or exchange of the CFC stock) was suspended.[1]

Section 133 of the Tax Reform Act of 1984 resolves the problem, although not by providing for an E&P adjustment, but by providing a mechanism which ensures that the amount of gain derived from the disposition of CFC stock and taxed as dividend income under §1248(a) or §1248(f) is not again taxed in the hands of the seller's successor-in-interest when actually distributed.

B. Detailed Analysis

Section 133(b) of the Tax Reform Act of 1984 (P.L. 98-369) adds a new subsection (e) to §959 and a new subsection (j) to §1248. Section 959(e) contains the substantive rule, whereas §1248(j) merely contains a cross-reference to §959(e). Specifically, §1248(j) provides that:

> "For provision excluding amounts previously taxed under this section from gross income when subsequently distributed, see section 959(e)."

Section 959(e) provides that:

> "For purposes of this section and section 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the

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gross income of such person under section 951(a)(1)(A)."

The general rule of §959 is that when a CFC's earnings and profits are taxed to its U.S. shareholders as Subpart F income under §951(a)(1)(A), any subsequent actual distribution of such previously-taxed earnings and profits is tax-free both in the hands of the U.S. shareholder who included in gross income such earnings and profits as Subpart F income and in the hands of the U.S. shareholder's successor-in-interest.[2] Thus, under new §959(e), whenever a U.S. shareholder sells or exchanges stock in a CFC (or a U.S. corporate shareholder sells or exchanges the CFC stock in a §311, §336, or §337 transaction) and recognizes gain which is characterized as ordinary dividend income under §1248(a) (or §1248(f)), then any subsequent distribution of earnings and profits previously taxed as a §1248(a) or §1248(f) dividend to the selling or exchanging shareholder's successor-in-interest will be tax-free.

Comment: Section 959(e) places emphasis on the necessity for a U.S. person, who acquires an interest in a controlled foreign corporation, to make sure that he can later demonstrate the prior Subpart F history of the shares. Particularly, the successor-in-interest must be able to satisfy the Service that the amounts in question were previously taxed under either §1248(a) or §1248(f).

Also, the treatment of §1248(a) or §1248(f) gain as previously taxed Subpart F income for §960(b) purposes ensures that foreign tax credit is obtained only once with respect to such earnings and profits.

Section 959(e) is generally effective with respect to transactions (subject to §1248(a) or §1248(f)) occurring after July 18, 1984.[3] However, if a taxpayer makes an appropriate election, §959(e) will apply to transactions (subject to §1248(a) or §1248(f)) occurring after October 9, 1975.[4] The election must be made no later than January 14, 1985, in the manner prescribed by the Secretary.[5]

II. Section 1248 E&P to Include E&P Accumulated by a Lower-Tier Subsidiary During Periods of Direct Ownership

A. Introduction

Section 133(c) of the Tax Reform Act of 1984 (P.L. 98-369) corrects an obvious error in §1248(c)(2)(D)(ii), which, in the past, has enabled taxpayers to make an end run around §1248.

Section 1248(a) recharacterizes gain recognized on the sale or exchange of stock in a controlled foreign corporation by a U.S. person who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all voting stock. The gain is treated as dividend income to the extent of the CFC's post-1962 earnings and profits accumulated during the period of the seller's stock ownership.

Section 1248(c)(2) provides that earnings and profits of any lower-tier foreign corporation shall be included in the earnings and profits of the first-tier foreign corporation, but not in excess of the appreciation in value of the lower-tier foreign corporation. The special rule of §1248(c)(2) applies when:

(i) §1248(a) or §1248(f) applies to a sale, exchange, or distribution by a U.S. person of stock of a foreign corporation;[6]

(ii) the U.S. person who owns stock in the foreign corporation that is being sold, exchanged or distributed, as a result of such stock ownership, is considered to own stock of a lower-tier foreign corporation by reason of §958(a)(2);[7] and

(iii) the U.S. person owned (within the meaning of §958(a) or §958(b)) at least 10 percent of the total voting power of the lower-tier foreign corporation at any time during the five-year period (ending on the date of the liquidation) when the lower-tier foreign corporation was a controlled foreign corporation.[8]

If conditions (i), (ii) and (iii) are met, the earnings and profits of the first-tier foreign corporation are deemed to include the earnings and profits of the lower-tier foreign corporation to the extent that: (i) the lower-tier foreign corporation's earnings and profits are attributable to its stock owned indirectly by the U.S. person as a result of his actual ownership of stock in the first-tier foreign corporation on the date of the sale or exchange (or on the date of any sale or exchange of the stock of the lower-tier foreign corporation occurring before the five-year period, but not in excess of the appreciation as of such date);[9] and (ii) the lower-tier foreign corporation's earnings and profits were accumulated during its taxable years beginning after December 31, 1962, while (a) the lower-tier foreign corporation was a controlled foreign corporation,[10] and (b) the U.S. person owned within the meaning of §958(a)(2) the stock of such foreign corporation.[11]

Section 958 provides rules for determining stock ownership. Section 958(a)(1) defines stock ownership as "stock owned directly and stock owned with the application of paragraph (2)." Section 958(a)(2) deals with indirect ownership through foreign entities.

The reference to §958(a)(2) in §1248(c)(2)(D)(ii) leaves a gap in the statutory scheme. For example, if the U.S. parent contributes the stock of a lower-tier CFC to a first-tier CFC and then sells the stock of the first-tier CFC, under a literal reading of §1248(c)(2)(D)(ii) the §1248 earnings and profits of the first-tier CFC will not include the lower-tier CFC's earnings and profits accumulated during the period it was owned directly by the U.S. parent. This amount, therefore, would escape dividend characterization under §1248(a).

While §133(c) of P.L. 98-369 was in draft form, the Service issued Rev. Rul. 84-72, I.R.B. 1984-20, 4, dealing with this issue. Under the facts of the ruling, P, a domestic corporation, owned directly all of the stock of foreign corporations FS1 and FS2 since their incorporation in 1964. In 1980, P transferred the stock of FS2 to FS1 for FS1 non-voting stock, and obtained favorable rulings under §§351 and 367(a). In 1981, in an unrelated transaction, P sold the FS1 stock. The Service conceded that the language of §1248(c)(2)(D)(ii) literally provides that only the earnings and profits of FS2 that were accumulated while FS2 was a subsidiary of FS1 should be aggregated with those of FS1 for purposes of §1248(a). The Service then asserted that §1248 does not really address a situation in which

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there is a sequential mixture of direct and indirect ownership, and that the omission of the period of direct ownership from the express language of the statute was not dispositive of the issue. It pointed out that all of FS2's earnings and profits would have been aggregated with those of FS1 if, prior to 1980, FS2 had been wholly owned by FS1, which had been wholly owned by P. The Service also pointed out that §1248(a) would have applied to FS2's earnings and profits if FS2 had been sold by P before being transferred to FS1. The Service stated that a failure to aggregate all of FS2's earnings and profits with those of FS1 would be clearly unwarranted because distinction between direct and indirect ownership has no relevance to the purpose of Congress in enacting §1248. Accordingly, it held that, for purposes of §1248, the earnings and profits of FS1 included the earnings and profits of FS2 accumulated since 1964.

B. Detailed Analysis

Section 133(c) of P.L. 98-369 resolves the controversy by substituting §958(a) for §958(a)(2) in Code §1248(c)(2)(D)(ii). The amendment to §1248(c)(2)(D)(ii) is effective for transactions (subject to §1248) occurring after July 18, 1984.

Thus, for purposes of characterizing the gain as dividend income, upon the disposition of stock in a CFC by a U.S. shareholder after July 18, 1984, the earnings and profits of the CFC will include the earnings and profits of any lower-tier CFC accumulated during the period the lower-tier CFC was owned directly by the U.S. shareholder.

III. Section 1248 to Apply in Certain Indirect Transfers of Stock

A. Introduction

Section 133(a) of the Tax Reform Act of 1984 (P.L. 98-369) is aimed at a specific technique utilized by certain taxpayers to avoid §1248. The technique involves the acquisition of the widely-owned U.S. parent's stock by the CFC in exchange for its own shares and small amounts of cash.

Section 1248, which treats the gain recognized from the disposition of CFC stock by a U.S. person owning 10 percent or more of the CFC's voting stock as dividend income, is designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a CFC and then disposing of the stock at capital gain rates for a price that reflects the accumulated earnings and profits (which would be taxable as ordinary income if repatriated as dividends). Since the above technique attempts to circumvent this purpose of §1248, Congress included §133(a) in P.L. 98-369. The Senate Finance Committee Report observes that:[12]

> "The purpose of the provision that recharacterizes gain upon the sale or exchange of stock in certain foreign corporations is to tax the accumulated profits of active foreign corporations upon repatriation. Although section 1248 has generally carried out this policy, it has come to the committee's attention that certain transactions may circumvent the statutory rules. For example, taxpayers have taken the position that section 1248 does not apply if a foreign corporation that is wholly owned by a widely held U.S. corporation issues new shares and pays a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation. If this interpretation is sustained, the shareholders of the U.S. corporation might pay a capital gains tax on the difference between the value of the foreign corporation's stock (plus the cash) and their basis in the stock in the U.S. corporation, but no ordinary income tax would be paid on the accumulated earnings and profits of the foreign corporation at that time. Further, because the transaction would result in the foreign corporation ceasing to be a controlled foreign corporation, earnings accumulated prior to the exchange could be permanently exempt from U.S. corporate tax. The committee is aware that present law is unclear, and intends no inference that the transaction works as described.
>
> "In the view of the committee, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would make a mockery of the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. The committee believes that a U.S. corporation should be required to recognize dividend income upon the acquisition of its stock by its wholly owned foreign corporation, to the extent that the U.S. corporation's ownership interest in the foreign corporation is reduced. This treatment is also appropriate in certain cases where a U.S. corporation owns less than 100 percent of a foreign corporation that is or was a controlled foreign corporation."

B. Detailed Analysis

Section 133(a) of P.L. 98-369 adds a new subsection (i) to §1248.

Section 1248(i) provides that where any shareholder of a U.S. corporation, which is a 10 percent or more corporate shareholder in a foreign corporation, exchanges stock in the U.S. corporation for the stock in the foreign corporation, for purposes of §1248, the foreign corporation's stock will be treated as if it had been issued to the 10-percent U.S. corporate shareholder and then distributed to the exchanging shareholder of such 10-percent corporate shareholder in redemption of his stock.

The term 10-percent U.S. shareholder means any domestic corporation which, as of the day before the exchange, satisfied the stock ownership requirements of §1248(a)(2).[13]

Thus, under §1248(i), when U.S. shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued or treasury stock of a foreign corporation in which the U.S. corporation is a 10-percent or more owner, the transaction will be recast. For purposes of applying §1248, the foreign corporation will be viewed as having issued the stock to the U.S. corporation and the U.S. corporation will be treated as having distributed that stock to its U.S. shareholders in redemption of their stock. Under §1248, the U.S. corporation, therefore, would be required to recognize dividend income equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corpora-

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tion's basis for its stock in the foreign corporation, to the extent of the foreign corporation's post-1962 accumulated earnings and profits.

The Senate Finance Committee Report contains the following example to illustrate §1248(i):[14]

> *"Example*: M, a U.S. corporation, is and always has been the sole shareholder of P, a foreign corporation. P, which was organized in 1959, has previously untaxed post-1962 earnings and profits of $40 million. M, whose shares are widely held, has assets worth $100 million (including P shares representing $40 million of value). In recent years, while profits from M's operations have declined, P's foreign operations have generated substantial income. M has a zero basis in the P stock. In addition, many of M's shareholders have losses in their M stock. M's shareholders transfer all of their stock in M to P in exchange for newly issued P stock representing 90 percent of the total number of outstanding P stock plus a *de minimis* amount of cash. After the exchange, P owns all of the outstanding stock of M, and the former M shareholders own stock of P with a value approximating $100 million. The principal purpose of this transaction was to enable the corporate group to retain and reinvest P's accumulated and future foreign earnings free of U.S. tax. On the basis of public and private rulings issued by the Internal Revenue Service and cases decided under the law in effect prior to enactment of the Internal Revenue Code of 1954, the parties to the transaction could take the position that the former M shareholders acquired all the P stock received by them in exchange for M stock worth $100 million, notwithstanding the fact that P's value was augmented by only $60 million dollars. *See* Rev. Rul. 84-30, 1984-9 I.R.B. 5; Rev. Rul. 57-465, 1957-2 C.B. 250; *Helvering v. Schoellkopf*, 100 F.2d 415 (2d Cir. 1938). But see *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959) (where a corporation that issued its stock in exchange for all the assets of its 79-percent owned subsidiary was treated as receiving the assets in consideration for its stock in the subsidiary by way of liquidation—to the extent of the 79-percent stock interest—rather than in a tax-free organization).
>
> "The bill taxes the transaction in accordance with its economic substance. The effect of the bill is to treat the excess of the value held by the former M shareholders after the exchange ($100 million) over the amount by which P's value was augmented ($60 million) as if M had distributed P shares equal to that difference ($40 million in the example) to its shareholders. Under the 1976 amendments to section 1248, M would recognize ordinary income of $40 million if the P stock were distributed as a dividend-in-kind or in liquidation. Similarly, under the bill, $40 million is includible in M's income as a dividend."

Section 1248(i) is effective for exchanges made after July 18, 1984, in taxable years ending after July 18, 1984.

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[1] The Service also issued Rev. Proc. 83-88, I.R.B. 1983-51, 17, which amplified Rev. Proc. 83-22 by adding the issue to the list of areas under extensive study in which no rulings are issued.
[2] Regs. §1.959-1(d).
[3] §133(d)(2) of P.L. 98-369.
[4] §133(d)(3)(A) of P.L. 98-369.
[5] §133(d)(3)(B) of P.L. 98-369.
[6] §1248(c)(2)(A).
[7] *Id.*
[8] §1248(c)(2)(B).
[9] §1248(c)(2)(C).
[10] §1248(c)(2)(D)(i).
[11] §1248(c)(2)(D)(ii).
[12] S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess., pp. 371-372 (1984).
[13] §1248(i)(2).
[14] *Supra*, note 12, at pp. 372-373.

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CHAPTER 69

OFFSHORE COMMODITY FUNDS

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I. Background

The use of offshore commodity funds to avoid taxes or to minimize tax liability in ways the Treasury found unjustifiable involved three "loopholes" in the pre-1984 TRA statutory provisions.

A. Accumulated Earnings Tax

The accumulated earnings tax provided by §531 is imposed on any corporation formed or availed of for the purpose of avoiding tax with respect to its shareholders by accumulating earnings rather than distributing them as dividends.[1] In the case of a foreign corporation having U.S. shareholders, the tax will apply with respect to any accumulated earnings attributable to income from U.S. sources. It will not, of course, apply where the shareholders are currently taxed on such income because the corporation is a personal holding company, a foreign personal holding company, or where the corporation is a controlled foreign corporation and the shareholders have sufficiently large (10 percent or more) interests to render them liable to tax under subpart F. The subsidiary (corporation S) of a foreign parent (corporation P) having U.S. shareholders is not subject to the §531 tax where it currently distributes its earnings to P as dividends.[2] S corporation can be availed of to engage in commodity futures trading in the U.S. Gains from such trading are not taxable by the U.S. since such trading through an independent agent is not treated as being engaged in a U.S. trade or business.[3] Moreover, although the gains are U.S. source income, they do not fall within the types of such income subjected to tax under §881. The trading income earned by S may then be distributed to P. In the hands of P, dividends from its foreign subsidiary do not constitute U.S. source income. Thus, if P has no other U.S. source income and is not engaged in conducting a U.S. trade or business, it is not subject to any U.S. taxes. The futures trading gains can thus be accumulated by P free from any U.S. income tax and exempt from the §531 tax so long as its stock is widely held by the U.S. shareholders.

B. Status as Foreign Investment Company

In the situation described above, P may carry on futures trading in countries other than the U.S. Since income from this activity is clearly not U.S. source income, no §531 tax is imposed on it. Further, where a U.S. shareholder sells his stock in P, the price will reflect the accumulated earnings attributable to the foreign futures trading. While the Code permits gain from the sale of stock in a foreign corporation to be treated as long-term capital gain where the shareholder has never held a 10 percent or greater interest in the corporation,[4] §1246(a)(1) provides that such gain, irrespective of the extent of the shareholder's interest, is to be treated as ordinary income to the extent of the shareholder's ratable share of the accumulated earnings and profits of the corporation since December 31, 1962, where the foreign corporation was a "foreign investment company" at any time during which the shareholder held the stock. The definition of a "foreign investment company" is (1) a company registered under the Investment Company Act of 1940, or (2) a corporation engaged in investing, reinvesting or trading in securities within the meaning of §3(a)(1) of such Act.[5] However, commodity futures are not "securities" within the meaning of the Act. Thus, P's commodity futures trading activity does not result in its having foreign investment company status. The gain from the sale of its shares attributable to the accumulated futures trading gains will not, therefore, be treated as ordinary income under §1246.

C. Avoidance of the Straddle Rules

Section 1092(a)(1) disallows and defers to later years any deductions with respect to losses sustained from positions of a straddle to the extent they do not exceed unrecognized gains from offsetting positions of such straddle. A straddle is defined as offsetting positions with respect to personal property.[6] "Personal property," for purposes of §1092 (prior to the 1984 TRA amendments) was defined as actively traded personal property other than stock.[7] A "position" in such property was defined as an interest (including a futures or forward contract or option) in such property.[8] The offshore commodity funds (P and S corporations in the foregoing discussion) could be formed or availed of to take positions in personal property offsetting positions taken by the shareholders of P. Where such shareholder held positions were disposed of at a loss, §1092 was inapplicable since the holding of stock in P was not treated as a "position in personal property," even though such stock, because of P's (or S's) holding of positions offsetting those of the shareholders, offset the loss positions. The loss deferral rule of §1092(a)(1) was thus avoided.

II. Overview

To deal with the above described sources of tax abuse, the following amendments were made to the Code by the 1984 TRA.

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A. Amendments to Section 535 (Defining "Accumulated Taxable Income")

Act §125(a) amends §535, adding new subsection (d) which provides the general rule that, for purposes of §§531-537,[9] if 10 percent or more of the earnings and profits of any foreign corporation for any taxable year is (A) derived from U.S. sources, or (B) effectively connected with a U.S. trade or business, any distribution out of such earnings and profits (and any interest payment) received by a "U.S. owned" foreign corporation is to be treated by the latter corporation as U.S. source income. This applies to distributions received directly or through one or more entities.[10] A "U.S. owned foreign corporation" has the meaning given that term by §904(g)(6) (as added to the Code by Act §121(a)): any corporation 50 percent or more of whose stock (voting power or value) is held directly or indirectly by U.S. persons. Indirect ownership is determined by application of §958(a)(2) and (3) and §318(a). "U.S. person" is defined by §7701(a)(30).

B. Amendments to Section 1246(b)(2)

Act §134(a) amends §1246(b)(2), defining "foreign investment company," as any foreign company engaged (or holding itself out as being engaged) primarily in the business of investing, revesting, or trading in: (A) securities (as defined as §2(a)(36) of the Investment Company Act of 1940, as amended), (B) commodities, or (C) any interest (including a futures or forward contract or option) in property described in (A) or (B) at a time when 50 percent or more of the stock (voting power or value) was held directly or indirectly by U.S. persons. Indirect stock ownership is determined by applying §958(a)(2) and (3) and §318(a).

C. Amendments to Section 1092

As is discussed in detail in chapter 27, §101 of the Act made numerous amendments to §1092. Of these, the most significant for purposes of this discussion were the amendments repealing the exclusion from the definition of "personal property" exchange — traded stock options, and, especially, the amendments made to §1092(d). Under new paragraph (3) of that subsection, while stock is still excluded from the definition of "personal property," there are provided three exceptions to this rule. Stock is personal property (and, as a result, direct ownership of such stock may be treated as a position in personal property for purposes of the loss deferral rule) where (1) the offsetting position is an option with respect to the stock, (2) the offsetting position is substantially similar or related property (other than stock)[11] and (3) where the stock is "any stock in a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder."[12]

D. Effective Dates

The amendment to §535 applies to distributions and interest payments received by U.S. owned foreign corporations on or after May 23, 1983 in taxable years ending after that date.[13] In the case of a U.S. owned foreign corporation in existence on May 23, 1983, the amendment applies to taxable years beginning after December 31, 1984.

The amendment to §1246(b)(2) applies to sales and exchanges (and distributions) on or after September 29, 1983 in taxable years ending after that date.[14] In the case of a sale or exchange (or distribution) no later than July 18, 1985, the amendment will not apply with respect to stock held by the taxpayer continuously from September 29, 1983 to the date of such sale, exchange or distribution.[15]

Section 1092(d)(3)(B)(ii) applies to any positions established on or after May 23, 1983 in taxable years ending on or after that date.

III. Detailed Analysis

The amendments to §§535 and 1246 described above appear effectively to deal with two of the perceived loopholes as set forth in the background, *supra*. A foreign corporation engaged in trading in commodity futures contracts or in options on such contracts (this will, presumably include both the buying and selling of such options and the granting of such options for premiums) or in trading in commodities at any time when 50 percent or more of its stock is held by U.S. shareholders, directly or indirectly, comes within the definition of a foreign investment company for purposes of §1246.

The amendments made to §535, described above, seem somewhat broader in scope than strictly needed to deal with tax avoidance by offshore commodity funds as set forth in the Overview. Where at least 10 percent of a foreign corporation's earnings and profits are attributable to either (a) U.S. source income (whether or not taxed under §881) or (b) to income effectively connected with a U.S. business (whether or not U.S. source income), distributions of such income to any corporation, 50 percent or more of whose stock is owned, directly or indirectly, by U.S. persons, are treated as U.S. source income for purposes of §§531-537 of the Code (but not for any other purposes). Distributions include the payment of interest. One problem which may well be encountered in applying these provisions is the determination of whether a given distribution or payment of interest is made from the tainted earnings where the distributing or paying corporation has other earnings. Some apportionment formula will undoubtedly be provided by regulations.

Observation: Such apportionment formula may conflict with the source of dividend rules for foreign tax credit purposes. But, typically, foreign commodity fund corporations are organized in tax haven countries so there probably will be few credit complications.

Determining a foreign corporation's earnings and profits attributable to commodity futures trading may itself present a number of difficulties. The somewhat complex mark to market rules of §1256 will apply, since presumably, the quantum of earnings and profits is to be determined under U.S. tax laws.

Finally, the determination, for purposes of §1092(d)(3)(B)(ii), of whether a corporation trading in positions in actively traded property has been "formed or availed of" to take positions offsetting those of *any shareholder* will, in some circumstances, almost certainly give rise to disputes. Some safe harbor guidelines would seem in order so that a taxpayer holding shares of a corporation engaged in dealing in commodities or other interests in property does not have to examine the corporation's hold-

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ings before investing in a position which may, if offset by another position, be subject to loss deferral. The legislation is, presumably, aimed at deliberate manipulation rather than the purely fortuitous simultaneous holding by a shareholder of a position the risk of loss with respect to which is reduced by his holding of stock of the corporation, or vise versa. It should be understood that the character of the corporation's holdings does not pass through to the shareholder. If the corporation holds, say, a regulated futures contract, its stock does not become subject to §1256. However, if it has been availed of to enter into the contract to reduce risk of loss by the shareholder who holds another such contract (which would offset the former if held by the shareholder), the stock of the corporation is a position in personal property and the shareholder thus holds a "mixed straddle" [16] to which the rules of §1092 apply."

Note that shares of stock in such a corporation constitute a position in personal property if the forbidden purpose exists with respect to any shareholder, regardless of whether or not a shareholder whose stock is treated as a position in personal property was even aware that the corporation was availed of to take offsetting positions. Thus, shareholder A, or a shareholder group of which A is a member, may cause the corporation to take positions offsetting positions held by them. Stock held by shareholder B, who played no part in this scheme, is equally tainted. Should such "innocent" shareholder enter into positions viewed under the very broad guidelines of §1092(c)(2) and (3) as "offsetting," he will be subject to the loss deferral rule of §1092(a)(1). This, however, is somewhat improbable. The language was probably framed so as to prevent any deficiencies from being challenged on the ground that the taxpayer played no role in the corporation's activities.

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[1] §532(a).
[2] §535(a); §561(a).
[3] §864(b)(2)(B).
[4] In which case, the provisions of section 1248 would apply treating the gain as ordinary income to the extent of the foreign corporation's earnings and profits accumulated since 1962 while the shareholder held the requisite stock interest.
[5] §1246(b)(1) and (2).
[6] §1092(c)(1).
[7] §1092(d)(1).
[8] §1092(d)(2).
[9] Part 1 of subchapter G, "Corporations Improperly Accumulating Surplus."
[10] §535(d)(1).
[11] §1092(d)(3)(B)(i).
[12] §1092(d)(3)(B)(ii).
[13] Act §125(b)(1).
[14] Act §134(b)(1).
[15] Act §134(b)(2).
[16] *See* §1256(d).
[17] §1092(d)(4)(A).

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CHAPTER 70

STAPLED STOCK TECHNIQUE NO LONGER AVAILABLE FOR DECONTROLLING A CFC

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I. Introduction

"Stapled stock" transactions have provided a unique opportunity to decontrol certain foreign corporations where control of those corporations by U.S. persons may have a significant impact on the tax liability of the controlled corporation and its shareholders. In a "stapled stock" transaction, stock of a foreign subsidiary of a U.S. corporation is distributed pro rata to the shareholders of the U.S. parent and then paired or "stapled" to the stock of the parent by restricting the transfer of the stock of one corporation without the transfer of the stock of the other. In some cases, the stock certificates of the stapled entities are printed on both sides of a single document. If the stock ownership of the domestic U.S. parent corporation is sufficiently widely-held, then the pro rata distribution of the stock of the foreign subsidiary to the shareholders of the U.S. parent will in most cases avoid the concentration of control in a few U.S. shareholders which is necessary for the corporation to be treated as a foreign personal holding company (FPHC) or controlled foreign corporation (CFC).

A corporation may be an FPHC if, assuming certain gross income requirements are met, more than 50 percent in value of its outstanding stock is owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States (the "United States Group").[1] A United States shareholder of an FPHC is required to include in income his proportionate share of the corporation's "undistributed foreign personal holding company income." [2]

A foreign corporation may be a controlled foreign corporation if more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned, actually or constructively, by United States shareholders on any day during the taxable year of the foreign corporation.[3] A "United States shareholder" is a United States person, including a corporation, which owns, directly or indirectly, ten percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.[4] Every United States shareholder of a controlled foreign corporation must include in his gross income his proportionate share of the corporation's "Subpart F" income for the year, as well as his proportionate share of certain other types of income designated in §951(a).

While the FPHC provisions define control in terms of the value of the stock held by U.S. persons and the CFC provisions define control in terms of voting power, both agree that a foreign corporation will not meet the definition of either a FPHC or a CFC if the interests of certain U.S. shareholders do not exceed 50 percent of the total interests in the corporation. Regulations promulgated under the CFC provisions [5] set forth a somewhat less than objective test for determining whether the U.S. shareholders own the requisite percentage of voting power. The regulations provide that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if, in reality, voting power is retained." [6] The courts have, in general, interpreted this provision to prohibit attempts to dilute U.S. share ownership through the nominal transfer of 50 percent of the voting power of a foreign corporation to non-U.S. shareholders in those cases where the new foreign shareholders are in fact, if not formally, under the control of the U.S. owners. In *Garlock, Inc. v. Comr.*,[7] the Second Circuit, in affirming the Tax Court, found that the formal transfer of 50 percent of the voting power of a Panamanian subsidiary through the transfer of preferred stock to friendly foreign investors with the understanding (which was reflected in the board of directors minutes) that the stock would be voted in accordance with the wishes of the U.S. parent was in fact an "arrangement" to shift voting control away from the U.S. shareholders. The court found that, based on the authority of the regulations, the subsidiary was in fact a CFC. In *CCA, Inc. v. Comr.*,[8] however, the Tax Court found that the U.S. shareholders, in transferring voting control to foreign interests, had indeed surrendered the requisite percentage of voting power since the stock was transferred, without significant restrictions, to foreign shareholders with substantial adverse business interests.

The validity of achieving decontrol of a foreign corporation through the distribution and stapling of the stock of a foreign subsidiary has not been litigated, although the IRS appears to have sanctioned at least the concept of stapled stock in a published revenue ruling [9] and in a number of private rulings issued to real estate investment trusts (REITs).[10]

II. Overview

A. *Statutory Changes*

Section 136 of the Act adds a new §269B ("Stapled Entities") to the Code. Subsection (a)(1) of §269B sets forth the general rules to be applied in the taxation of stapled domestic and foreign entities. Under this provision, if a domestic and foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic

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corporation.[11] In §269B(b), the Act directs the Secretary to prescribe regulations necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities, including regulations providing the extent to which one of such entities shall be treated as owning the other entity (to the extent of the stapled interest).[12] Although the term "entity" as used in §269B includes corporations, partnerships, trusts, associations, estates or any other form of carrying on a business or activity, it will be the corporate entities which are of primary concern for foreign tax purposes.

A "stapled entity" is any group of two or more entities if more than 50 percent in *value* of the beneficial ownership in each consists of stapled interests.[13] An interest is considered to be stapled if "by reason of form of ownership, the restrictions on transfers, or other terms or conditions, in connection with the transfer of 1 of such interests the other interests are also transferred or required to be transferred."[14] The law provides that, in general, no treaty provisions or any other provisions of the law shall be construed as permitting an exemption from the provisions of §269B.

B. Effective Dates

Section 269B is generally effective in general on July 18, 1984, the date of enactment of the Act. There are a number of exceptions to the effective date, four of which specifically are directed to domestic and foreign stapled entities. First, the Act provides that, with respect to entities which were stapled on June 30, 1983, §269B shall take effect on January 1, 1985. In the case of stapled interests in a foreign corporation, however, the effective date is extended to January 1, 1987. Second, the provisions applicable to a stapled domestic and foreign corporation shall not apply to a "qualified Puerto Rican corporation" and a domestic corporation which were stapled on June 30, 1983. For this purpose, a "qualified Puerto Rican corporation" is a corporation which is described in §957(c) of the Code, so long as that corporation does not own any stock of a corporation which is not described in §957(c).[15] Third, the Act provides an exception for entities which were stapled as of June 30, 1983, and enjoyed a treaty benefit as of such date, so that §269B of the Code shall not override such benefit so long as the treaty remains in effect. Fourth, there is a relief provision for those foreign and domestic corporations which, as of June 30, 1983, were stapled entities. Under this exception, the domestic corporation may treat the stapled foreign entity as owned by the domestic corporation to the extent of the stapled interests, if such election is made by January 14, 1985 (not more than 180 days after July 18, 1984, the date of enactment) in a manner to be prescribed by the Secretary of the Treasury or his delegate. The election, once made, may be revoked only by the Secretary or his delegate.

III. Detailed Analysis

A. General Rule

Section 269B was designed in part to limit the abuse of the provisions relating to FPHCs and CFCs in situations in which formal decontrol was achieved by the stapling of related entities.[16] An additional concern in the foreign area was that the stapling of a taxable entity to a nontaxable entity (or to a foreign corporation taxed at a considerably lower rate than a domestic corporation) might result in the opportunity to shift profits away from the taxable U.S. entity through improper transfer prices or other means which, while subject to correction under §482 of the Code, have proven difficult to correct in practice.[17]

Section 269B(a)(1) treats a foreign corporation which is stapled to a domestic corporation as a domestic corporation. Therefore, the stapled foreign corporation will be subject to U.S. tax on its worldwide income. The Act provides an exception in the effective date provisions for those foreign and domestic corporations which were stapled entities on June 30, 1983. The U.S. corporation in that case may elect to treat all of the stapled interests in the foreign corporation as owned by the U.S. corporation. In many cases this will result in the stapled foreign corporation being treated as a CFC or a FPHC.[18] The U.S. corporation therefore would be subject to tax on the undistributed foreign personal holding company income or Subpart F income attributable to the stapled stock. Since the U.S. corporation would not be taxable on any of the earnings attributable to stock held by non-U.S. shareholders, however, this election generally would result in a smaller tax on the income of the stapled foreign entity than would be imposed if it were treated as a domestic corporation under §269B(a)(1). The election to treat the stapled foreign corporation as a subsidiary to the extent of the stapled interests generally would not make it eligible to file consolidated returns with the U.S. parent, except in the case of a contiguous country stapled corporation which might be eligible to consolidate under the rules of §1504(d).[19]

Since the Act defines "stapled entities" to mean any group of two or more entities where more than 50 percent in value of the beneficial ownership of each consists of stapled interests, it is conceivable that, in order to avoid §269B, U.S. corporations may attempt to formally "destaple" 50 percent of the beneficial ownership in the related entity, much in the same way as there have been attempts to "decontrol" a CFC through the formal transfer of voting rights to foreign interests. Thus, new litigation may arise concerning the extent to which 50 percent in value of an entity is in fact stapled to another such entity. Regulations to be promulgated under the directive of §269B(b) might, however, deal with this situation in a manner more specific than the regulations currently promulgated under §957.

B. Exceptions

As noted above, the effective date provisions contain four exceptions to the applicability of Code §269B to domestic and foreign stapled entities. Two of these — the delay to January 1, 1987 of the effective date for foreign entities, and the election to treat pre-existing stapled entities as owned by the domestic sister corporation — provide general relief for pre-existing structures. The exception for U.S. corporations stapled to pre-existing Puerto Rican corporations was inserted because, under the possession's corporation rules (§936), tax benefits comparable to those of stapling are accorded to certain Puerto Rican corporations.[20] The exception to the general rule that the stapled stock provisions override treaties will not restrict the availability of treaty benefits for entities stapled on June 30, 1983 so long as the treaty is not renegotiated to eliminate benefits to such stapled companies under the relevant

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treaty. Since the draftors hope to encourage restrictions on the availability of such benefits in future treaties, this exception is limited to treaty benefits under treaties in effect on June 30, 1983.[21]

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[1] §552(a)(2).
[2] §551(a).
[3] §957(a).
[4] §951(b).
[5] Regs. §1.957-1(b).
[6] Regs. §1.957-1(b)(2).
[7] 58 T.C. 423 (1972), aff'd, 489 F.2d 197 (2nd Cir. 1973), cert. denied, 417 U.S. 911 (1974). *See also Krause v. Comr.*, 59 T.C. 681 (1973), aff'd, 490 F.2d 898 (2nd Cir. 1974) and *Estate of Weiskopf v. Comr.*, 64 T.C. 78 (1975), aff'd, 76-1 USTC ¶9387 (2nd Cir. 1976).
[8] 64 T.C. 137 (1975), acq., 1976-2 C.B. 1 (withdrawn) nonacq., 1982-1 C.B. 1.
[9] Rev. Rul. 54-140, 1954-1 C.B. 116 (Paired stock arrangement that resulted in the distribution of the stock of a subsidiary of a national bank, which due to national banking regulations could not hold the stock directly, resulted in a distribution to which §301 applied).
[10] *See, e.g.*, PLR 8002026 (October 16, 1979) and PLR 8120107 (February 20, 1981). *Cf.* Rev. Proc. 81-4, 1981-1 C.B. 619 (IRS will not rule on the validity of a paired stock transaction where the activities of the REIT and the stapled corporation continue to be "integrated").
[11] §269B(a)(1).
[12] §269B(b).
[13] §269B(c)(2).
[14] §269B(c)(3).
[15] Act section 136(c)(4). The term "qualified Puerto Rican corporation" also will mean any corporation organized in Puerto Rico if, while not described in §957(c), would be so described if any dividends it received from any other corporation and described in such section were treated as gross income of the type described in such section.
[16] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1543 (1984).
[17] *Id.* at p. 1544.
[18] Since a foreign corporation is a "stapled entity" (within the meaning of §269B(c)(2)), if 50 percent or more in value of its beneficial ownership is stapled, while the CFC rules provide that it is *voting* power rather than value which is determinative of CFC status, electing to treat the stapled foreign entity as a subsidiary may not always result in the treatment of that corporation as a CFC.
[19] H.R. Rep. No. 432 (Part 2), *supra* note 16, at p. 1546.
[20] *Id.* at 1545.
[21] *Id.* at 1546.

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CHAPTER 71

MODIFICATION OF FOREIGN PERSONAL HOLDING COMPANY RULES

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I. Foreign Personal Holding Company Attribution Rules Amended [Act §§132(a) and (b)]

A. Introduction

The foreign personal holding company (FPHC) provisions have been part of the Internal Revenue Code since 1937 when they were enacted as a complement to the personal holding company (PHC) legislation of 1934 to prevent the abuse known as the foreign "incorporated pocketbook," whereby United States shareholders would accumulate in foreign corporations certain types of passive income without incurring any U.S. tax liability. Since the United States has no jurisdiction over a foreign corporation which does not have any U.S. source income, the FPHC rules require "United States shareholders" of the foreign corporation to include in gross income their proportionate share of the corporation's "undistributed foreign personal holding company income" (UFPHCI). "United States shareholders" [1] may include U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than those estates and trusts whose gross income includes only income from sources within the United States). Since, prior to the 1984 amendment, the "United States shareholders" included only those individuals or entities which actually owned stock in the FPHC, a United States person could avoid the requirement of inclusion of UFPHCI in income by interposing a foreign partnership, foreign operating corporation (other than an FPHC), or foreign estate or trust between the United States person and the FPHC.

For purposes of determining which corporations meet the definition of FPHC, Code §552 sets forth both a "gross income test" and a "stock ownership test." Under the gross income test, at least 60 percent of the gross income of a foreign corporation for the taxable year must be foreign personal holding company income for it initially to qualify as an FPHC.[2] After initial qualification as an FPHC, the gross income test will be satisfied if the corporation in any subsequent year has foreign personal holding company income equal to at least 50 percent of its gross income during the taxable year.[3] Code §553 defines the foreign personal holding company income of a corporation to be that portion of its gross income which consists in general of dividends, interest, royalties and annuities, gains from the sale or exchange of stock or securities and commodity futures transactions, distributions from a trust or estate, amounts received under personal service contracts, amounts received as compensation for the use of corporate property by major stockholders, and rents (unless the rents constitute 50 percent or more of the corporation's gross income.)

The "stock ownership test" requires that at any time during the taxable year more than 50 percent in value of the outstanding stock of a foreign corporation must be owned directly or indirectly by or for not more than five individuals who are citizens or residents of the United States (the "United States group").[4] For purposes of determining the ownership of stock under this section, the attribution rules of Code §554 apply. Under those rules, prior to their amendment by the 1984 Act, stock was attributed from an entity such as a corporation, partnership, estate, or trust to its individual shareholders, partners, or beneficiaries in proportion to their interest in the corporation, partnership, estate, or trust.[5] In addition, an individual was considered to own the stock owned directly or indirectly by or for his family or by or for his partner. For this purpose, the term "family" included brothers and sisters, spouses, ancestors, and lineal descendants.[6] Also, any person having an option to acquire stock in an FPHC was considered as actually owning such stock. In certain cases, Code §554(a)(5) provides that the same stock which is considered to be constructively owned by an individual as a result of attribution from a corporation, partnership, estate, or trust or by reason of having an option to acquire stock, could be "reattributed" in order to make another the constructive owner of the stock.[7]

At least one case casts doubt on the ability of the constructive ownership rules to attribute the stock of nonresident alien siblings to U.S. family members for the purpose of determining whether or not a corporation is a FPHC.[8] In *Estate of Nettie S. Miller v. Comr.*, the Tax Court refused to attribute the stock of two Canadian sisters who owned over half of the stock of a Canadian corporation to their brother, a U.S. citizen and resident who owned no stock. Without this attribution, the corporation was not a foreign personal holding company and its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to the tax on the corporation's undistributed foreign personal holding company income. From the language of the opinion it is unclear whether the Tax Court's refusal to apply the language of the statute literally was based on the premise that the U.S. citizen to whom the stock was attributed actually owned no stock in the foreign corporation, or whether the opinion meant to restrict the application of the constructive ownership rules to bar all attribution from nonresident aliens to U.S. persons. In the opinion, the majority noted that:

> "We construe [the predecessor to §554(a)(2)] as meaning that if there are five or less U.S. shareholders who together own over 50 percent of the stock of the foreign

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corporation, then it is a foreign personal holding company and they form the U.S. group. If there are six or more U.S. shareholders who together own over 50 percent of the stock of the foreign corporation, then the foreign corporation is not a foreign personal holding company, unless by applying [the predecessor to §554(a)(2)] the ownership of family-held stock is attributed to one family member and the effect is to have no more than five shareholders." [9]

The opinion thus may be read as limiting §554(a)(2) "strictly to concentrating stock ownership among related U.S. shareholders in order that five or less be found to have the requisite control." [10] The Internal Revenue Service has announced its nonacquiesence in this case.[11]

The FPHC attribution rules are at variance with the attribution rules under Subpart F (Code §§951-964), which was enacted in 1962 to prevent circumvention of the FPHC provisions by requiring the shareholders of a "controlled foreign corporation" (CFC) to include certain types of income (Subpart F income) in gross income. The constructive ownership rules of Subpart F (which appear in Code §958) are based upon the rules of Code §318, and therefore do not require attribution of stock ownership between siblings and prohibit attribution of stock ownership from a nonresident alien individual to a citizen or resident of the United States, thus codifying the result of the *Nettie Miller* case.

B. Overview

1. Attribution for Purposes of Determining FPHC Status

Section 132(a) of the Act amends Code §554 in two ways. First, the Act eliminates family attribution from a nonresident alien individual to a citizen or resident of the United States who is not the spouse of the nonresident alien individual, but only in those cases in which the U.S. citizen or resident does not otherwise own stock in the foreign corporation. In determining whether the U.S. citizen or resident otherwise owns stock in the foreign corporation, the amendment requires attribution (other than family attribution) from a corporation, partnership, estate or trust, or by reason of owning an option, to the U.S. citizen or resident. Second, §132(a) of the Act also provides that stock of a foreign corporation owned by a foreign partner shall not be attributed to a U.S. citizen or resident who does not otherwise own stock in the foreign corporation. For this purpose, as in the case of family attribution, the Act requires that, in determining whether the U.S. citizen or resident otherwise owns stock in the corporation, the attribution rules (other than attribution from a partner who is not related to the U.S. shareholder) must be applied.

2. Attribution for Purposes of Inclusion in Gross Income

With respect to inclusion in income of United States persons who hold no stock directly in an FPHC, but who have interposed between themselves and an FPHC a foreign entity (*e.g.*, a corporation, partnership, trust or estate) §132(b) of the Act amends §551 of the Code by redesignating subsection (f) as subsection (g) and by adding a new subsection (f) to provide that stock of a FPHC owned by a foreign partnership, estate or trust, or by a foreign corporation which is not a foreign personal holding company shall be considered as being owned proportionately by its partners, beneficiaries, or shareholders.

3. Effective Dates

Both paragraphs (a) (amending Code §554) and (b) (amending Code §551) of §132 of the Act are effective with respect to taxable years of foreign corporations beginning after December 31, 1983.[12] There is a one-year extension, to December 31, 1984, however, for certain trusts created before June 30, 1953 if (1) none of the beneficiaries of the trust was a citizen or resident of the United States at the time of its creation or within five years thereafter, and (2) if the trust does not after July 1, 1983 acquire (directly or indirectly) stock of any foreign personal holding company other than a company where substantially all of its assets were previously held by such trust or such company ceases to be a foreign personal holding company before January 1, 1985. The exception is applicable with respect to stock which is held by such a trust directly or indirectly within the meaning of §554 of the Code.

C. Detailed Analysis

1. Attribution for Purposes of Determining FPHC Status

Under the Act, as under prior law, the attribution rules of Code §554 apply for purposes of determining when a corporation has met the stock ownership test of Code §552(a)(2) and (assuming the gross income test is met) is a FPHC for the taxable year. Family attribution from a nonresident alien individual to a U.S. citizen or resident is however limited under the Act in most cases to attribution from a nonresident alien spouse to a U.S. citizen or resident so long as the U.S. citizen or resident does not otherwise own stock in the foreign corporation. Similarly, the Act limits attributions from a foreign partner to a U.S. citizen or resident partner who does not otherwise own stock in the foreign corporation.[13] The rationale for the change in family attribution as expressed by both the House and Senate was that attribution from nonresident alien family members was generally "inappropriate," particularly where the U.S. person to whom the ownership was attributed owns no stock.[14] The House and Senate versions of H.R. 4170 did not, however, restrict the amendment made by the bill to those cases in which the U.S. person actually owned stock. This restriction was added in the Conference which saw "the possibility of significant abuse [in the case where the U.S. person to whom the stock was attributed otherwise owned stock in the foreign corporation]." [15] Attribution from nonresident alien partners to U.S. citizens or residents likewise was viewed as "inappropriate" by the Senate which eliminated such attribution in those cases in which the U.S. partner does not otherwise own stock in the foreign corporation.[16] The partnership attribution provision apparently originally was inserted in the 1937 FPHC rules "[b]ecause of the close business relationship existing between members of a partnership." [17] The need for such attribution may be considerably diminished today, however, since partnership relationships often are the result of anonymous investments in public limited partnerships.

As noted, the limitations on family and partnership attribution apply only where the U.S. citizen or resident

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does not "otherwise" own stock in the foreign corporation. In the case of family members, the U.S. citizen or resident to whom ownership would be attributed but for the amendment made by the Act may not own stock in the foreign corporation actually or constructively, determined after the application of both the attribution and the reattribution rules of §554(a) (other than family attribution). In the case of partners to whom stock ownership would be attributed but for the amendment made by the Act, such partners may not under the Act actually or constructively own stock in the foreign corporation, determined after application of both the attribution and reattribution rules of §554(a) (other than attribution from partners who are not members of a U.S. shareholder's family).[18]

The amendment to the attribution rules as finally drafted goes beyond the most restrictive interpretation of *Nettie S. Miller, supra,* since that case had refused to attribute the stock ownership of nonresident alien sisters to their brother, a U.S. citizen and resident, who had no actual ownership of stock in the Canadian corporation. The effect of any constructive ownership (other than through family membership) through which ownership might have been attributed to the U.S. citizen was not discussed in that case. In the future, therefore, U.S. taxpayers to whom ownership of a foreign holding company might be attributed by reason of family attribution (other than spousal attribution) will be exempt from such attribution only if there is no other provision of §554(a) through which stock ownership could be attributed or reattributed to them.

2. *Inclusion in Income of United States Persons Holding Interest through a Foreign Entity*

Under prior law, U.S. taxpayers have been able to interpose between themselves and a foreign personal holding company a foreign entity; *e.g.,* a foreign trust, partnership, or corporation (which was not itself a foreign personal holding company).[19] The foreign trust, in particular, has been a useful tool for providing significant income tax deferral and, in some cases, complete tax avoidance. Before 1962, no distinction was made between a foreign trust with a U.S. beneficiary and a foreign trust with a foreign beneficiary. A foreign accumulation trust created by U.S. persons for the benefit of U.S. beneficiaries was treated the same as a foreign trust created by a foreign grantor for the benefit of foreign beneficiaries. Thus, a U.S. grantor could create a trust in a foreign tax haven jurisdiction with corpus consisting of foreign securities and other foreign investment assets without any current U.S. income tax consequences to the trust. The U.S. beneficiaries were taxed only when the trust income was distributed under the old five-year throwback rule. The Revenue Act of 1962 made several changes in these rules, with the most notable being the imposition of an unlimited throwback rule on foreign accumulation trusts created by U.S. persons. In 1976, Congress enacted other reforms, which included the addition of §679 to the Code. Section 679 provides that a United States person who directly or indirectly transfers property to a foreign trust is taxed on the income of that portion of the trust attributable to the transferred property if, for the taxable year, there is a U.S. beneficiary of any portion of the trust. In addition, the 1976 Act replaced the cumbersome "exact" throwback rule and the "shortcut" throwback rule of §668 with a new mandatory five-year throwback rule for both domestic as well as foreign trusts. The Act also imposed an interest charge on the beneficiary's additional tax upon an accumulation distribution.

Since foreign entities continued even after these reforms to afford significant avoidance opportunities when interposed between a U.S. person and a foreign holding company, however, the Act attributes the ownership of stock in a FPHC by a partnership, corporation, estate or trust to its partners, shareholders, or beneficiaries. As under current law, the grantor of a trust, rather than the beneficiaries, will be treated as its owner for purposes of the foreign personal holding company rules to the extent that he is taxed on the income of the trust.[20]

The impact of the 1984 Act on a foreign accumulation trust, for example, may be seen by the following illustration: Suppose that X, a U.S. citizen, owns one-third of the stock of S, a foreign holding company. The balance of the stock of S is owned by a foreign trust. The foreign trust has two beneficiaries, Y and Z, who are husband and wife. Y, however, is a U.S. citizen and Z is a nonresident alien. Under §554(a)(1), the stock owned by the trust is considered to be owned proportionately by its beneficiaries for purposes of determining whether the stock ownership test of §552(a)(2) is met.[21] Y and Z each would have a 1/3 constructive ownership interest in S, therefore, due to attribution from the trust. Y also would be deemed to own the stock constructively owned by Z by reason of the reattribution rules of Code §554(a)(5). (Z is deemed to own her proportionate share (1/3) of the stock of S held by the trust, which is then reattributed to her spouse, Y.) Thus, since U.S. citizen Y constructively owns two-thirds (or more than 50 percent) of the stock of S, S will be considered to be a foreign personal holding company (assuming the gross income requirements are met) for the taxable year. Prior to the Act, however, X, due to his actual ownership of stock in S, would be required to report his proportionate share of foreign personal holding company income of S currently, while Y, although a constructive owner of two-thirds of the stock of S and a U.S. citizen, would not be subject to current U.S. taxation because he did not *actually* own any stock in S. Under the Act, however, Y would be considered *actually* to own his proportionate share of the stock of S held by the trust and would be taxed, along with X, on his share of the undistributed foreign personal holding company income of S.

The transitional rule with respect to certain long-term trusts, summarized above, creates a one-year extension on the application of the new "inclusion in income" rules to trusts in existence before June 30, 1953, if none of the beneficiaries of such trusts were citizens or residents of the United States at the time of their creation or within five years thereafter and if certain other requirements with respect to stock ownership by the trust are met. The purpose of this amendment appears to be to ameliorate the effect of the provision on trusts established many years ago by foreign persons solely on behalf of foreign beneficiaries for purposes unrelated to U.S. tax considerations. The amendment allows such trusts a transition period to restructure their holdings by, for instance, selling or otherwise liquidating any interest in foreign holding companies during the remainder of 1984.

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II. Coordination of Subpart F Rules with the Foreign Personal Holding Company Provisions [Act §132(c)]

A. Introduction

Subpart F (Code §§951-964) was added to the Internal Revenue Code in 1962.[22] The avowed purpose of the Subpart F provisions was to prevent the use of "tax havens" to reduce or eliminate tax liabilities of United States persons both at home and abroad.[23] Under Subpart F, a United States person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a "controlled foreign corporation" (CFC) is required to include in gross income his pro rata share of certain types of income of the CFC. In general, the includible income consists of: (1) the pro rata share of the CFC's "Subpart F income" for the year; (2) the pro rata share of the CFC's previously excluded "Subpart F income" withdrawn from investments in less developed countries; (3) the pro rata share of the CFC's previously excluded "Subpart F income" withdrawn from foreign base company shipping operations for such year; and (4) the pro rata share of the CFC's increase in earnings invested in U.S. property.[24]

The term "Subpart F income" includes: (1) income derived from the insurance of United States risks; (2) foreign base company income; (3) certain international boycott income; and (4) the amounts of any illegal bribes, kickbacks, or other payments made by or on behalf of the corporation during the taxable year.[25] The term "foreign base company income" in turn means for any taxable year the sum of: (1) the foreign personal holding company income; (2) the foreign base company sales income; (3) the foreign base company services income; (4) the foreign base company shipping income; and (5) the foreign base company oil-related income.[26]

"Foreign personal holding company income" required to be included in gross income under Subpart F generally includes the same types of income as are included under the FPHC rules, except that rents are included under the CFC rules without regard to the 50 percent limitation. Under the CFC rules, however, foreign personal holding company income does not include dividends and interest received from a related person which is (1) created or organized under the laws of the same foreign country in which the CFC is created or organized, and (2) has a substantial part of its assets used in its trade or business located in such same foreign country.[27]

The definition of the term "controlled foreign corporation," which appears in Code §957(a), includes any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned, actually or constructively, by United States shareholders on any day during the taxable year of such foreign corporation. For purposes of determining whether the 50 percent ownership test is met, the constructive ownership rules of Code §958 apply. The constructive ownership rules of Code §958 are modeled on those of Code §318(a), rather than Code §554 (FPHC attribution rules), and, unlike the FPHC rules, prohibit the attribution of stock owned by a nonresident alien individual to a U.S. citizen or resident.

Because of the overlap between the definition of a CFC in Code §957 and of an FPHC in Code §552, situations will arise where a United States shareholder may be subject to tax imposed both under Subpart F and the FPHC provisions. In order to coordinate Subpart F and the FPHC provisions, Congress enacted Code §951(d) (which prior to the Act provided that a United States shareholder who was subject to tax under the FPHC provisions on the income of a CFC was not required to include in gross income any amount under Code §951(a) with respect to such company). A literal reading of §951(d) suggests that the FPHC provisions preempt the Subpart F provisions in any year in which a shareholder of an FPHC is taxed on the UFPHCI of a CFC under Code §551(b). Regulations §1.951-3 provides that the prohibition on inclusion in gross income of a shareholder of an FPHC of amounts under Subpart F is limited, however, to amounts attributable to the earnings and profits of the corporation for that taxable year. Thus, under this regulation, a U.S. shareholder of a FPHC also meeting the definition of a CFC might be required to include in income under Subpart F his proportionate share of, for example, the corporation's increase in earnings invested in United States property for such year if such investment were made out of earnings and profits attributable to one or more prior taxable years.

As might be expected, Regs. §1.951-3 has been subject of litigation; the result is a conflict between the 10th Circuit and the Court of Claims on the validity of the regulation.[28] In *Estate of Whitlock v. Comr.*,[29] the 10th Circuit upheld the validity of Regs. §1.951-3 and ruled that the stockholders of a CFC which was also an FPHC must include in their gross income increases in earnings invested in United States property which were made out of earnings and profits accumulated prior to the taxable year in issue. Six years later, the United States Court of Claims in *Estate of Lovett v. U.S.*,[30] ruled that, in accordance with the literal language of Code §951(d), a U.S. shareholder subject to tax on FPHC income during the taxable year "shall not be required to include in gross income, for such taxable year, any amount under [§951(a)] with respect to such company." The Court of Claims thus invalidated Regs. §1.951-3 to the extent that they required a U.S. shareholder of a corporation which was both a CFC and an FPHC to include in income during the taxable year the amount of its increased investment in U.S. property which was attributable to earnings and profits of prior years.

B. Overview

1. Amendment of Code §951(d)

Section 132(c)(1) of the Act amends Code §951(d) to provide that U.S. shareholders of a CFC which is also an FPHC will be taxed on the CFC's Subpart F income only under Subpart F, and not under the FPHC rules, to the extent that it otherwise would be taxable under both.

2. Same Country Dividend and Interest Rule

Section 132(c)(2) of the Act amends Code §552 (defining an FPHC) by adding a new Subsection 552(c), which excludes from the definition of foreign personal holding company income in Code §553(a)(1) any dividends or interest which are described in subsection (A) of Code §954(c)(4) of Subpart F, and are received from a related person which is not itself an FPHC.

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3. Effective Dates

The amendment made to Code §951(d), relating to the relationship between Subpart F and the FPHC provisions, is effective beginning after July 18, 1984, the date of enactment. The amendment which adds to the FPHC provisions the "same country dividend and interest rule" of Subpart F, however, is effective for taxable years of foreign corporations beginning after March 15, 1984.

C. Detailed Analysis

1. Amendments to Code §951(d)

The amendment to Code §951(d), which, prior to the Act, arguably required the provisions of Subpart F to be preempted by the FPHC rules, will, under the Act, provide that a CFC's Subpart F income will be taxable under Subpart F but not under the FPHC rules to the extent that it otherwise would be taxable under both. Therefore, a corporation which is subject to tax under the FPHC rules will not be exempt from tax under Subpart F. If income is includable under only one set of rules, it will be taxed under that set of rules. Where, as in the *Lovett* and *Whitlock* cases, a taxpayer may be taxable under Subpart F on amounts other than Subpart F income, such as increased investments in U.S. property, the taxpayer will be taxable under Subpart F whether or not it is subject to the FPHC tax.[31] The result of the *Lovett* case, therefore, is reversed by the legislation. Since the amendment is effective beginning after the date of enactment, however, and since both the Senate and House Reports [32] provide that no inference as to the proper result under present law is intended, taxpayers wishing to litigate the issue of the includability in income of amounts under Subpart F where a foreign corporation also is taxable under the FPHC provisions apparently may continue to do so, at least if and until the issue is resolved by the Supreme Court.

The effect of the change in Code §951(d) on the facts presented in the *Lovett* case may be seen by the following example: In the taxable year 1963, in which a foreign corporation qualified both as a CFC and an FPHC, the taxpayer, a U.S. shareholder, paid a tax under Code §551(b) in the amount of $405,120 on the corporation's UFPHCI. Also, in 1963, the corporation increased its investment in U.S. property by $305,820 out of earnings and profits accumulated prior to 1963. The Court of Claims, in the *Lovett* case, held that, under §951(d), the U.S. shareholder need only pay the $405,120 tax on UFPHCI. Under the Act, however, both the UFPHCI and the $305,820 increased investment in U.S. property would be taxed to the shareholder in 1963.

2. Same Country Dividend and Interest Rule

As noted above, under Subpart F (Code §954(c)(4)(A)), it has been the rule since 1962 that foreign personal holding company income does not include dividends and interest received from a related person created or organized under the laws of the same foreign country as the CFC, which had a substantial part of its assets used in its trade or business located in that same foreign country. The Act extends this exception to the FPHC provisions by adding to Code §552 a new subsection (c) excluding from *both* gross income and foreign personal holding company income the dividends and interest described in subparagraph (A) of §954(c)(4). The dividends and interest are only excluded, however, if received from a related person which is *not* a foreign personal holding company.

This provision was added by the Senate "because there appears to be no shifting of income to a tax haven when a foreign personal holding company receives interest or dividends from a related corporation organized and operating in the same country." [33] Since the Senate Finance Committee did not, however, believe that such income should count as non-foreign personal holding company income,[34] such income was excluded both from the definition of foreign personal holding company income in Code §§552 and 553, and from the computation of "gross income" in Code §552. Thus, such dividends and interest are excluded both from the numerator and the denominator of the fraction from which one determines whether the "gross income test" of Code §552(a)(1) is met. For example, if a foreign corporation has gross income consisting of $80,000 of interest received from a related operating company organized in the same country and $20,000 of gains from the sale or exchange of stock or securities,[35] the gross income requirement of Code §552(a)(1) would be satisfied: The $80,000 of interest income would be excluded from "gross income" for purposes of determining the percentage of gross income which constitutes foreign personal holding company income; and the remaining $20,000 in gains from the sale or exchange of stock or securities would account for 100 percent of the gross income of the foreign corporation, all of which would be foreign personal holding company income.

3. Remaining Differences Between Subpart F and FPHC Provisions

The amendments made by the Act, while entitled "Coordination of Subpart F with Foreign Personal Holding Company Provisions," still leave a number of differences between the two sets of provisions. One of these, the difference in the attribution rules, has been noted above. For a more detailed comparison of the remaining differences between Subpart F and the FPHC provisions, *see* Lerner and Kirschbaum, 103-2nd T.M., *Foreign Personal Holding Companies*, Chapter V, pp. A-28-A-32.

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[1] Code §551(a).
[2] Code §552(a).
[3] *Id.* The gross income percentage will rise to 60 percent again after three consecutive taxable years expire in each of which less than 50 percent of the corporation's gross income is FPHCI or until the taxable year during the whole of which the stock ownership test is not satisfied. See Regs. §1.552-2(a)(2)(ii).

[4] Code §552(a)(2).
[5] Code §554(a)(1).
[6] Code §554(a)(2).
[7] Stock constructively owned by reason of attribution from a family member or a partner could not, however, be reattributed for this purpose.
[8] *See Estate of Nettie S. Miller v. Comr.*, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4.

[9] *Id.* at 767.
[10] *Id.*, concurring opinion at 769.
[11] 1966-1 C.B. 4.
[12] Act §132(d)(1).
[13] The requirement that the U.S. family member or partner to whom ownership would be attributed from a nonresident alien family member or partner not otherwise own stock in the foreign corporation was added in the Conference. The Senate and House versions of the Bill did not contain this requirement and merely prohibited attribution from a nonresident family member (other than a spouse) or partner to a U.S. citizen or resident. The Conference amendment appears to be an attempt to codify the more restrictive reading of the majority opinion in *Estate of Nettie S. Miller, supra*, footnote 8.

[14] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1535 (1984) and S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 401 (1984).
[15] H.R. Rep. No. 861 (Conf. Rep.), 98th Cong., 2d Sess., p. 958 (1984).
[16] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 402 (1984).
[17] S. Rep. No. 1242, 75th Cong., 1st Sess. (1937), 1937-2 C.B. 609, 614.
[18] New Code §554(c)(2).

[19] Interposing a corporation which itself is merely a holding company would in most cases be to no avail since §555 of the Code requires inclusion in the gross income of a FPHC which was a shareholder in another FPHC the amount of the dividend that the first tier company would have received had the second tier company distributed an amount equal to its UFPHCI for the taxable year. This "deemed distribution" made it impossible to insulate a U.S. shareholder from tax on UFPHCI merely by accumulating that income in a second or lower tier subsidiary where the parent corporation had no actual income.
[20] Rev. Rul. 62-155, 1962-2 C.B. 132, holds that, for purposes of determining stock ownership under §544(a)(1), shares held by an irrevocable trust should be considered owned by its present and future beneficiaries in accordance with their actuarial interest. With respect to revocable trusts, all of the shares of the trust will be attributed to the owner of the trust.
[21] Note that under the Act, this result will obtain even though Y and Z are not husband and wife but brother and sister, since the limitation on family attribution will not apply where the U.S. family member actually or constructively owns stock in the foreign corporation. Under the Act, as under prior law, Y constructively owns the stock held by the trust.
[22] P.L. No. 87-834, 87th Cong., 2d Sess., October 16, 1962.
[23] *See, e.g.*, H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 461.
[24] Code §951(a)(1).
[25] Code §952(a).
[26] Code §954(a).
[27] Code §954(c)(4)(A).
[28] *See Estate of Whitlock v. Comr.*, 494 F.2d 1297 (10th Cir. 1974), cert. denied 419 U.S. 839 (1974), on remand, 547 F.2d 506 (10th Cir. 1976), cert. denied, 430 U.S. 916 (1977); and *Estate of Lovett v. Comr.*, 621 F.2d 1130 (Ct. Cl. 1980).
[29] 494 F.2d 1297 (10th Cir. 1974), cert. denied 419 U.S. 839 (1974), on remand, 547 F.2d 506 (10th Cir. 1976), cert. denied, 430 U.S. 916 (1977).
[30] 621 F.2d 1130 (Ct. Cl. 1980).
[31] *See* H.R. Rep. No. 432 (Part II), 98th Cong., 2d Sess., pp. 1541-1542 (1984); and S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 403 (1984).
[32] H.R. Rep. No. 432 *supra*, at page 1542, and S. Rep. No. 169, *supra*, at 402.
[33] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 402 (1984).
[34] *Id.*
[35] *See* Code §553(a)(2).

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CHAPTER 72

RULES PERTAINING TO TAXATION OF OID DERIVED BY FOREIGN INVESTORS AMENDED

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Section 128 of the Act has amended the rules set forth in Code §§871 and 881 and elsewhere regarding withholding on original interest discount ("OID") derived by foreign investors. The amendments have a number of purposes: (i) to clarify ambiguities created by the Revenue Act of 1971 as to the scope of OID withholding;[1] (ii) to coordinate the withholding provisions with the rules enacted in the Tax Equity and Fiscal Responsibility Act of 1982[2] ("TEFRA") relating to the accrual of OID; (iii) to subject foreign investors to the stripped coupon bond rules; and (iv) to provide for the matching of deductions for OID by an issuer on the accrual method of accounting with inclusions of OID in income by a related foreign holder.

I. Elimination of Ambiguities Created by the 1971 Revenue Act

A. Introduction

The amendments to §§871, 881, and 1441 that were made by section 313 of the Revenue Act of 1971 were intended to clarify the U.S. tax treatment of OID that is derived by nonresident aliens and foreign corporations from U.S. sources and is not effectively connected with the conduct of a U.S. trade or business. The amendments excluded OID (as defined in §1232(b)) from the term "interest," so that the taxation of OID would be governed exclusively by specific rules contained in former Code §§871(a)(1)(C) and 881(a)(3). In general, OID on bonds with a maturity of more than six months was made subject to the 30 percent withholding tax under these latter provisions. The specific taxing provisions contained in §§871(a)(1)(C) and 881(a)(3) were ambiguous, however, because they referred to §1232(a)(2)(B).

Section 1232(a)(2)(B) was the pre-1969 provision that taxed OID derived by domestic taxpayers at the time a discount obligation was sold, exchanged, or retired (and not ratably each year during which the obligation was held). The reference to §1232(a)(2)(B) was probably intended to refer only to the manner in which OID accruing during a holder's period of ownership was to be measured. It was not clear, however, that the reference to §1232(a)(2)(B) was intended to refer only to the manner of measuring OID under that section, and several ambiguities arose:

(i) Did the fact that §1232(a)(2)(B) referred only to certain corporate and government bonds mean that OID on obligations issued by other persons (individuals and partnerships) was not subject to tax under §§871(a)(1)(C) and 881(a)(3)?

(ii) Did the fact that §1232 generally referred to capital assets mean that OID on obligations which were non-capital assets in the hands of the holders was not subject to tax?

(iii) Did the fact that §1232(a)(2)(B) referred to bonds held for the long-term holding period mean that OID on obligations held for less than the long-term holding period was not subject to tax?

(iv) Finally, did the fact that §§871(a)(1)(C)(ii) and 881(a)(3)(B) referred to post-March 31, 1972, bonds that would be subject to §1232(a)(2)(B) but for the fact the bonds were issued after May 27, 1969, exempt OID on government bonds from tax since government bonds were subject to §1232(a)(2)(B) regardless of whether issued before or after 1969?

The Proposed Regulations issued in 1976 took an expansive view of the government's taxing authority and provided that OID accruing on bonds with a maturity of more than six months was taxable under §§871(a)(1)(C) and 881(a)(3) regardless of whether: (i) the issuer is a corporation, a government, or a partnership or individual; (ii) the bond is a capital asset in the hands of the holder; or (iii) the bond is held for the long-term holding period.[3] Furthermore, the regulations overlooked the defect in statutory drafting and provided that post-March 30, 1972, government bonds are subject to OID taxation.[4]

The changes made by TEFRA, and their interaction with the language of the 1971 amendments, resulted in another ambiguity as to the scope of OID withholding. Under TEFRA, government bonds issued after July 1, 1982, were made subject to the economic accrual rules of §1232A. Thus, §1232(a)(2)(B) was amended to exclude post-July 1, 1982, government bonds. If the OID provisions of §§871(a)(1)(C) and 881(a)(3) were given their literal meaning, they no longer applied to such bonds.

B. Overview

The Act has eliminated these ambiguities as to the

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scope of OID withholding, resolving each of them in favor of the taxability of OID obligations.

C. *Detailed Analysis*

Consistently with old law, new §§871(a)(1)(C) and 881(a)(3) impose a gross basis tax on U.S. source OID that is not effectively connected with a U.S. business and that accrues on an obligation while such obligation is held by a nonresident alien or foreign corporation. If the obligation is interest bearing, accrued OID is subject to U.S. withholding tax at the time interest is paid. Otherwise, OID is subject to tax at the time the obligation is sold, exchanged, or retired.

At the same time, the Act terminated the trouble-making dependence of §§871(a)(1)(C) and 881(a)(3) upon §1232(a)(2)(B). While new Code §871(g) refers to new §1272 (old §1232A) and corresponding provisions of prior law (*e.g.*, §1232(a)(2)(B)), it is clear that such reference is made only for purposes of measuring the amount of OID that is considered to accrue as of the time (payment of interest or sale or exchange) when OID becomes taxable. Furthermore, new §871(g)(1)(A) defines OID obligations subject to §§871(a)(1)(C) and 881(a)(3) to include any bond or other evidence of indebtedness having OID within the meaning of §1273 (old §1232(b) as revised). Thus, OID is subject to §§871(a)(1)(C) and 881(a)(3) regardless of whether: (i) the obligation is issued by corporations, governments, partnerships, or individuals; (ii) the obligation is a capital asset in the hands of the holder; and (iii) the obligation is held for the long-term holding period for capital assets.

Note: The exemption for obligations with a maturity of six months or less has been retained in new §871(g)(1)(B)(i), although the six months has been changed to 183 days to correspond to the term of issue of short-term Treasury bills. In addition, new §871(g)(1)(B)(ii) clarifies that municipal bonds exempt under §103 are also exempt under §§871 and 881.

The changes made to §§871(a)(1) and 881(a) are applicable to payments made on or after the 60th day after July 18, 1984 (the date of enactment of the Act) with respect to obligations issued after March 31, 1972.[5] It thus appears that the law as it existed prior to the Act will continue to apply to obligations issued before April 1, 1972.

II. Coordination with the TEFRA Rules on Accrual of OID

A. *Introduction*

Code §1232A as adopted by TEFRA (recodified as §1272 by the Act) changed the accrual of OID from a straightline method of accrual whereby a pro rata portion of OID accrued during each month the bond was held to a non-linear method of accrual that reflects the compounding of interest. Under this non-linear method, more OID accrues during the later portions of the term of the obligation since interest is effectively being paid not only on the principal (issue price) but also on interest accruing during earlier periods.

The General Explanation of TEFRA states that Congress intended the non-linear formula for accrual of OID to apply for purposes of the 30 percent withholding tax on foreign persons under §§871 and 881.[6] It has not been clear, however, that this result follows from the language of the statute.[7]

B. *Overview*

The Act makes it clear that the non-linear accrual method applies to OID instruments held by foreign investors as well as those held by U.S. persons.

C. *Detailed Analysis*

New §871(g)(2) provides that the determination of the amount of OID accruing during any period will be made under §1272 or the corresponding provisions of prior law. Thus, the non-linear formula introduced by TEFRA will apply for purposes of §§871 and 881 with respect to bonds issued generally after July 1, 1982 (the effective date of the TEFRA provisions). The non-linear formula would apply to bonds issued by natural persons, however, only if issued after March 1, 1984.[8] The formula is to be applied without regard to the exemption from the OID rules for instruments of less than six months' duration.

Note: This change relating to the manner of measuring accrued OID does not change the rules regarding when OID is recognized. Foreign investors are still subject to tax only on the sale or exchange of an OID bond or at the time of interest payments and are not subject to partial inclusion during each year the bond is held as in the case of domestic taxpayers. On the matter of the sourcing of the OID income of foreign investors, §871(g)(3) states that whether such income will be treated as derived from sources within the United States will be determined, except as otherwise provided in regulations, at the time of the interest payment or sale or exchange giving rise to such income as if the payment or sale or exchange involved the payment of interest. The legislative history indicates that Congress intended for regulations to be issued under which recognized OID would be allocated between U.S. and non-U.S. sources in cases in which the source changes (*e.g.*, by virtue of a change of residence by the issuer) between the date of issuance and the date of the payment or sale or exchange causing recognition.[9]

For the effective date of these changes, *see* I, C, *supra*.

III. Application of TEFRA Stripped Bond Rules

A. *Introduction*

Section 1232B, which was added to the Code by TEFRA, provided that in the case of interest coupons which had been detached from the corpus of the bonds, both the coupons and the stripped corpus would be treated as OID bonds subject to periodic income inclusion in the hands of domestic taxpayers. In the hands of foreign investors purchasing a stripped coupon, the investor would presumably get basis for the coupon equal to the purchase price paid for the coupon. It was unclear, however, whether the gain received by the foreign investor on a sale of the coupon before maturity was: (i) OID (and, if so, whether it was OID on an obligation with a maturity of six months or less if the coupons were six-month coupons); (ii) interest, which would be subject to 30 percent withholding; or (iii) gain, which would generally be exempt from 30 percent with-

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holding.[10] Similar ambiguities existed with respect to the tax treatment of a sale of the stripped corpus if held by a foreign investor.

B. Overview

The Act has assured that the treatment of stripped bonds and stripped coupons held by foreign investors will be the same as the treatment of those held by U.S. persons except that, in the case of foreign investors, the recognition of any OID will be deferred until sale, exchange, or retirement.

C. Detailed Analysis

Section 871(g)(4) provides that the provisions of §1286 (§1232B as enacted by TEFRA) will apply for purposes of §§871 and 881. As a result, any discount from face value on the post-July 1, 1982 purchase of a stripped bond or stripped coupon by a foreign investor will generally be treated as OID and will be subject to the 30 percent withholding tax.

Comment: It seems clear that treaty provisions that reduce or eliminate U.S. withholding tax on interest will apply (as under prior law) to OID, including that resulting from the stripped coupons provisions.

For the effective date of these changes, *see* I, C, *supra*.

IV. Matching of Related Party OID Deductions and OID Inclusions

A. Introduction

Because an accrual method obligor on an OID instrument held by a foreign investor is entitled to deduct the OID periodically during the life of the instrument, while the foreign investor recognizes OID income only upon the payment of any stated interest or upon the sale, exchange, or retirement of the instrument, the issuance or sale of OID instruments to foreign investors results in a mismatching of OID income and deductions that works to the disadvantage of the government. Both the House and the Senate Committee Reports reflect concern with the mismatching problem,[11] but neither the House bill nor the Senate bill contained any provision that would have attempted to solve it.

B. Overview

The Conference Committee added to the provisions of the Act relating to OID derived by foreign investors a new rule delaying the obligor's deduction for OID accrued but not paid with respect to an OID instrument held by a related foreign person until the time of actual payment. In effect, the provision puts accrual method taxpayers on the cash method for purposes of determining the interest deduction for OID on instruments held by related foreign persons.

C. Detailed Analysis

Subsection (c) of Act §128 adds to subsection (e) of §163 a new paragraph (3), which provides that if any debt instrument having OID is held by a related foreign person, no portion of such OID shall be allowable as a deduction to the issuer until paid. The term "related foreign person" is defined as any person (i) that is not a United States person and (ii) that is related to the issuer within the meaning of §267(b).

Note: The related-party test of §267(b) has been expanded by Section 174 of the Act.

A somewhat cryptic example in the Conference Report illustrates the application of this rule as well as the application of the rules for recognizing accrued OID income.[12] The Conference Report postulates a foreign parent of a U.S. corporation that lends the U.S. corporation funds on a discount bond providing for $30 of stated interest in a year in which $150 of OID accrues. The interest is not exempt from withholding because the Act's repeal of withholding on interest paid to foreign investors does not apply to interest paid to the foreign shareholders of a U.S. corporation. In fact, the full $30 of interest payable to the foreign shareholder will apparently be withheld — $9 constituting 30 percent of the stated interest, and the other $21 constituting 30 percent of $70 of the $150 of accrued OID. As a result of the withholding of this interest, $80 of accrued OID will be left — although the Committee Report does not say so — to be recognized upon sale, exchange, or retirement. As for the U.S. corporation, its OID deduction for the year in question is limited, under §163(c)(3), to $30.

The Conference Report notes that the new rule added to §163(e) is only a partial solution to the mismatching problem and calls for "further examination" of the problem in general. Moreover, the Conference Committee showed its awareness that its limited rule could easily be evaded by means of back-to-back loans under which a U.S. taxpayer wishing to make a discount loan to a related foreign entity loans the desired amount to an unrelated party who in turn lends an equal amount to the related entity. The Conference Report states the Committee's intention that the Internal Revenue Service should, where appropriate, investigate the capitalization of foreign-owned U.S. corporations issuing OID debt to determine whether such back-to-back loan arrangements exist.

Comment: Not only does the Act not completely address the mismatching problem, it also fails to address an acute enforcement problem relating to OID derived by foreign investors. Specifically, if a foreign investor sells an OID bond to another foreign person, the foreign buyer cannot be forced to withhold OID accruing to the foreign seller. For this reason, the proposed OID regulations issued under §1441 in 1976 required only U.S. persons to act as withholding agents. Foreign investors can easily avoid OID withholding, therefore, by selling the OID bond to a foreign bank or broker shortly before maturity (*e.g.*, one day). No withholding is (or can be) required on that sale. The next day, the foreign bank or broker redeems the bond with the U.S. issuer, who is required to withhold tax on OID accruing to the bank or broker, *i.e.*, one day's worth. The OID withholding tax is thus effectively and pervasively avoided.

New Code §163(e)(3) applies to obligations issued after June 9, 1984.[13]

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[1] P.L. 92-178.
[2] P.L. 97-248.
[3] Prop. Regs. §1.871-7(c)(4)(ii).
[4] Prop. Regs. §1.871-7(c)(4)(iii).
[5] Act §128(d)(1).
[6] Staff of Joint Comm. on Taxation, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, p. 162 (Comm. Print 1983).
[7] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1331 (1984).
[8] *See* §1272(a)(2)(E).
[9] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1332 (1984); S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 377 (1984).
[10] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess., p. 1331 (1984).
[11] *Id.*; S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 376 (1984).
[12] Conf. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., pp. 939-940 (1984).
[13] Act §128(d)(2).

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CHAPTER 73

CAPTIVE INSURANCE INCOME AS SUBPART F INCOME

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I. Introduction

The income of a controlled foreign corporation ("CFC") derived from the insurance of U.S. risks is included in Subpart F income,[1] and thus the U.S. shareholders of a CFC are subject to current taxation on such income.[2] In addition, the "foreign base company services income" of a CFC is included in Subpart F income,[3] and thus can also generate a current tax to the U.S. shareholders of a CFC. In theory, "foreign base company services income" can include income derived from the insurance of non-U.S. risks of parties related to the CFC. In fact, such income seldom is subject to current taxation.

The term "foreign base company services income" generally means income derived in connection with the performance of various kinds of services as to which two requirements, set forth in paragraphs (1) and (2) of Code §954(e), are satisfied: (1) the services are performed for or on behalf of any person related to the CFC under the related-person test of §954(d)(3) (essentially a control or 50-percent test); and (2) they are performed outside the country under the laws of which the CFC is created or organized. Although the performance of insurance services for a 50-percent related person satisfies the first or related-person condition, the place of performance of services, under Treasury Regulations interpreting the second or foreign-performance condition, is generally where the persons performing the services are physically located when they perform their duties.[4] Since insurance personnel employed by a CFC will customarily be physically located in the country of organization of the CFC, the practical effect of this rule is that the foreign-performance condition of §954(e)(2) will seldom be satisfied by insurance services and thus the income derived from the performance of such services for a related party is largely immunized from current taxation. Certain U.S. taxpayers have taken advantage of this fact and organized insurance subsidiaries in low-tax foreign jurisdictions to insure the risks of their other foreign affiliates. The legislative history of the Act makes it clear that Congress regards with disfavor this practice under which income from related-party insurance services has been "shift[ed] to tax haven jurisdictions."[5]

II. Overview

The Act amends §954(e) of the Code so that CFC income derived from the insurance of foreign risks of related parties will be included in Subpart F income and thus made subject to current taxation to U.S. shareholders without regard to where the insurance personnel of the CFC are physically located.

III. Detailed Analysis

Section 137 of the Act adds to the definition of "foreign base company service income" in Code §954(e), at the end thereof, a new sentence stating that, for purposes of the foreign-performance condition of §954(e)(2), services performed with respect to a policy of insurance with respect to which the primary insured is a related person will be treated as having been performed in the country within which the insured hazards, risks, losses, or liabilities occur. Thus, the effect of the physical location rule of the regulations is nullified in the case of insurance services. For example — an example taken from the Senate Finance Committee report — if a Bermuda subsidiary of a U.S. corporation insures the French risks of a French subsidiary of its parent, the income derived from the insurance services, under the law as amended by the Act, will be "foreign base company services income."[6] No inquiry will need to be made into the physical location of the CFC personnel performing the services.

Significantly, the Conference Committee, approving the addition of the aforedescribed new sentence to §954(e), adopted a more expansive definition of the term "related person" than that found in the Senate bill (there was no comparable provision in the House bill). Under the Senate bill, the term "related person" would have had the same definition for purposes of the new sentence as it has in Code §267(b), as amended by the Act. Like Code §954(d)(3), §267(b) essentially provides a control or 50-percent test for determining what persons will be treated as related. Under §137 of the Act as it emerged from the Conference Committee, however, the term "related party" has the same meaning as it has in new subsection (d) of §864, where a 10 percent or more ownership interest causes two parties to be related.

The purpose of expanding the scope of the term "related person" was "to impose tax on an insurance company owned (directly or indirectly) by a relatively small number of U.S. shareholders that use it in whole or in part to insure their foreign risks or foreign risks of parties related to them."[7] It would appear, however, that the Conference Committee failed to achieve this purpose. Because the narrower meaning of "related person" given in Code §954(d)(3) was retained for purposes of the related-party condition of §954(e)(1), and since services must satisfy

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both conditions in order for the income therefrom to be "foreign base companies services income," it appears that income from services performed in insuring the foreign risks of a 10 percent affiliate of a CFC or its parent, where those risks were located outside the country of organization of the CFC, would not be "foreign base company services income." Although such services would satisfy the foreign-performance condition of §954(e), since they would be deemed to be performed outside the CFC's country of organization under the sentence added by the Act to Code §954(e), they would not satisfy the related-party condition. Presumably, this defect in the statute will be addressed in the forthcoming technical corrections bill.

Observation: The Senate Finance Committee Report states that, in adopting the amendment to Code §954(e) under which income from the insurance of foreign risks can be treated as "foreign base company services income," it did not intend to affect "any determination as to whether a payment made to a related insurer constitutes self-insurance, the 'premium' for which is non-deductible." [8] Presumably, this statement is attributable to a desire not to undermine the government's current litigating position that any payment to a related party for insurance necessarily constitutes self-insurance. Nevertheless, as a matter of logic, §137 of the Act would seem inconsistent with this position since, if the government is correct and there is no such thing as related-party insurance for tax purposes, then §137 is a nullity.

The amendment to Code §954(e) made by §137 of the Act is effective for taxable years of CFCs commencing after the date of enactment (July 18, 1984).

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[1] Code §§952(a)(1) and 953.
[2] Code §951.
[3] Code §§952(a)(2), 954(a)(3) and 954(e).
[4] Regs. §1.954-4(c).
[5] *See* S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 383 (1984).
[6] *Id.* at 384.
[7] H.R. Rep. No. 861, 98th Cong., 2d Sess., p. 965-66 (1984).
[8] See S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., p. 383 (1984).

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CHAPTER 74

PASSIVE U.S. SOURCE INCOME OF CERTAIN POSSESSIONS RESIDENTS SUBJECT TO 30 PERCENT WITHHOLDING

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I. Introduction

Passive or investment gross income (*i.e.*, fixed or determinable, annual or periodical income including rents, royalties, dividends, and some interest) of foreign corporations derived from U.S. sources which is not effectively connected with the conduct of a trade or business within the United States is subject to a flat 30 percent (or lower treaty rate) tax.[1] The tax is levied by way of withholding at the source.[2]

The United States, however, does not impose withholding tax on payments of passive income to corporations organized in Guam, the Commonwealth of the Northern Mariana Islands, or the U.S. Virgin Islands (USVI).

The Internal Revenue Code of the U.S. is generally used by the U.S. possessions as their territorial income tax law through application of the "mirror theory," *i.e.*, the name of the possession is substituted for the words "United States" wherever necessary to give the law proper effect. The mirror theory is based on the assumption that the possessions and the United States are separate tax jurisdictions, foreign to one another. Because of this assumption, the United States and each possession generally look upon one another's nationals as foreigners.

As an exception to this rule, §§881(b) and 1442(c) provide that a Guam corporation is not considered to be a foreign corporation for purposes of U.S. withholding tax on fixed or determinable annual or periodical income. Since the withholding tax on passive income is only levied upon foreign corporations, §§881(b) and 1442(c) exempt from U.S. withholding tax non-effectively-connected U.S. source passive income paid to Guam corporations. The Guam exemption was originally introduced in 1972 [3] for taxable years beginning after December 31, 1971, as an incentive to promote U.S. investments in Guam. United States source passive income not effectively connected with a U.S. trade or business received by a Guamanian corporation is therefore taxed in the hands of the recipient at the regular corporate rates of Guam.

Application of the mirror theory exempts from territorial tax Guam source passive income not effectively connected with a Guamanian trade or business when paid to a U.S. corporation.[4]

The §881 effective exemption from withholding on payments to Guam corporations also applies to payments to corporations organized in the northern Marianas since references in the Code to Guam are generally deemed to apply also to the Marianas (unless a contrary intent is expressed).[5]

With respect to the USVI, the exemption from U.S. withholding tax on passive income results from Section 28(a) of the Revised Organic Act of the Virgin Islands of 1954.[6] This section provides that "inhabitants of the Virgin Islands" satisfy their income tax obligations to the United States by paying their income tax on worldwide income to the Virgin Islands. Pursuant to this section, permanent residents or "inhabitants" of the Virgin Islands may earn U.S. source income without having to file a U.S. return or pay U.S. tax. They are exempt from withholding of U.S. tax if they reasonably expect to satisfy their USVI tax obligation under Section 28(a).[7]

USVI source fixed or determinable annual or periodical income paid after January 12, 1983, to U.S. citizens or residents and to U.S. corporations is subject to withholding tax in the USVI at a rate not to exceed 10 percent.[8] However, the Virgin Islands legislature has the power to reduce to zero the rate of withholding on payments made to U.S. persons.

The exemptions (or low rate in the case of USVI source passive income paid to U.S. persons) from withholding tax on passive income described above, together with the source rules of §861, have enabled investors from jurisdictions other than the United States or one of its possessions to avoid U.S. tax on U.S. source income.

Code §861 in effect provides that interest or dividends paid by a U.S. corporation to a foreign corporation are not subject to the 30 percent tax if less than 20 percent of the paying corporation's gross income is derived from U.S. sources. When applied to the mirror codes of the possessions, this rule (known as the "80-20 source rule") exempts from territorial withholding tax the income of a possessions corporation which derives most of its income from foreign sources, including the United States. The exemption from withholding applies regardless of whether the income of the possessions corporation is paid to a U.S. shareholder or any other foreign shareholder.

Example: A foreign corporation (other than a U.S. or a possession's corporation) sets up a subsidiary in Guam. The Guam corporation holds stock in a U.S. corporation and/or lends it money. Interest and/or dividends paid by the U.S. corporation to the Guam corporation are exempt from U.S. withholding tax under §881(b). If more than 80 percent of the income of the Guamanian corporation is from U.S. sources, the 80-20 rule [9] is satisfied. Distribution of the income of the Guamanian corporation to foreign investors is therefore exempt from territorial withholding tax. The effective rate on

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the overall transaction would probably be very low in spite of the relatively high corporate rate in Guam because the tax base (Guam net income) would probably be relatively small.

Through these provisions, the U.S. possessions, especially Guam, had hoped to become new financial centers catering to both U.S. and foreign investors and to take the place of jurisdictions, such as the Netherlands Antilles, with which the United States has concluded tax treaties and which have been threatened by the U.S. policy to limit the benefits under these treaties to bona fide residents of the treaty country. The Guam legislature even adopted legislation which it hoped would facilitate its becoming such a financial center.

The U.S. Treasury, however, issued Temporary Regulations on December 28, 1982,[10] to create an exception to the 80-20 source rule thereby thwarting the possessions' hope to attract foreign investors. The Temporary Regulations provide that for purposes of the 20 percent test, income derived from Guam, the Northern Mariana Islands, and the U.S. Virgin Islands is U.S. source income if such income is not taxed to the recipient in the possession by the jurisdiction of actual source. The application of the Temp. Regs. was illustrated in two IRS Revenue Rulings.[11]

In Rev. Rul. 83-9, a foreign corporation organized a Guam corporation. The Guam corporation received interest from its U.S. subsidiary and paid interest to the foreign corporation. Under §881(b), the Guam corporation is not treated as a foreign corporation. Thus, no withholding tax is required under §881(a) or §1442(a). Prior to the Temp. Regs. amending the 80-20 rule in §861(a)(1)(B), interest paid by the Guam corporation was treated as foreign source income if more than 80 percent of its income was derived from foreign (U.S.) sources. Under Temp. Regs. §4a.861-1(a), however, and the "mirror" code, since interest received by the Guam corporation had not been taxed in the United States, it is treated as Guam source income. The Guam corporation must, therefore, withhold 30 percent of its interest payments under §1442(a).

Revenue Ruling 83-10 involved a similar fact pattern, except the foreign corporation organized a Virgin Islands corporation. Under §28(a) of the Revised Organic Act of the Virgin Islands, no withholding is required since the recipient reasonably expects to satisfy its USVI tax obligation under Rev. Proc. 81-20, 1981-1 C.B. 690. The Virgin Islands uses a "mirror" of the U.S. code, as does Guam. Thus, prior to the Temp. Regs., the 80-20 rule of §861(a)(1)(B) would classify the interest payments by the Virgin Islands corporations as foreign source income. Temp. Regs. §4a.861-1(a), however, treats the interest in the ruling as Virgin Islands source income, since no tax was withheld by the U.S. payor under the Revised Organic Act. Consequently, the USVI corporation must withhold tax under §1442(a) on interest payments made to the foreign corporation.

On November 22, 1983, the Government of Guam challenged in court the legality of Treasury's Temporary Regulations and the IRS ruling concerning Guam.

The Tax Reform Act of 1984 amends Code §881 and §1442 to clarify the situation. These provisions were originally introduced in the House Bill [12] and were adopted in the conference agreement with a technical correction. According to the House Ways and Means Committee Report,[13] the new provisions reflect the Committee's concern with:

> "the proliferation of conduit entities that purport to shield foreign investors from U.S. tax. The committee particularly opposes artificial devices that purport to shield foreign investors from U.S. tax on dividends. If successful, these devices could allow foreign investors who buy or invest in U.S. companies a significant tax advantage over U.S. investors ... The committee believes that rules that eliminate U.S. tax on payments of passive income to corporations organized in U.S. possessions should not apply to foreign-owned corporations or to corporations that derive a large portion of their gross income from outside U.S. possessions. However, the committee does not wish to alter tax incentives that the possessions extend to U.S. investors."

II. Overview

Section 130 of the Tax Reform Act of 1984, amending §§881(b) and 1442(c), provides in effect that withholding tax at the rate of 30 percent can now be imposed on dividends, interest, rent, and other passive income not effectively connected with the conduct of a trade or business within the United States paid to a corporation created or organized in Guam or the Virgin Islands.

The withholding will not be imposed, however, if the two conditions relating to the degree of foreign ownership of the stock of the possession's corporation and to the percentage of local source income are met.

The provisions of section 130 apply with respect to Virgin Islands corporations in spite of Section 28(a) of the Revised Organic Act of the Virgin Islands.

Code §§881(b) and 1442(c), as amended by Act §130, are not subject to the mirror theory for purposes of income tax liability incurred to Guam or the Virgin Islands.

The provisions apply not only to payments to corporations organized in Guam and the Virgin Islands but also to those organized in the Northern Marianas because, as previously noted, references in the Code to Guam are deemed generally to apply to the Marianas absent expressed intent to the contrary.

III. Detailed Analysis

Code §881(b) is amended by section 130(a) to provide that, for purposes of the tax imposed on U.S. source passive income (as defined in §881(a)) received by foreign corporations, corporations created or organized in Guam or the Virgin Islands are not considered to be foreign corporations for any taxable year if two conditions are met. The two conditions are:

> (i) At all times during such taxable year less than 25 percent in value of the stock of such corporation is owned (directly or indirectly) by foreign persons; and
>
> (ii) At least 20 percent of the gross income of the corporation is shown to the satisfaction of the Secretary of the Treasury to have been derived from sources

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within Guam or the Virgin Islands during the three-year period ending with the close of the corporation's preceding taxable year (or for such part of this period as the corporation has been in existence).

A conforming amendment is made to §1442(c) to provide that if the two conditions of §881(b)(1), as amended, are met, a corporation organized or created in Guam or the Virgin Islands is not considered to be a foreign corporation and is therefore exempt from withholding tax on U.S. source passive income.

A. Degree of Foreign Ownership

The first requirement that must be met in order to be exempt from U.S. withholding tax on passive income is that less than 25 percent in value of the stock of the Guam or Virgin Islands corporation be owned directly or indirectly by foreign persons.

The Act defines "foreign persons" [14] for purposes of §881(b)(1) as any person other than a U.S. person or a person who would be a U.S. person if the general definition of the United States [15] included references to the U.S. possessions. As a consequence, residents of the possessions are not deemed to be foreign persons in this context.

To determine whether the stock of a Guam or Virgin Islands corporation is owned by a foreign person through a partnership, estate, trust, or another corporation, the rules of attribution of §318(a)(2) must be followed. However, to determine indirect ownership through a corporation, foreign persons owning five percent or more in value of the stock of a corporation which owns the Guam or Virgin Islands corporation are deemed to be shareholders of the Guam or the Virgin Islands corporation. Although this rule is substantially more stringent than the normal attribution rule, it will, according to the Conference Committee Report,[16] "allow territorial subsidiaries of publicly traded U.S. corporations many of whose stockholders are nominees (but with less than 25 percent in value of their stock held by foreign persons owning 5 percent or more in value) to meet the ownership requirement for reduced withholding."

B. Territorial Source of Income

To avoid U.S. withholding tax on passive income, a corporation organized or created in Guam or the Virgin Islands must derive at least 20 percent of its gross income during the three-year period ending with the close of the corporation's preceding taxable year from sources within the territory.

The Conference Committee Report [17] states that this requirement makes it clear that a corporation formed in a U.S. possession is not eligible for reduced U.S. withholding tax on any U.S. source income if the possessions corporation could make payments of passive income that are free from withholding tax in the possession. This requirement assures collection of one tax on foreigners who invest in the United States.

If the ownership and gross income requirements are met, U.S. payments of passive income to the possessions corporation would be exempt from U.S. tax. However, payments by the possessions corporation to foreign investors would necessarily be subject to territorial withholding tax under the 80-20 source rules.[18] If the requirements are not met, the U.S. will impose its tax at 30 percent.

C. Effects on Mirror Rule

The rules of §§881(b) and 1442(c), as amended by TRA 1984, are not to be mirrored. Act §130 does not affect the liability to tax in Guam, the Marianas, or the Virgin Islands on passive income derived from sources in the possessions when paid to U.S. corporations. According to the House Ways and Means Committee Report,[19] such payments from sources in Guam and the Marianas will remain free of tax in those possessions, regardless of the U.S. corporation's owners or the source of its other income. Such payments from sources in the Virgin Islands remain subject to a Virgin Islands tax of up to 10 percent.[20]

D. Effective Date

The amendments introduced by Act §130 are effective for payments made after March 1, 1984, in taxable years ending after such date.

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[1] §881(a).
[2] §1442(a).
[3] P.L. 92-606.
[4] Mirror of Code §881(b).
[5] P.L. 94-241, §601(c).
[6] P.L. 83-517, 1954-2 C.B. 595.
[7] Rev. Proc. 81-20, 1981-1 C.B. 690; T.D. 7777, 1981-1 C.B. 448.
[8] The reduced rate results from §§1444 and 881 as modified by §934A, enacted by P.L. 97-455.
[9] Mirror of Code §861.
[10] Temp. Regs. §4a.861-1(a).
[11] Rev. Rul. 83-9, 1983-1 C.B. 126, and 83-10, 1983-1 C.B. 127.
[12] H.R. 4170.
[13] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d. Sess., (1984).
[14] §881(b)(3)(A), as introduced by Section 130(a).
[15] §7701.
[16] H.R. Rep. No. 861, 98th Cong., 2d. Sess., p. 950 (1984).
[17] *Id.*
[18] Mirror of Code §861.
[19] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d. Sess., p. 1344 (1984).
[20] Code §934A.

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CHAPTER 75

TREATMENT OF COMMUNITY PROPERTY INCOME OF NONRESIDENT ALIENS

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I. Introduction

Prior to the Tax Reform Act of 1976,[1] married nonresident aliens were not entitled to file joint returns. Because of their inability to file joint returns, their income effectively connected with the conduct of a U.S. trade or business (which is subject to tax at graduated rates) could not be split between the spouses (and therefore benefit from lower graduated rates). However, if both spouses are nonresident aliens from a community property country, they could split the effectively connected income of one spouse to reduce their U.S. tax liability.

In general, community property law provides that one-half of the earnings of each spouse is deemed to belong to the other spouse. Income from property acquired during the marriage is deemed to be owned in equal shares by both spouses. Property acquired before the marriage or acquired by gift or inheritance during the marriage can be separate or community property. When it cannot be ascertained whether the property is separate, it is frequently presumed to be community property and the income therefrom community income.

The Supreme Court [2] has held that spouses are permitted to divide or "split" income between them for tax purposes, regardless of whose property or which spouse generated the income, if the marriage is viewed as a community under the law of the domicile of the spouse generating the income (or that of the jurisdiction where the property is located) and each spouse has a vested (rather than a mere expectant) right over income earned by the other spouse.

Community property jurisdictions exist both within and without the United States. The Internal Revenue Service and the courts have recognized a number of jurisdictions as qualifying as community property jurisdictions for U.S. tax purposes, including: (i) states (*e.g.*, California, New Mexico and Nevada); (ii) U.S. territories (*e.g.*, Puerto Rico); and (iii) foreign countries (*e.g.*, Belgium, France, Mexico, and Switzerland).

With respect to a nonresident alien married to a U.S. citizen or resident, the Tax Reform Act of 1976 [3] rendered certain community property laws inapplicable for income tax purposes for taxable years beginning after December 31, 1976. Code §879, as enacted by the Tax Reform Act of 1976, introduced the following rules governing the allocation of income between spouses. Earned income, other than trade or business income and a partner's distributive share of partnership income, is treated as the income of the spouse who rendered the personal services. Trade or business income (other than a partner's distributive share of partnership income) which is community income under community property laws applicable to such income is treated as the income of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case it is treated as the income of the wife. Any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership which is community income or loss under the community property laws applicable to such share is included in computing the net earnings from self-employment of such partner, and not that of his or her spouse. Community income derived from the separate property of one spouse is treated as the income of such spouse. Finally, all other community income is allocated as provided under the applicable community property law.

While §879, as enacted by the 1976 Act, barred a nonresident alien married to a U.S. citizen or resident from splitting their community income, another provision enacted by the 1976 Act enabled them to split their income by filing a joint return.

Code §§6013(g) and (h), as enacted by the 1976 Act, permit a nonresident alien married to a U.S. citizen or resident to be treated as a U.S. resident if both spouses elect to file a joint return for taxable years ending on or after December 31, 1975, and agree to be taxed on their worldwide income and if they supply all necessary books and records. The election under §6013(g) applies for the taxable year for which made and remains in effect until terminated. The election under §6013(h) is available to couples in which one spouse is a U.S. citizen or resident and the other is an alien who becomes a U.S. resident during a taxable year. This is a one-time election which enables such couples to file a joint return in the year the alien becomes a resident.

Both §§879, 6013(g), and 6013(h) apply only to couples in which one spouse is a nonresident alien and the other a U.S. citizen or resident. Couples in which both spouses are nonresident aliens could, therefore, continue to split their community income if they were domiciled in a community property jurisdiction rather than in a common law jurisdiction.

Section 139 of the Tax Reform Act of 1984 expands the scope of §879(a) so that it overrides community property laws with respect to married couples in which either one or both spouses are nonresident aliens.

The reasons for the change, as stated in the House Ways and Means Committee Report, are as follows:[4]

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"The committee believes that the U.S. income tax treatment of nonresident aliens from community property countries should be the same as the U.S. income tax treatment of nonresident aliens from common law countries. A graduated income tax like that of the United States imposes less tax on a given amount of income if the income belongs to more than one person. Therefore, when married taxpayers split their income, they generally reduce their combined tax liability. The committee does not believe that nonresident aliens who earn income that is effectively connected with a U.S. trade or business should be able to split that income for U.S. tax purposes by virtue of foreign community property laws. Furthermore, it does not believe that such a couple should be taxed more favorably than a similarly situated U.S. couple."

II. Overview

Section 139 of the Act amends §879(a) to provide that, in the case of a married couple in which one or both spouses are nonresident alien individuals and who have community income for the taxable year, the community property laws will not apply with respect to earned income, income from a trade or business, partnership income, and other community income derived from the separate property of one spouse. These types of income will be taxable to the spouse generating the income in spite of the fact that the couple may be domiciled in a community property jurisdiction.

III. Detailed Analysis

For taxable years beginning after December 31, 1984, the rules of allocation of §879(a) governing community income earned by one spouse are extended to cover married couples in which one or both spouses are nonresident aliens.

Section 879(a), as amended by §139 of the Act, provides that a married couple, one or both of whom are nonresident individuals having community income for the taxable year, must allocate the income in the following way, notwithstanding any applicable community property law: (i) earned income is allocated to the spouse who rendered the personal services; (ii) trade or business income or a partner's distributive share of partnership income is allocated following the rules of Code §1402(a)(5); (iii) community income derived from the separate property of a spouse is allocated to that spouse; and (iv) all other community income is allocated following the rules of allocation of the applicable community property law.[5]

Section 138 of the Act provides a "companion rule" to §879 as amended by Act §139. Section 138 introduces a new definition of resident alien which, in effect, makes it easier for an alien with U.S. source earned income to qualify as a resident alien for U.S. tax purposes. Under these rules, an alien individual is a resident alien for any calendar year if he or she is a lawful permanent resident of the United States at any time during that year or if he or she meets a "substantial presence" test. The substantial presence test will not be met if the alien spent less than 183 days in the United States during the current year and the alien can demonstrate that he or she has a tax home in a foreign country and has closer connections with that country.

The interaction of Act §§138 and 139 may be illustrated by a recent case[6] in which the Tax Court determined that Sweden qualified as a community property jurisdiction. The taxpayer, an employee of IBM Svenska (a Swedish subsidiary of IBM), was assigned to work in New York. At all times the taxpayer and his spouse were citizens of and domiciled in Sweden. The taxpayer worked in New York for IBM on an intercompany exchange from October 21, 1975, through July 1, 1978, and was in the United States on an L-1 intercompany visa while his wife was admitted on an L-2 visa. Because they were found to be domiciled in a community property jurisdiction, the taxpayer and his spouse were allowed to file nonresident alien returns reporting only one-half of the taxpayer's U.S. earned income for the relevant taxable year.

Pursuant to §879(a), as amended by TRA 1984, the Westerdahls would no longer be able to file returns with each spouse reporting one-half of the taxpayer's U.S. earned income, even though they are domiciled in a community property jurisdiction. However, under the new U.S. resident alien definition of §138 of the Act, Mr. Westerdahl would be considered a U.S. resident alien for U.S. tax purposes. As a U.S. resident alien, he and his spouse would be entitled to make an election under §6013 to file a joint return and thereby split their income and benefit from taxation at the lower graduated rates.

The negative aspect of this election is that the nonresident alien spouse would be subject to tax in the U.S. on worldwide income.

Section 139 of the Act, amending Code §879(a), is effective for taxable years beginning after December 31, 1984.

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[1] P.L. 94-455.
[2] *Poe v. Seaborn*, 282 U.S. 101 (1930).
[3] P.L. 94-455.
[4] H.R. Rep. No. 432 (Part II), 98th Cong., 2d Sess., p. 1532 (1984).
[5] Examples of such other community income are dividends, rents and royalties. It should be noted, however, that most passive income of nonresident aliens is subject to withholding at source at a flat rate of 30 percent.
[6] *Westerdahl v. Comr.*, 82 T.C. 83 (1984).

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CHAPTER 76

RESTRICTIONS ON SECTION 341(f) CONSENT FOREIGN COLLAPSIBLE CORPORATIONS

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I. Introduction

In the more than 30 years of its existence, §341 has proven to be one of the more effective and durable aspects of the Internal Revenue Code. Designed to prevent taxpayers from utilizing the corporate entity to avoid corporate level tax and convert ordinary income into capital gain at the shareholder level,[1] §341 has survived as a generally active Code ombudsman, (albeit with several amendments of extraordinary complexity[2]). This has occurred despite the exponential growth in size and complexity of the U.S. and world economy.

The latest amendment, in which §135 of TRA 1984 adds §341(f)(8) to the Code, is yet another manifestation of the intricacies of §341 and of taxpayers ongoing efforts to avoid these strictures. A complete and very lucid explanation of the implications and operation of §341(f), together with suggestions for its effective use is contained in 29 T.M., *Collapsible Corporations — General Coverage.*[3]

Although governmental experience with taxpayer "anti-collapsible" planning devices has served to constrain many corporate ordinary income — capital gains conversion schemes, the latest concern in Congress in this area — reflected in §135 — represents more a problem of tax administration and international tax compliance rather than a newly discovered anomaly or loophole in the operation of §341. Notwithstanding that §341 is cast[4] in terms of "a corporation," and therefore applies with the same force to both a foreign and domestic corporation, and notwithstanding that §341(f), itself an amelioratory provision enacted in 1964,[5] was carefully drafted to preclude abuse, its utilization to convert ordinary income to capital gain by U.S. persons in sales or dispositions to foreign persons apparently[6] became a matter of governmental concern.

Under §341(f), an electing corporation can guarantee capital gains to selling shareholders under circumstances in which, in the case of sales or dispositions to U.S. persons, assures the preservation of ordinary income treatment at the corporate level with respect to all "tainted," *i.e.*, so-called §341(f) assets, thereby effectively implementing the policy of the 1964 legislation.

As described by the Senate Finance Committee, a corporation to which a §341(f) election may be appropriate is a corporation:

> "... that is rapidly growing and expects to continue in business, but which holds constructed or produced properties which are worth substantially more than their cost and upon which there has not been substantial realization of the profits to be derived from the properties. The shareholders, through the sale of stock (whether or not through a single 'public offering'), would like to capitalize on the future prospects of this growing company. The buyers of the stock clearly intend to have the corporation continue in business. However, on such stock sale the corporation might be regarded as fitting precisely into the literal definition of a collapsible corporation (under sec. 341(b)) if the shareholders intended to sell the stock of the corporation prior to the realization by the corporation of a substantial part of the income to be derived from the constructed or produced property. Moreover, the corporation usually cannot qualify under any of the several existing exceptions, principally because it has not had a substantial prior business history and is growing rapidly ... [§341(f)] meets the problem described above by providing that the collapsible provisions will not apply to the sale of stock in a corporation which consents to a special type of tax treatment ... the treatment provided has the effect of assuring that ultimately there will be the same tax consequences as if the assets had been sold before the stock."[7]

The mechanism of subsection (f) requires that the corporation in question consent under regulations (which were promulgated in final form 12 years after the enactment of §341(f), in 1979)[8] to recognize gain with respect to any "subsection (f)" (*i.e.*, ordinary income) asset, whenever that asset is "disposed of."[9] Such corporate level ordinary income reorganization occurs; (a) in the case of a dividend distribution which (prior to the amendment of §311(d)(1) of the Code by §54 of TRA 1984 would not have generated a corporate level gain),[10] (b) "... an abandonment or retirement, gift, sale in a sale — and — leaseback transaction, and (c) a transfer upon the foreclosure of a security interest."[11] Further, if a subsection (f) asset is transferred in a nontaxable transaction (for example, under §351 or §332) gain will also be recognized to the consenting corporation unless the transferee corporation itself agrees to have the gain recognition provisions of §341(f)(2) apply to the same extent and in the same manner as such provisions would have applied with respect to the original consenting corporation.[12]

If the absence of litigation with respect to §341(f) during the 20 years of its existence is any measure, it would appear that this provision, in general, is serving its dual

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purpose: On the one hand, ameliorating the ordinary income "lock in" of shareholders of young, active, and growing businesses by enabling them at capital gains rates to dispose of their shares pursuant to the §341(f) consent mechanism before the corporation has realized its full earnings potential. On the other hand, the federal fisc has been protected, since the very broad scope of the mandated corporate level ordinary income recapture assures the ultimate [13] imposition of a double tax.

It is next appropriate to observe that the problem at which §135 is aimed, was, it seems clear, not unanticipated by the Treasury department, if not at the time of enactment of §341(f) at least in the pertinent proposed and final regulations. Thus, §1.341-7(e)(3) of the final regulations treats the subject of §135:

> "In the case of a foreign corporation which files a statement of consent pursuant to paragraph (b) of this section, such statement, in addition to the information required in paragraph (b) of this section, shall also contain a declaration that the corporation consents that any gain upon the disposition of a subsection (f) asset which would otherwise be recognized under section 341(f)(2) will, for purposes of section 882(a)(2), be considered as gross income which is effectively connected with the conduct of a trade or business which is conducted through a permanent establishment within the United States." [14]

In light of the foregoing paragraph, the need for a new statutory provision may well be questioned. One response apparently lies in visualized [15] Internal Revenue Service's difficulties of assuring adequate compliance by, under §341(f), the "consenting" foreign corporation.

As stated by the Conferees:

> "Treasury regulations provide that, in the case of a foreign corporation that gives a section 341(f) consent, any gain on the corporation's disposition of a subsection (f) asset is considered gross income that is effectively connected with a U.S. trade or business (Treas. Reg. sec. 1.341-7(e)(3)). A foreign corporation is subject to the regular corporate income tax with respect to income that is effectively connected with a U.S. trade or business. The regulatory provision may have no practical effect, however, where the foreign corporation's income is not subject to U.S. taxes (because the corporation has no U.S.-source income and is not engaged in a U.S. trade or business) and the stock is sold to a foreign person." [16]

Treasury may also have believed that the absence of a practical mechanism of enforcement of the recapture provisions of §341(f) is a virtual impossibility where the corporation, (for example, a company engaged in the production but not the distribution) of a foreign film may have no U.S. operating nexus, such as a corporation organized in a tax haven jurisdiction without a treaty or other provision for the exchange of information with the United States. If, in such a case, a foreign corporation makes a proper §341(f) election, its domestic shareholders would be assured of capital gains but no correlative enforcement mechanism exists to collect the tax on the disposition, at some indefinite future date, of §341(f) assets by the foreign entity.

Another issue which may underlie enactment of §341(f)(8) derives from a long held concern that taxpayers may take the position that a foreign corporation which does not realize U.S. source income may not be subject to §341 at all. While no reference to this is made neither in the statute nor in the Committee Report, the following comment in the Report of the Conferees appears to constitute the message to the Treasury and the courts to apply §341 on a worldwide basis:

> "The provisions of section 341 make no distinction between domestic corporations and foreign corporations. Thus, the collapsible corporation rules are applicable to a foreign corporation that is used as the vehicle for the proscribed tax avoidance scheme. Rev. Rul. 56-104, 1956-1 C.B. 178. [Footnote omitted see fn. 27 of chapter.]" [17]

Section 135 attempts to solve both problems, at least from the standpoint of §341(f), by as a general rule, effectively withdrawing the opportunity for the §341(f) election in this situation. While such an approach deprives U.S. shareholders of foreign corporations from availing themselves of the benefits of §341(f), the new statute also provides for limited exceptions to the general rule. Specific situations to which the exception would apply are not identified by the Conferees. However, some indication of the intended parameters within which the exception would operate is reflected in the Report of the Conferees:

> "There is no policy reason to allow the use of the collapsible corporation device by U.S. taxpayers simply because the corporation is organized under the laws of a foreign country to engage in an activity abroad. This result may occur, however, where the stock of a foreign collapsible corporation is sold to a foreign person and the section 341(f) consent given by a foreign corporation will not be given effect if the consenting corporation is not engaged in a U.S. trade or business and stock in the corporation is sold to a foreign person. The conferees recognize that there may be cases in which a section 341(f) consent given by a foreign corporation should be given effect. Accordingly, the conference agreement authorizes the Secretary to prescribe regulations setting forth circumstances in which it would be appropriate to give effect to a section 341(f) consent given by a foreign corporation." [18]

II. Overview

Section 135 of TRA 1984 narrows the scope of §341(f) by providing as a "Special Rule for Foreign Corporations" that "Except to the extent provided in regulations prescribed by the Secretary . . .," if a foreign corporation executes a consent under §341(f)(1), such consent pursuant to §341(f)(8)(A), shall "not be effective." Thus, a selling shareholder of a foreign collapsible corporation will not enjoy the benefits of the §341(f) election. Further, under §341(f)(8)(B), any foreign transferee (whether or not a §341(f) consent has been filed) may not avail itself of the benefits of the nontaxable transfer rule of §341(f)(3)(B) even if the transferor to it has made a valid §341(f) election. Of course, if the transferor is a foreign corporation, the new provision appears to be a nullity with respect to the transferee since the transferor is barred from filing a

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consent by reason of §341(f)(8)(A), and the foreign transferee would also be barred (since it is a foreign corporation) from the consent procedure on theory that, if with respect to its future transfers, it seeks to treat itself as a transferor.

Note: It should be observed that the Secretary's authority to except certain foreign corporations from the general rule of §341(f)(8) extends to transferees as well, since the positioning of the "Except" clause makes clear that transferees as well as transferors are included in its scope. Thus, if constraints under regulations are imposed upon a foreign transferor similar, indeed more rigid conditions may be applied to a foreign transferee.[19] By the same token, any regulatory relaxation of the general rule under authority of the "Except" clause will be subject to adequate security safeguards, also applying to a future transferee.

III. Detailed Analysis

Because a complete explanation of the mechanism of §341(f) is thoroughly and lucidly explained in 49 T.M., *Collapsible Corporations — General Coverage*, there is no occasion to restate these general rules. Further, because in the *Introduction* and *Overview* portion of the materials contained therein, many of the concepts underlying §341(f)(1) have been set forth, only its principal areas of operation will be noted.

Under §341(f)(8), unless a foreign corporation can avail itself of a regulatory "safe harbor" (under circumstances yet to be described in regulations to be promulgated), a §341(f) election, made by a foreign corporation, will not be effective to protect a shareholder from the generally applicable rules of §341. For example, assume a dealer in paintings (taxable at ordinary income rates in profits) who incorporates in a corporation organized in Panama, under circumstances which would, in general, cause the dealer's corporation to constitute a collapsible foreign corporation (within the definition contained in §341(b)).[20] If such a shareholder sells his shares in the Panamanian corporation (or receives a distribution from it including a distribution in a partial or complete liquidation or a nonliquidating distribution in excess of basis) he will be taxed on the gain at ordinary income rates, unless one of the exceptions to the general rule provided in §§341(d) or 341(e), applies, notwithstanding that the Panamanian corporation seeks to execute a consent under §341(f). In addition, even if a subsequent domestic transferee (for example, a Delaware corporation) of the Panamanian corporation agrees, pursuant to §341(f)(3)(B), to be bound by such consent, the new statute will apply, notwithstanding that the transferee is a domestic corporation which itself could have initially executed a valid §341(f) consent.

Although the statute does not substantively indicate the circumstances in which the regulations will provide an exception to the general rule of §341(f)(8), the following possibilities may be noted:

(1) If a foreign corporation is otherwise engaged in business in the United States, so that — independently from the subject of the consent — such corporation regularly files a U.S. tax return and establishes to the satisfaction of the Treasury that it possesses adequate assets in the United States to support a §341(f) recapture tax, no reason appears for denial of the consent procedure. Doubtless, specific assurances will be required with respect to the adequacy, (such as through a bonding procedure) of the assets, together with a demonstrated continuity of U.S. business presence during the period in which §341(f) assets can be estimated to be in the hands of the consenting corporation.

(2) Even in the case in which no U.S. assets are present, it is not inconceivable that the regulations will permit a qualifying consent to be made if the foreign corporation can provide reliable security with respect to the potential gain which otherwise would be subject to corporate level tax in the hands of the consenting corporation. Doubtless, difficult problems will be encountered in establishing the adequacy of the security in this instance.

Finally, reference is appropriate to the statement in the Conference Report as follows:

> "The conferees acknowledge that it may be appropriate for Congress to review the relationship between the Subpart F provisions, section 1248 and section 341." [21]

Although the Conferees reference to the identified three Code provisions is somewhat cryptic, one may speculate that Congressional and Treasury technicians will focus on these factors respecting the indicated Code provisions:

(1) Under §341, all of the gain (determined without regard to earnings and profits) realized by a shareholder holding stock in a foreign collapsible corporation constitutes ordinary income, provided *inter alia*, that the shareholder owns more than 5 percent in value of the outstanding stock of the corporation and that none of the other exceptions to collapsible treatment otherwise apply.[22]

(2) Under §951, a shareholder in a controlled foreign corporation (CFC) is taxed on his *pro rata* share of the corporation's Subpart F income, a concept which is limited to the earnings and profits of the CFC.[23] Further, the test of ownership of a CFC under Subpart F requires that more than 50 percent of the total combined voting power of all classes of voting stock [24] be owned by "United States persons" who own 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation.[25] Ownership, for purposes of Subpart F is in turn determined under its own rules provided in §958.

(3) Under §1248, any U.S. person who owns 10 percent or more of the total combined voting power of stock in a foreign corporation must include in income, as a dividend, that portion of the gain which does not exceed post-1962 accumulated earnings and profits of the foreign corporation.[26] Unlike the provisions of Subpart F no overriding more than 50 percent ownership test is applied for purposes of §1248.

Although the draftsmen of §341(f) evidently have viewed the discontinuities as a subject for future technical revision, the direction of change is also unclear. Whether a new rule, if enacted, would or should expand Subpart F and §1248 beyond its current earnings and profits limitation (as the Conferees seem to suggest [27]), or reduce the ordinary income taxation of 100 percent of the gain in the case of a

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collapsible corporation (which may prove too generous in the "dealer" case, described above) must await consideration of a future Congress.

In this connection, it also may be observed that somewhat similar anomalies exist in a domestic setting. For example, liquidation of a collapsible corporation will generate ordinary income to the full extent of gain, whereas liquidation of a noncollapsible corporation under §333 results in ordinary income taxation only to the extent of post-1913 accumulated earnings and profits.[28] Because §333, by definition, does not apply to a collapsible corporation, the distinction here may be regarded as appropriate. More generally, however, is the fact that the abuse to which §341 is directed *inter alia* concerns persons who, were it not for the opportunity to avoid corporate level tax, would never have incorporated. For example, a dealer in real estate would, in the absence of a corporation, realize ordinary income with respect to total gains, not just the earnings and profits accumulated by the corporation whose stock is sold. Thus, the application of ordinary income taxation to the sale of shares seems quite appropriate in that case (since the sale of stock was treated comparably to the sale of shares for purposes of §341), whereas under §951 and §1248, the statutory objective appears limited to assurance of dividend taxation of a presumably ongoing corporation's ongoing earnings. Since, by reason of newly enacted §341(f)(8), §341(f) may effectively no longer be availed of by a foreign corporation, the broader measurement of gain may well be appropriate in certain cases, such as the described situation of a U.S. dealer in real estate who incorporates land (whether situated in the U.S. or abroad) held for sale to customers in a foreign collapsible corporation. In that case, it is questionable whether an earnings and profits limitation is appropriate.

IV. Effective Date

The ostensibly straightforward effective date provisions of §135 state that such provision "shall take effect" on date of enactment, *i.e.*, on July 18, 1984. This form of effective date may be contrasted with that provided in the 1964 effective date provision of §341(f).[29] There it was stated that such provision "shall apply with respect to transactions after the date of enactment of this Act in taxable years ending after such date." The contrast between the two provisions would suggest that under §135 the pivotal factor is the date of filing of the statement of consent provided in §1.341-7(b) of the regulations under §341(f). Under Regs. §1.341-7(b)(3) such consent "... may be filed at any time ..." with the District Director having jurisdiction over the consenting corporation's income tax return.[30] Thus, it would appear that unless by reason of §135 of TRA 1984, a consent actually or constructively reaches the District Director's office before July 18, 1984, it will not avoid the constraints of §341(f)(8). Those which arrive on or after such date will be subject to the new rules.

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[1] In the initial "classic" collapsible case, a motion picture enterprise, which typically would have been conducted in corporate form, was "collapsed" or liquidated before such corporation realized income. Another "abuse" occurred in the case of an activity which normally may not have been conducted in corporate form, such as the activities of a dealer in land. In that case, the corporate device would have been utilized to create a vehicle to hold the property and thereafter, when values had ripened, the capital gains provisions available in corporate liquidations were utilized, in lieu of sales by the dealer, which otherwise would have constituted ordinary income to him.

[2] *See, e.g.*, §§341(e), 341(c)(5)(A).

[3] For a comprehensive discussion of §341, *see*, 29 T.M., *Collapsible Corporations — General Coverage*, and 226 T.M., *Collapsible Corporations — Section 341(e)*.

[4] *See* §341(b).

[5] P.L. 88-484, 78 Stat. 596.

[6] *See, supra*, note 15.

[7] S. Rep. No. 1241, 88th Cong., 2d Sess., 1964.

[8] T.D. 7655, 44 Fed. Reg. 68458 (November 28, 1979).

[9] *See* §341(f)(2).

[10] *See* §311(d)(1) as amended by P.L. 98-369.

[11] *See* Regs. §1.341-7(e)(7) (1979).

[12] *See* Regs. §1.341-7(f) (1979).

[13] The Code's current tendency to focus on the true value of money (*see, e.g.*, §1274) could imply an interest at some date in the future, or other charge for the privilege of deferral. *See* §679.

[14] *See* Regs. §1.341-7(e)(3) (1979).

[15] No published information indicates that actual tax evasion by consenting foreign corporations has been evident. On the other hand, the possibility for total disregard of the statute and regulation by a foreign corporation is both tempting and obvious, and this factor, as well, may have accounted for the congressional concern.

[16] *See* H.R. Rep. No. 861, 98th Cong., p. 963 (1984).

[17] *See, id.*, at 962.

[18] See, *id.*, at 964.

[19] *See* §341(f)(8)(B).

[20] §341(b)(3).

[21] *See* H.R. Rep. No. 861, *supra* footnote 16, at 964 note 6.

[22] §341(d)(1)(A). Under §341(d)(1)(B), indirect ownership is taken into account, and under §341(d) ownership of stock is determined by reference to §544.

[23] §951(a)(1)(A)(i). Under §951(a)(1)(A)(ii) and under §951(a)(1)(A)(iii), the shareholder must include in income his *pro rata* share of income withdrawn from investment in less developed countries and income withdrawn from the foreign base company shipping operations.

[24] §957(a).

[25] §951(b).

[26] §1248(a), (d).

[27] *See*, H.R. Rep. No. 861, *supra* footnote 16, at 962 note 2. "Congress has addressed the issue of the extent to which U.S. taxpayers can use foreign corporations to defer U.S. tax on foreign-source income in sections 951-964 (Subpart F) and 1248 of the Code. Under these provisions, the earnings and profits of certain foreign corporations are taxed as ordinary income to U.S. shareholders who own ten percent or more of the corporation's stock. Because the classic collapsible corporation has insignificant earnings and profits, neither Subpart F nor section 1248 prevents the use of a foreign corporation for the proscribed device."

Another possible consideration is concern that regulations identifying income subject to a consent has effectively connected U.S. source income may constitute regulations which are legislative, rather than regulatory, in nature and therefore subject to invalidation.

[28] §333(e), (f).

[29] P.L. 88-484, 78 Stat. 596.

[30] *See* Regs. §1.341-7(b)(1) (1979).

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CHAPTER 77

MISCELLANEOUS PROVISIONS

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I. Extension of Moratorium on Research and Experimental Expense Allocation Regulations

A. Introduction

U.S. residents (including domestic corporations) are subject to U.S. income tax on their income derived from worldwide sources. Since U.S. residents may also be subject to income tax in a foreign country on income derived from such foreign country, the United States allows a credit for foreign income taxes. This foreign tax credit, however, is limited to the U.S. tax liability attributable to foreign source income. The purpose of the limitation is to prevent income taxes paid to foreign countries from reducing U.S. taxes on U.S. source income. The limitation is expressed in the form of the following formula:

$$\text{Tentative U.S. Tax Liability} \times \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

Regs. §1.861-8 provides rules for the allocation and apportionment of the research and experimental expenses and other deductions (*e.g.*, interest, taxes, stewardship expenses, etc.) to foreign source and U.S. source gross income for purposes of computing the foreign source taxable income and the worldwide taxable income. The objective of these regulations is to match the expenses with the foreign and domestic source income generated by or related to the expenditure.

The effect of allocating an expense, such as the R & D expense, to foreign source income is to reduce the foreign source taxable income (*i.e.*, the numerator of the foreign tax credit limitation fraction) and thereby, the foreign tax credit limitation. In the case of R & D activities conducted in the United States, foreign countries generally do not allow a deduction for such expenses because the research is not conducted there. Thus, if R & D expenses of U.S.-based research activities are allocated (at least, in part) to foreign source income (as was certain to occur under Regs. §1.861-8(e)(3) prior to 1982), it will result in increasing the taxpayer's worldwide tax liability.

The possibility of increased taxes and the accompanying effect on U.S.-based R & D activity motivated the enactment of §223 of the Economic Recovery and Tax Equity Act of 1981 (ERTA). U.S. multinational businesses contended that Regs. §1.861-8(e)(3) caused U.S. business to transfer U.S.-based research activity abroad. The legislative history of §223 of ERTA indicates that Congress believed that the transfer of U.S. research activities overseas was not in the best interests of the United States.

Section 223 of ERTA suspended Regs. §1.861-8(e)(3) for a period of two years and provided that, for their two taxable years beginning after August 13, 1981, taxpayers must allocate and apportion all expenditures incurred with respect to research activities (within the meaning of §174) conducted in the United States to U.S. source income. In addition, §223 of ERTA required the Secretary to conduct a study of the effect which §1.861-8 of the regulations has on both R & D activities conducted within the United States and on the availability of the foreign tax credit. A report on the study was required to be submitted to the Congress by February 13, 1982.

The Treasury Department conducted the required study and submitted a report on June 14, 1983. In its report, the Treasury concluded that "an allocation of research and development expenses to foreign source income may increase a taxpayer's worldwide tax liability if the foreign government did not allow the apportioned expense as a deduction. Some allocation to foreign income, however, is appropriate on tax policy grounds when domestic research and development is exploited in a foreign market and generates foreign income." The report went on to recommend that, because a reduction in research and development may adversely affect the competitive position of the United States, the moratorium on Regs. §1.861-8(e)(3) should be extended for two years in order to allow Congress time to consider the report's findings and work with the Administration to develop a coherent national program of research and development incentives.

In the Tax Reform Act of 1984, the U.S. Congress accepted the Treasury's recommendation and extended the moratorium on the regulations pertaining to the allocation and apportionment of R & D expenses for two years.

B. Detailed Analysis

Section 126 of the Tax Reform Act of 1984 (P.L. 98-369) extends the moratorium on the application of Regs. §1.861-8(e)(3) for two years. It provides that, for a taxpayer's taxable years beginning after August 13, 1983, and on or before August 1, 1985, all amounts allowable as a deduction for qualified research and experimental expenditures shall be allocated to and deducted from the taxpayer's U.S. source income. Section 126(b) of the Act defines the term "qualified research and experimental expenditures" to mean expenditures which are deductible under §174 and which are allocable to research and experimental activities conducted in the United States.

Section 126(c) of the Act also provides a special rule under which a taxpayer can benefit from the moratorium

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for its third taxable year beginning after August 13, 1981, even if such third taxable year does not begin on or before August 1, 1985.

II. Definition of FORI and Recapture of Foreign Oil Related Losses Clarified

A. Introduction

Section 211 of TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) repealed the per-country loss rule of §907(c)(4). It also tightened the limitations imposed by §907 on amounts of foreign taxes paid or accrued on foreign oil and gas extraction income and nonextraction foreign oil related income which may be credited against U.S. tax under §901 by U.S. multinational oil companies.

Because the repeal of per-country extraction loss rule requires a netting of foreign oil and gas extraction income and losses from all foreign countries, a taxpayer may have an overall foreign oil and gas extraction loss in a given taxable year. If a taxpayer does have an overall extraction loss, there are no restrictions on such a loss offsetting the taxpayer's other foreign source income and U.S. source income in that order. Where a taxpayer has an overall extraction loss in a given year, §907(c)(4) (enacted by TEFRA) provides rules for the recapture of such a loss in subsequent years.

The recapture rules of §907(c)(4), however, created a special problem. Under pre-TEFRA law, foreign taxes paid on oil-related foreign source income were subject to a separate foreign tax credit limitation under §§904 and 907(b). The §904 overall limitation for foreign taxes paid on non-oil related income was computed separately. The separate limitation for oil-related income, however, was repealed by TEFRA. Consequently, for purposes of loss recapture, the distinction between oil-related and non-oil related losses was eliminated. Thus, a non-oil related loss suffered in years before 1983 could be recaptured from post-1982 oil-related income and vice versa.

To deal with this problem, §211(e)(2) of TEFRA, as amended by the Technical Corrections Act of 1982, provided a special rule. Under this special rule, for purposes of recapturing a pre-1983 loss, post-1982 income of an oil company is required to be segregated into two separate baskets: an oil-related income basket and a non-oil-related income basket. Pre-1983 oil-related loss is first recaptured from the post-1982 oil-related income basket. To the extent such loss is not fully recaptured from the oil-related income basket, it is recaptured from the non-oil-related income basket. The recapture from the non-oil-related income basket need not be recaptured more rapidly than ratably over an eight-year period beginning with the first taxable year beginning after December 31, 1982.

Section 212 of TEFRA amended §954 (adding a new subsection (h)) to include nonextraction foreign oil-related income (other than certain shipping income) of large oil producers as a new category of foreign base company income. Thus, for taxable years beginning after December 31, 1982, nonextraction oil-related income (FORI) became the fifth category of foreign base company income.

There are some discrepencies between foreign base company FORI as defined in the Senate and Conference Committee Reports to TEFRA and as defined in §954(h). Section 954(h), as enacted by TEFRA, provides that base company FORI means foreign oil-related income within the meanings of §907(c)(2). This definition clearly appears to exclude indirect FORI (as defined in §907(c)(3)) from the base company FORI. The Senate Finance Committee Report, however, clearly and explicitly appeared to include FORI earned indirectly by U.S. taxpayers in foreign base company FORI. It provided, for example, that foreign base company FORI includes dividends, interest, amounts, or a distributive share received by a CFC to the extent such dividends, interest, amounts, or distributive share is attributable to FORI.

Sections 712(e) and (f) of the Tax Reform Act of 1984 (P.L. 98-369) make technical amendments to the special rule pertaining to the recapture of pre-1983 losses, and to the definition of foreign base company FORI in §954(h) respectively.

B. Detailed Analysis

Section 712(f) of the Tax Reform Act of 1984 amends the definition of foreign base company FORI and §712(e) amends the special pre-1983 foreign oil-related loss recapture rule.

1. The Definition of Base Company FORI Amended

Section 712(f) of the Act amends §954(h) to include a cross-reference to §907(c)(3). Thus, the amended §954(h) provides that the foreign base company FORI means foreign oil-related income as defined in §§907(c)(2) and 907(c)(3).

Section 907(c)(2) provides that the term "foreign oil related income" means the taxable income derived from foreign sources from: (i) the processing of minerals extracted from oil or gas wells into their primary products, (ii) the transportation of such minerals or primary products, (iii) the distribution or sale of such minerals or primary products, and (iv) the disposition of assets used by the taxpayer in the trade or business described in (i)-(iii) above.

Section 907(c)(3) provides that the term "foreign oil related income" includes dividends, interest, amounts, or a distributive share received by a CFC to the extent such dividends, interest, amounts, or distributive share is attributable to FORI.

Thus, foreign base company FORI includes not only foreign oil-related income earned directly by the taxpayer but also such income earned indirectly by the taxpayer.

2. Special Pre-1983 Loss Recapture Rule Amended

Section 712(e) of the Act amends the special rule which provides for the recapture of pre-1983 oil-related loss from the non-oil-related income basket over an 8-year period. Specifically, §712(e) of the Act amends §211(e)(2) of TEFRA to clarify that a taxpayer may, at its option, select a period shorter than eight years for the recapture of pre-1983 oil-related loss from the non-oil-related basket.

III. Foreign Earned Income Exclusion — Scheduled Increases Postponed

The Economic Recovery and Tax Equity Act of 1981 (ERTA) repealed §913 and enacted an amended version of

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§911 providing liberal rules for the exclusion of foreign earned income of U.S. citizens and resident aliens.

Under §911(a), a qualified individual may elect to exclude from gross income for any taxable year: (i) the foreign earned income of such individual, and (ii) the housing cost amount of such individual.

Section 911(b)(2), as originally enacted by ERTA, however, provided certain limits on the maximum amount of foreign earned income that a qualified individual could claim as an exclusion for any particular taxable year. This maximum amount of exclusion was $75,000 for the taxable years beginning in 1982; $80,000 for taxable years beginning in 1983; and was further scheduled to increase by $5,000 yearly until it reached $95,000 for taxable years beginning in 1986 and thereafter.

Section 17 of the Tax Reform Act of 1984 postpones the scheduled increases for 1984 and later years in the maximum amount of foreign earned income exclusion that a qualified U.S. citizen or resident alien may claim from gross income until 1988. Thus, the maximum amount of foreign earned income exclusion under §911(b)(2) remains at $80,000 for taxable years beginning in 1984, 1985, 1986 and 1987. For taxable years beginning in 1988, the maximum limit will increase to $85,000. This limit will further increase to $90,000 for taxable years beginning in 1989, and to $95,000 for taxable years beginning in 1990 and thereafter.

IV. Restrictions on Foreign Tax-Exempt Entity Leasing

Section 168(j), added by Act §31, extends the cost recovery period for property leased to a tax-exempt entity. For this purpose, the term "tax-exempt entity" encompasses any foreign person or entity, except for a foreign partnership or other foreign pass-through entity. The Act carves out exceptions for certain property (*e.g.*, property with respect to which more than 50 percent of the gross income derived by the foreign person or entity is subject to United States income tax, or is includible in gross income under §951).

The Act also extends the restrictions on investment tax credits to property used by foreign persons or entities. Again, exceptions are provided for specific classes of property.

V. Technical Correction Made to Section 1256(g)(1): "Foreign Currency Contract"

The Technical Corrections Act of 1982, §105(c)(5)(B), amended §1256(b) defining "regulated futures contract" by adding "Such term includes a foreign currency contract." The term "foreign currency contract" was defined in §1256(g), added by §105(c)(5)(C) of the 1982 TCA, to mean a contract "which requires delivery of a foreign currency" in which positions are also traded through regulated futures contracts. It was unclear whether this definition also applied to foreign currency contracts which are settled or could be settled in cash (as was true in the case of regulated futures contracts under the definition as amended by the 1982 TCA). Section 722(a)(2) of the 1984 TRA amends §1256(g), effective as if enacted by ERTA (as were the other 1982 TCA amendments), to add after the words "delivery of," in the definition of "foreign currency contract" the words "or the settlement of which depends on the value of." Thus, cash settlement foreign currency contracts are included in the definition of regulated futures contract for purposes of §1256 prior to its amendment by §102(a) of the 1984 TRA. Act §102(a), amending §1256, effective as to positions established after July 18, 1984, includes foreign currency contracts in the definition of "§1256 contract." The definition of foreign currency contract in §1256(g) is the same as pre-enactment §1256(g), as corrected by Act §722(a)(2), *supra*. *See* discussion in Chapter 37 of the amendments made to §1256.

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CHAPTER 78

AMENDMENTS TO THE EXCISE TAXES

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I. Three Percent Excise Tax on Communications Services Extended (Act §26)

A. Introduction

A three percent excise tax is imposed on amounts paid for local telephone service, toll (long-distance) telephone service, and teletypewriter exchange service.[1] These services are defined in §4252. The tax is paid by the person paying for the services. Prior to the Tax Reform Act of 1984, the tax was scheduled to terminate on January 1, 1986.[2]

B. TRA Amendment

Section 26 of the Act extends the current three percent tax on communications services for two years, through December 31, 1987.

C. Effective Date

The three percent excise tax is extended to amounts paid pursuant to bills rendered prior to 1988.

II. Amendments Relating to the Windfall Profit Tax (Act §§25, 722(a)(7))

A. Introduction

1. General

The Crude Oil Windfall Profit Tax of 1980 [3] imposes a windfall profit tax on the owner of an economic interest in the oil, *e.g.*, a domestic oil producer or royalty owner.[4]

Rather than taxing "profits" however, the Act imposes an excise or severance tax on each barrel of production when the oil is removed from the premises. The tax liability equals the "tax rate" multiplied by the "windfall profit." The windfall profit equals the removal price of the oil minus the sum of a specified base price, as adjusted for inflation, and state severance taxes imposed on the windfall profit.[5] The tax rate, base price, and inflation adjustment to the base price vary depending upon the character or "tier" of the oil.[6]

Section 4991 of the Code sets forth the definitions of the various categories of oil for purposes of the tax. Generally, tier one oil is domestic crude oil discovered and put into production prior to 1979. Specifically, tier one includes domestic crude oil not treated under any other provision of the windfall profit tax.[7]

Tier two includes any oil produced from a stripper well property and any oil from an economic interest in a Naval Petroleum Reserve held by the United States.[8]

Tier three oil is newly discovered oil, heavy oil, and incremental tertiary oil.[9]

Tier one oil is generally taxed at a 70 percent rate; tier two oil generally is taxed at a 60 percent rate. Tier three oil, other than newly discovered oil, is subject to a 30 percent rate. For up to 1,000 barrels a day of tier one oil production by independent producers a 50 percent rate applies; a 30 percent rate applies for the same amount of tier two production by independent producers.[10]

Beginning in 1982, the rate on newly discovered oil was reduced to 27.5 percent and to 25 percent in 1983. Prior to the Tax Reform Act of 1984, the rate of windfall profit tax on newly discovered oil would have been 22.5 percent for 1984, 20 percent for 1985, and 15 percent for 1986 and thereafter.[11]

2. Special Rule for Net Profits Interests

The Windfall Profits Tax is imposed on the producer of the oil, that is, the owner of an economic interest. A so-called "net profits interest" is an economic interest in gross production measured by the net profit which remains after the owner of the working interest has recovered the cost of exploration, development and production. This arrangement can arise, for example, by the landowner granting a lease and retaining a right to a percentage of the net profits derived by the lessee.

According to the House Ways and Means Committee Report, because of certain interactions between the definition of producer and the 90 percent net income limitation, whereby the windfall profit tax cannot exceed 90 percent of net income allocable to each barrel of crude oil, prior to the Technical Corrections Act of 1982, it was possible to design a transaction in which the owner of a working interest in proven property could transfer the interest to another party for a very large (*e.g.*, 99 percent) net profits interest. In such manner, the new working interest owner's windfall profit tax on the production allocated to him could be limited by the net income limitation. If effectively structured, these transactions could eliminate the windfall profit tax on that portion of the oil produced that was used to pay for the cost of operating the property.[12]

The Technical Corrections Act foreclosed the use of such agreements, entered into after March 31, 1982, to eliminate the windfall profit tax on cost recovery oil. Section 201(h)(1)(E) of the Act also provided that, for net profits interest agreements which provide that 90 percent or more of the net profit is to be received by a governmental entity or charity exempt from the windfall profit tax, the

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new rules would be applicable without regard to the March 31, 1982 effective date. Thus, preexisting arrangements between governmental units or charities and private producers would be subject to the new rule if the exempt entity were entitled to 90 percent or more of the net profit.[13]

B. Overview

1. Summary of Amendments

Under the Tax Reform Act of 1984 the rate of windfall profit tax on newly discovered oil would be reduced to 22.5 percent in 1984. The rate would remain at 22.5 percent from 1984 through 1987. In 1988, the rate would be 20 percent. In 1989 and subsequent years, the rate would be 15 percent.

Additionally, the Act provides a simplified procedure under which refunds arising by reason of Section 201(h)(1)(E) of the Technical Corrections Act of 1982 for periods before 1983 may be made to a partnership rather than to the partners individually.

2. Effective Date

Revision of the tax rate on newly discovered oil applies to taxable periods beginning after December 31, 1983.[14]

Provision of the expedited procedure for refunding of overpayments of the windfall profit tax by reason of Section 201(h)(1)(E) of the Technical Corrections Act of 1982 is effective as if included in the provisions of the Technical Corrections Act.

C. Detailed Analysis

1. Deferral in Reduction of Tax Rate on Newly Discovered Oil

Section 25 of the Tax Reform Act of 1984 amends subparagraph (B) of §4987(b)(3), relating to the rate of tax on newly discovered oil,[15] by revising the table contained therein. Prior to the Act, the rate for taxable periods beginning in 1984 was 22.5 percent, in 1985 was 20 percent and in 1986 and thereafter was 15 percent. The amendment establishes a 22.5 percent rate for taxable periods beginning in 1984 through 1987, a 20 percent for taxable periods beginning in 1988, and a 15 percent for taxable periods beginning in 1989 and thereafter.

2. Overpayments of Tax Due to Section 201(h)(1)(E) of Technical Corrections Act of 1982

Section 722(a)(7) of the TRA provides an expedited refund procedure for partnerships that may have overpaid windfall profit tax due to the application of Section 201(h)(1)(E) of the Technical Corrections Act of 1982, which provided that preexisting arrangements between governmental units or charities and private producers would be subject to rules eliminating the availability of reducing windfall profit tax on cost recovery oil if the exempt entity were entitled to 90 percent or more of the net profit.

In such case, if the refund is payable to the partnership, and the partners must pay the refund to one or more exempt entities, the partnership is authorized to act for each person who was a partner at any time in the partnership claiming the refund.[16]

Notwithstanding §6511,[17] the time for filing a claim for credit or refund of any such overpayment shall not expire prior to July 19, 1985, one year after the date of enactment of the Tax Reform Act of 1984.[18]

III. Amendments Affecting Excise Taxes on Cigarettes and Distilled Spirits (Act §§27, 452, 455, 1020)

A. Distilled Spirits Excise Tax; Taxation of Certain Floor Stocks (Act §27(a) and (b))

1. Introduction

Prior to the Tax Reform Act of 1984, the excise tax on distilled spirits produced in or imported into the United States was imposed at a rate of $10.50 per gallon.[19] Imported perfumes containing distilled spirits were also subject to a $10.50 tax rate per gallon.

Distilled spirits are subject to tax when they come into existence, but the amount of tax is not determined until the spirits are removed from the bonded premises in which they are held.[20]

Prior to 1979, one of two alternative methods was used for computing the tax, depending on the alcohol content of the spirits at the time of tax determination. Under the first of these methods, the "proof gallon" method, the distilled spirits tax is based both upon the volume of distilled spirits and its alcohol content. "Proof" is measured on a scale of zero to 200. Spirits are considered to be "at proof" when they are 100 proof, *i.e.*, 50 percent alcohol. The volume of the spirits is measured in standard U.S. liquid gallons. A proof gallon, consequently, is one gallon of 100 proof spirits. Prior to the Tax Reform Act of 1984, for example, one gallon of 150 proof spirits, equal to 1.5 proof gallons, would have been subject to a tax of $15.75 (1.5 times $10.50).

The second method of taxation is the "wine gallon" method, which is based solely on volume of liquid; one U.S. gallon, 231 cubic inches, equals one wine gallon.[21] This method applied when the alcohol content was below 100 proof. For example, under prior law, one gallon of 86 proof spirits would have been subject to a tax of $10.50.

In practice, domestic producers usually withdraw the spirits from bond before they are bottled for sale, at a time when they are above 100 proof, and subsequently reduce the spirits to the proof at which they are bottled for consumption.

Under the Title VIII of the Trade Agreements Act of 1979,[22] the wine gallon method of determining the excise tax on distilled spirits generally was repealed, leaving as the basis for tax determination the proof gallon method. The only exception was that imported perfumes containing distilled spirits continue to be taxed on a wine gallon basis.[23]

2. Overview

a. Summary of Amendments

The Tax Reform Act of 1984 increases the tax rate on distilled spirits produced or imported into the United States by $2.00 per proof gallon, to $12.50 per proof gallon, effective on October 1, 1985. A like increase, to $12.50 per wine gallon, is applicable on all perfumes containing distilled spirits imported into the United States.

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The Act clarifies and expands the Treasury Department's regulatory authority to prescribe the time for payment of the special tax imposed on certain floor stocks held for sale on October 1, 1985, and to exempt certain small businesses from that tax. The floor stocks tax generally will be due on April 1, 1986. Additionally, certain special *de minimis* provisions are included for small- and middle-sized wholesale and retail dealers.

b. Effective Dates

The amendments are effective on October 1, 1985.

3. Detailed Analysis

a. Distilled Spirits Excise Tax Rate

Section 5001(a)(1) is amended by §27 of the Tax Reform Act so as to increase the tax rate on distilled spirits produced or imported into the United States by $2.00 per proof gallon, to $12.50 per proof gallon. Section 5001(a)(3) is amended to increase to $12.50 per wine gallon the tax rate on all perfumes containing distilled spirits imported into the United States.[24]

A technical amendment amends paragraphs (1) and (2) of §5010(a) (relating to the credit for wine content and for flavors content) by striking out "$10.50" and inserting in lieu thereof "$12.50".[25]

b. Taxation of Certain Floor Stocks

(1) In General

The Act imposes a "floor tax" of $2.00 per proof gallon on any person[26] holding distilled spirits[27] on October 1, 1985, the effective date of the increase in the §5001 tax.

(2) Exception for Certain Small or Wholesale Retail Dealers

Dealers holding 500 wine gallons or less in volume of distilled spirits on October 1, 1985 are exempt from the floor tax,[28] provided they submit to the Secretary of the Treasury, as directed, such information as the Secretary may direct.[29]

(3) Credit Against Tax

Dealers are also accorded a credit against the floor tax in an amount equal to $800. The credit cannot exceed the amount of tax imposed.[30]

(4) Liability for Tax and Method of Payment

The person holding the distilled spirits on October 1, 1985, is liable for the floor tax of $2.00 per proof gallon. Generally, the tax is payable on or before April 1, 1986. An exception provides that dealers with gross sales receipts for the most recent taxable year not in excess of $500,000 (so called "small- or middle-sized dealers") are allowed to pay the floor stocks tax in three installments, one-third on each of April 1, 1986, July 1, 1986, and October 1, 1986.[31]

(5) Special Rules for Controlled Groups

The 500 wine gallon amount, the $800 credit, and the $500,000 gross receipts test are all to be apportioned among the members of a controlled group according to regulations to be issued by the Secretary. For these purposes, a controlled group has the meaning given the term in §1563(a), except that "more than 50 percent" is substituted for "at least 80 percent" for purposes of determining whether the stock ownership tests are met. Similar rules are to be promulgated for groups of dealers under common control when one or more are not corporations.[32]

(6) Special Rule for Imported Perfumes

Imported perfumes that contain distilled spirits and are located on the premises of any retail establishment on October 1, 1985, are exempt from the $2.00 per wine gallon floor tax.[33]

B. Refund of Excise Tax on Certain Cigarette Floor Stocks (Act §1020)

1. Introduction

TEFRA raised the tax on small cigarettes, defined as weighing not more than three pounds per thousand, from $4.00 to $8.00 per thousand. This translated to an increase in the tax on a pack of cigarettes from 8 cents to 16 cents. The tax on large cigarettes, defined as weighing more than three pounds per thousand, was also doubled.[34]

The increase applies to cigarettes removed from bonded premises after December 31, 1982, and before October 1, 1985. Thereafter, the tax rate reverts to pre-TEFRA rates.

2. Overview

a. Summary of Amendment

The Tax Reform Act of 1984 provides for a refund of tax with respect to cigarettes held for sale on October 1, 1985, on which tax, imposed at a higher rate before that date, was paid.

b. Effective Date

The amendment is effective for cigarettes held for sale on October 1, 1985.

3. Detailed Analysis

Floor stocks of cigarettes held for sale,[35] held for sale on October 1, 1985, will be eligible for a refund equal to the difference between the tax actually paid and the tax in effect on October 1, 1985 (*e.g.*, 8 cents per pack of 20 cigarettes for small cigarettes).[36]

Floor stock refunds will be paid to the manufacturers and importers who originally paid tax on the cigarettes involved. To be eligible for a refund, a manufacturer (including an importer) must submit a claim to the Bureau of Alcohol, Tobacco, and Firearms before July 1, 1986, based on a request submitted by a wholesale distributor before April 1, 1986, reflecting floor stocks refunds due such distributors and to customers of such distributors.[37]

Before (or simultaneous with) the time any payment is made or credit granted by the Treasury Department, the manufacturer also must either (1) reimburse distributors in an amount equal to the amount of the refund[38] or (2) absent such a payment to the distributor, obtain the distributor's written consent to the manufacturer's or importer's receiving the floor stocks refund with respect to cigarettes held on October 1, 1985, for sale by the wholesale distributors. Wholesale distributors must also reimburse their customers or obtain written consent as a condition of receiving any payment from a manufacturer or importer with respect

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to cigarettes not actually held by the distributors on October 1, 1985.[39]

The manufacturer must have commercial records to substantiate the claim that the tax on the cigarettes to which the claim relates was paid.[40]

c. Requirement of Electronic Funds Transfer for Alcohol and Tobacco Excise Taxes (Act §27(c))

1. Introduction

Cigarette and alcohol excise taxes are due the following number of days after the last day of the semimonthly period when the taxable product is removed from bonded premises:

Cigarettes	25 days
Domestically produced and bulk imported distilled spirits	30 days
Bottled imported distilled spirits	15 days
Wine and beer	15 days

Example: If the distilled spirits tax becomes payable during the January 1-15 return period, the taxpayer would have until February 15 to report and pay the tax for the January 1-15 period.

Prior law generally required payment of the cigarette and alcohol product excise taxes to accompany a return for each semimonthly period.[41] There was no requirement of payment by electronic funds transfer.

2. Overview

a. Summary of Amendment

Section 27(c) of the Tax Reform Act requires taxpayers whose gross tax liability with respect to the product involved was $5 million or more during the preceding calendar year pay excise taxes on cigarettes and all alcohol products by means of electronic funds transfer to a Federal Reserve Bank.

b. Effective Date

The provision is effective for taxes required to be paid on or after September 30, 1984.

3. Detailed Analysis

a. Alcohol Products

Section 5061 is amended by adding subsection (e) which requires the payment of excise taxes imposed on distilled spirits,[42] wine,[43] and beer[44] by electronic funds transfer.

Persons who, during any twelve month period ending December 31, were liable for a gross amount of $5,000,000 in taxes on an alcohol product must, in the succeeding taxable year, make payment in this manner, regardless of the amount of excise tax due in such succeeding year. The provision applies both to domestic producers and manufacturers (including Puerto Rican and Virgin Island producers and manufacturers) and importers of taxable alcohol products.[45]

The determination as to whether a person owed $5 million in excise taxes is to be made by reference to the person's gross tax liability without regard to "drawbacks" (returns) or refunds. The term "person" includes all members of a controlled group of corporations as defined in §1563; likewise, all plants at which a person carries on business are to be aggregated.[46]

b. Tobacco Products

Section 5703(b) is amended by adding paragraph (3), which requires any person who, in any twelve-month period, was liable for a gross amount of $5,000,000 or more of tax imposed on tobacco products and cigarette papers and tubes by §5701 (or §7652), to pay such taxes in the succeeding year by electronic funds transfer to a Federal Reserve Bank.

Comment: It appears that the electronic funds transfer requirement would not apply if, for example, a single producer paid taxes of $4 million on distilled spirits and $2 million on wine in a twelve-month period, even though the total tax collected exceeds the $5 million floor. The language of new §5061(e) is couched in the disjunctive,[47] and the Finance Committee Print specifically states that the gross tax liability is to be made treating distilled spirits, wine, and beer as separate products. Contrast with this the conjunctive language of the amendment to §5703(b)[48] and accompanying Finance Committee Print language to the effect that all types of tobacco products are treated as liable for tax with respect to one product.[49]

D. Allowance of Certain Drawback Claims (Act §452)

1. Introduction

Upon the submission of a properly executed claim by a qualifying user of distilled spirits in the manufacture of food products, flavorings, or medicines unfit for beverage purposes, a return or "drawback" of a major portion of the excise tax on distilled spirits is allowed.[50]

Taxpayers claiming a drawback of distilled spirits taxes are required to maintain records to establish such qualified use.[51] Treasury regulations require, for example, quantitative formulae to be filed prior to or at the time of manufacture of the nonbeverage product.[52] Failure to comply with these requirements results in a denial of the claim.

2. Overview

a. Summary of Amendment

The Act provides that a penalty shall be imposed for violations of the regulatory requirements, in lieu of merely denying a claim for a drawback.

b. Effective Date

The amendment is effective on the first day of the first calendar month that begins more than 90 days after July 18, 1984, the date of enactment of the Act (*i.e.*, November 1, 1984).[53]

3. Detailed Analysis

Section 5134 is amended by adding subsection (c) which prohibits the denial of a drawback claim for failure to comply with statutory requirements under subpart F (Code §§5131-5134) as well as regulations issued thereunder, if the claimant can prove that the distilled spirits for which drawback is claimed were, in fact, used for the qualified purposes enumerated in section 5131.[54]

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In lieu of mere denial, the claimant is liable for a $1,000 penalty for each failure to comply with the applicable laws or regulations (unless it is shown that the failure was due to reasonable cause).[55] The aggregate amount of the penalties may not exceed the amount of the taxpayer's claim.[56]

Example: The Finance Committee Print provides that if nonbeverage products deviate from previously filed formulae, the determination of a failure to comply with the regulations would be made with respect to each separate product reflected in a drawback claim. Thus, if a manufacturer of two distinct flavors or extracts were to submit a drawback claim, and some portion of each flavor deviated from the previously filed formula, the claimant would be liable for a penalty of $2,000 (unless the failure to comply was due to reasonable cause).[57]

Section 5134(c)(3) provides that any penalty imposed shall be assessed, collected and paid in the same manner as taxes, as provided in §6662(a).

E. Fortification of Cooking Wine (Act §455)

1. Introduction

Prior to the Tax Reform Act of 1984, an excise tax was imposed at a rate of $10.50 per gallon on distilled spirits produced in or imported into the United States.[58] The amount of tax has been generally determined when the spirits are removed from the bonded premises in which they are held.[59]

In certain cases, however, distilled spirits may be removed from the bonded premises without payment of tax.[60] Prior to the Tax Reform Act of 1984, for use in the production of wine, only wine spirits or brandy were allowed to be removed absent the payment of tax under these rules.[61] Therefore, distilled spirits (other than wine spirits) used in a nonbeverage wine product had to be removed "tax paid," and claim for refund made.

2. Overview

a. Summary of Amendment

The Act expands the circumstances under which distilled spirits for use in producing nonbeverage wine products, *e.g.*, cooking wine, may be removed from a distilled spirits plant without payment of tax.

b. Effective Date

The amendment is effective on the date of enactment (July 18, 1984).[62]

3. Detailed Analysis

Section 5214(a) is amended by adding paragraph (13), which provides for the tax-free removal from a distilled spirits plant of spirits used on bonded wine cellar premises in the production of nonbeverage wine or wine products that will later be removed from the bonded wine cellar pursuant to §5362(d).[63]

Act §455(b) also amends §5005(e)(1), to relieve the original distiller of liability for tax upon the removal of the distilled spirits, and §5005(e)(2), to relieve the subsequent transporter from liability if the distilled spirits are, in fact, used in the production of nonbeverage wine products.

Section 5354 requires the calculation of the required surety bond for bonded wine cellars to be based on the amount of tax on such wine and wine spirits as were on hand or in transit. In light of the expanded category of products able to be removed tax free to a bonded wine cellar, a technical amendment allows the calculation to be based on the amount of wine and distilled spirits on hand or in transit.[64]

IV. Amendments Relating to Excise Taxes on Stills and Condensers (Act §451)

A. Introduction

Prior to the Tax Reform Act of 1984, §5101 imposed an occupational tax of $55 per year on manufacturers of stills. In addition, a tax of $22 was imposed on each still (or condenser to be used in distilling) manufactured. An exemption from these taxes was provided for stills manufactured by a proprietor of a distilled spirits plant exclusively for use in the proprietor's plant.[65]

In addition, manufacturers of stills were required to notify the Treasury Department, in writing, of the removal of a still, boiler, or other distilling vessel from the place of manufacture and the person and place to which it was delivered. The still (or other distilling apparatus) could be set up only upon receipt of a written permit from the Treasury.[66] Further, every person having possession or control over a still was required to register with the Treasury immediately after setting up the still. The registration set forth the name and address of the owner and the location, capacity and purpose of the still.[67]

B. Overview

1. Summary of Amendment

The Act repeals both the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still.

The Act repeals the mandatory requirement of notice of manufacture and removal of a still and the requirement of permission prior to set up of a still. In lieu thereof, the Act provides that the Treasury Department may, pursuant to regulations, require manufacturers of stills, boilers, or other distilling vessels to give notice before removal of the facility. This notice (if required) would set forth the capacity of the facility, the time of removal, and the person by whom the facility is to be used. The Act retains the requirement of registration by the still user after setting up the facility.

2. Effective Date

The amendment is effective on the first day of the first calendar month that begins more than 90 days after July 18, 1984, the date of enactment of the Act (*i.e.*, November 1, 1984).[68]

C. Detailed Analysis

Subpart C of the Internal Revenue Code (§§5101 5106) is amended by repealing §§5103-5106. Section 5101 is amended. Section 5102, relating to the definition of a manufacturer of stills, remains unchanged.

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Section 5101 is amended to provide the Secretary of the Treasury the discretionary authority to require the manufacturer of the still to give written notice prior to the removal of the still from the place of manufacture. Such notice must include the name of the person by whom the still is to be used, its capacity, and the date of its removal from the place of manufacturer.[69]

The Secretary may also require that no still or distilling vessel be set up without the manufacturer first giving written notice thereof to the Secretary.[70]

As under prior law, §§5616(2) and 5687 provide for penalties and forfeiture for failure to give notice of manufacture or for setting up a still without first giving notice.[71]

The mandatory requirement of registration immediately after setting up a still, pursuant to §5179, has been retained. Accordingly, the penalty and forfeiture for failure to register a still when set up, under §§5601(a) and 5616(1), remain in effect.[72]

Technical amendments are made to §§5179(b)(2) (relating to registration of stills) and §5615(2) (relating to property subject to forfeiture) to conform them to the above-mentioned changes.[73] Section 5691, which imposes a special penalty for nonpayment of special taxes relating to liquors, is amended to remove from its application manufacturers of stills.[74]

V. Repeal of Stamp Requirement for Distilled Spirits (Act §454)

A. Introduction

Prior law required distilled spirits containers transported or sold in the United States to bear a stamp indicating that the Federal excise tax on the spirits has been paid.[75] Strip stamps that satisfy this requirement, printed by the Bureau of Engraving and Printing and distributed to distillers and bottlers free of charge, generally have continued to be used on distilled spirit containers, despite regulations authorizing alternate methods of indication of payment of tax.[76]

Government-supplied strip stamps must generally be broken in order to open a distilled spirits container. Thus, the stamps act as closure devices for the containers. However, subsequent to the Distilled Spirits Tax Revision Act,[77] the presence of such stamps no longer determines conformity with Federal bottling or tax laws.

B. Overview

1. Summary of Amendment

Section 454 of the Tax Reform Act of 1984 repeals the strip stamp requirement for distilled spirits containers and associated penalty provisions.[78] However, the Act requires that distilled spirits containers, on determination of tax, bear a closure or other device designed to require breaking in order to gain access to the contents of the container.[79] The provision applies to domestically produced and imported distilled spirits. Closure devices are not required for containers having a capacity in excess of one wine gallon.

2. Effective Date

The amendments are effective July 1, 1985.

C. Detailed Analysis

1. In General

Section 454(a) of the TRA repeals §5205. Section 5301 is amended by the addition of new subsection (d) which requires distilled spirits containers, on determination of tax, bear a closure or other device designed to require breaking in order to gain access to the contents of the container.[80]

The provision applies to domestically produced distilled spirits, imported distilled spirits, and distilled spirits entering the United States from Puerto Rico and the Virgin Islands.[81]

The Finance Committee Print also states that, although government-supplied strip stamps may be affixed to containers of distilled spirits only until July 1, 1985, if strip stamps are affixed to containers of distilled spirits before that date, the Federal strip stamp on such containers shall meet the Act's requirement for an antitampering device on distilled spirits containers.[82]

2. Technical Amendments

a. Effacement of Mark or Seal

Section 5206 (relating to containers of distilled spirits) is amended to require the effacement or obliteration of any such mark or closure on empty containers.[83]

b. Penalty Relating to Marks, Brands, and Containers

Section 454(c)(11)(A) of the Act amends §5604 to provide that for each of the following offenses, an individual may be fined not more than $10,000, and/or imprisoned for not more than five years:

(1) transfer of distilled spirits absent closure required in new section 5301(d);

(2) emptying, with fraudulent intent, a distilled spirits container without breaking or defacing the closure;

(3) emptying a distilled spirits container without effacing or obliterating any mark or brand as required in section 5206(d);

(4) use a distilled spirits container that has already once been filled and fitted with a closure without removing and destroying such closure;

(5) unlawfully removing a closure or defacing a seal affixed to a distilled spirits containers;

(6) fraudulently transporting any empty container with a seal or mark affixed thereto; and

(7) fraudulently using a mark or seal that misrepresents the contents of the container.[84]

c. Containers Without Closures

Section 454(c)(12)(A) of the Act amends §5613(b) to provide that all distilled spirits found in containers without closures in compliance with Chapter 51 of the Code shall be forfeited to the United States.[85]

d. Miscellaneous

The Act makes conforming and technical amendments to the following Code sections: §5062(b) (relating to drawbacks in case of exportation);[86] §5066(a)(2) (relating to

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bottled distilled spirits eligible for export with benefit of drawback);[87] §5116(b) (relating to cross references);[88] §5206(f);[89] §5207(a)(4) (relating to records and reports);[90] §5215(c) (relating to return of tax determined distilled spirits to bonded premises);[91] §5235 (relating to bottling of alcohol for industrial purposes),[92] §5301(c) (relating to regulation of traffic in containers of distilled spirits);[93] and §5555(a) (relating to records, statements, and returns).[94]

VI. Changes Relating to Gasoline, Tire and Vehicle Excise Taxes [Act§§731-735, 901-935]

A. Introduction

The Highway Revenue Act of 1982 (P.L. 97-424) (Title V of the Surface Transportation Assistance Act of 1982) made numerous amendments to highway use-related federal excise tax provisions. The major provisions increased the use tax on heavy trucks, increased the excise tax on gasoline, diesel fuel and special motor fuels, imposed a manufacturer's excise tax on trucks, truck trailers and semi-trailer chassis and bodies, and imposed a floor stocks tax on gasoline and unused heavy truck tires held as inventory by dealers, with floor stock refunds provided for in the event of repeal or reduction of a manufacturer's excise tax. These provisions are discussed in detail below.

1. Heavy Vehicle Use Tax

An annual excise tax is imposed on the use of public highways by any motor vehicle whose taxable gross weight[95] exceeds a prescribed minimum weight. For use occurring before July 1, 1984, the minimum weight was 26,000 pounds, and for uses occurring on or after that date, the minimum weight was increased to 33,000 pounds. Those vehicles falling below these respective weights were exempt from the tax.

The rate of tax for uses prior to July 1, 1984 was $3.00 per 1,000 pounds of taxable gross weight, or fraction thereof, while a graduated rate applied for post-June 30, 1984 uses.[96] Additionally, further increments were scheduled beginning on July 1, 1986 which were to last until termination of the excise tax on July 1, 1988.[97]

Various exemptions are provided based upon both the type of user and the extent of use. Uses by state, local and federal governments are exempt,[98] as are uses by qualified private transit buses. In addition, as of July 1, 1984, there was an exemption (regardless of taxable gross weight) for vehicles traveling less than 5,000 miles on public highways during the tax period[99] and a pro rata credit or refund was allowed for retired vehicles, whether such retirement is caused by theft, accident or other casualties.[100]

Small owner-operators, defined as persons who own and operate no more than 5 taxable vehicles, during the taxable period, were treated in a more lenient manner, so that the pre-July 1, 1984 rules continue to apply until July 1, 1985, and the provisions for mileage exemptions and pro rata refund or credit continue to apply to then until July 1, 1985.[101]

The heavy vehicle use tax is currently scheduled to expire on October 1, 1988.[102]

2. Treatment of Various Fuel Taxes

a. Diesel Fuel

Prior law provided for an excise tax of 9 cents on the sale of diesel fuel for use in a highway vehicle.[103] The tax expires on October 1, 1988. The Highway Trust Fund received appropriations of amounts equivalent to the diesel fuel tax receipts and one-ninth[104] of this amount was designated for the Mass Transit Account.

Full exemption from tax is provided for diesel fuel sold to a state, local government or nonprofit educational institution for its exclusive use.[105] Partial exemption was provided for alcohol fuel mixtures at 5 cents a gallon.[106] In the case of diesel fuel used in an intercity, local or school bus, full exemption was achieved through the use of a refund or credit for tax paid.[107]

b. Gasohol and Alcohol Fuel Mixtures

A five cent per-gallon exemption from the gasoline, diesel fuel and special motor fuel excise taxes was provided for fuels consisting of a mixture of at least 10 percent alcohol with any of these fuels.[108] For these purposes, "alcohol" was defined[109] as only alcohol which is derived from a source other than petroleum, natural gas or coal.

Where certain alcohol fuels are comprised of at least 85 percent alcohol derived from a source other than petroleum or natural gas (*e.g.*, methanol or methanol), a nine cent per gallon exemption was allowed from the excise tax on special motor fuels.[110]

An income tax credit of 50 cents per gallon was allowed where alcohol comprised at least 10 percent of the mixture in a combination of alcohol and gasoline, diesel fuel and special motor fuel[111] or where alcohol was used as a fuel, other than in a qualified fuels mixture.[112] For these purposes, alcohol was defined so as to include only that alcohol which is derived from a source other than petroleum, natural gas, or coal.

Alcohol imported into the United States for use as a fuel was subject to a duty of 50 cents per gallon.[113]

c. Certain Fuel Used in Taxicab

Taxicabs qualify for partial exemption from fuel excise tax where they are rated at above-average fuel economy and where the driver is not precluded from offering ride sharing.[114] The exemption of four cents per gallon from the excise tax or gasoline, diesel fuel and special motor fuels is created through either a refund or a credit against tax. The exemption expired October 1, 1984.

B. Detailed Analysis

1. Reduction in Heavy Vehicle Use Tax

Effective July 1, 1984, §901 of the new law restructures and reduces the tax rate so that vehicles under 55,000 pounds are exempt from the excise tax and, for vehicles exceeding that weight, the rate ranges from $100 per year plus $22.00 per 1,000 pounds (or fraction thereof) in excess of 55,000 pounds, up to a maximum rate of $550 per year for vehicles exceeding 75,000 pounds.[115]

This reduction and restructuring had its genesis in taxpayer objections to a large tax which was not necessarily correlated to the amount of business done[116] and in a Department of Transportation Report (DOT Report) sub-

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mitted to Congress in January, 1984, which was commissioned to suggest improvements to the heavy use tax, as well as alternative taxing schemes.[117]

The small owner-operator continues to receive special treatment. Under §901(b) of the Act, a one-year tax rate of $3 per 1,000 pounds of gross taxable weight applies (unless this tax exceeds the regular rate described above, in which case the regular rate applies) for the period of July 1, 1984 to June 30, 1985. Thereafter the regular rate described above applies to owner-operators as well as all other vehicle owners. The small owner-operator also received the same benefit as vehicle owners in general through the accelerated effective date (from July 1, 1985 to July 1, 1984) [118] for the 5,000 miles-and-under excise tax exemption and for the prorated tax as a result of a theft or other casualty loss. Thus, these rules are effective for all qualified vehicle owners on July 1, 1984.

Two special rules apply to provide relief for special purpose vehicles. Vehicles which are registered in a state for hauling farm commodities to and from a farm or for use directly in agricultural production on the farm are entitled under §903 of the Act to a total of 7,500 miles (instead of 5,000 miles) when determining the exemption for low mileage vehicle use.[119] The mileage exemption for all agricultural vehicles was increased from 5,000 miles to 7,500 miles by Senate floor amendment. The rationale for the increase was given by Senator Trible who cited, among other factors, the agricultural vehicle mileage increase due to rail line abandonment and grain elevator bankruptcies.[120]

Section 902 of the Act provides that vehicles used exclusively to transport harvested forest products to and from forested sites and which are registered for such use in a state are entitled to a 25 percent reduction in the use tax.[121] The tax rate for logging vehicles was to be reduced by one half under the Senate rule [122] but in Conference this was cut back to 25 percent.[123] Logging vehicles, in order to qualify, must exclusively haul harvested forest products to and from forest sites and be registered for that purpose. This rule is effective July 1, 1984.[124]

2. Treatment of Various Fuel Taxes

a. Diesel Fuel Tax

Section 911 of the Act increases the diesel fuel excise tax to 15 cents per gallon.[125] The exemption (in the form of a refund) for intercity, local, and school buses was indirectly increased, through §915 of the Act, to 15 cents per gallon, but the Act then reduced the refund by 3 cents a gallon with respect to all vehicles, except for certain qualified subsidized intracity buses.[126] A full exemption is provided for a qualified subsidized intracity bus, which is defined as any local bus seating at least 20 passengers under contract to the state or local government (or where such government pays more than a nominal subsidy for operation) and the bus offers regular scheduled routes to the general public.[127] Therefore, all intercity, local and school buses, with the exception noted, will pay a three cent a gallon diesel fuel tax, effective August 1, 1984.[128]

A one-time rebate was enacted to compensate the purchasers and holders of lighter weight diesel fuel powered vehicles (gross weight of 10,000 pounds or less) for the new higher fuel tax.[129] This so-called "diesel fuel differential amount" [130] will amount to $102 for all vehicles other than trucks and vans and, for trucks and vans, $198, in the case of qualified vehicles purchased after January 1, 1985, and before January 1, 1988. For qualified vehicles already held on January 1, 1985, the diesel fuel differential amount is calculated as a fraction of the general rate, reduced by one-sixth per year according to model year until no differential is allowed with respect to a 1978 or earlier model year diesel fuel vehicle.[131] With respect to investment tax credit and depreciation calculations, the law also requires that the basis of the diesel powered vehicle be reduced by the amount of the differential payment.[132]

b. Gasohol and Alcohol Fuel Mixtures

Effective January 1, 1985, the excise tax exemption for special fuel mixtures containing at least 10 percent alcohol (including gasohol) is increased from five cents a gallon to six cents a gallon [133] from the gasoline excise tax. The definition of "alcohol" for this purpose is modified so that alcohol derived from peat is deemed to be derived from coal and thus not entitled to exemption.[134] Section 732 of the Act clarifies that the gasoline excise tax (nine cents per gallon) applies to gasohol or other fuels which consist of at least 10 percent alcohol. Thus, a four and four-ninths cents a gallon tax applies to the sale of gasoline used in producing gasohol and a four cents a gallon tax applies to the sale of gasohol.[135] Under Code §4081(c)(2), the later separation and sale of the gasoline from the mixture is taxed at a rate of four and five-ninths cents a gallon.

Section 912(b) further amends Code §4081(c)(1) by providing that, effective January 1, 1985,[136] the four and four ninths cent per gallon tax applied to the sale of gasoline for use in producing gasohol is reduced to three and one-third cents and the four cents per gallon tax imposed on the sale of gasohol is reduced to three cents per gallon.

The five cents per gallon refund related to gasoline used to produce alcohol fuels is reduced to four and five-ninths cents and the floor stocks tax on gasohol is reduced to four cents a gallon.[137] Effective January 1, 1985,[138] however, the refund related to gasoline used to produce alcohol fuel is increased to five and two-thirds cents per gallon.[139]

The alcohol fuels credit and alcohol fuels mixture credit were increased to 60 cents per gallon [140] except that, in the case of alcohol having a proof of at least 150 but less than 190, the credit is 45 cents per gallon.[141] These provisions are effective January 1, 1985.[142]

Effective August 1, 1984, the excise tax on partially exempt ethanol or methanol fuel is cut in half from nine cents per gallon to four and one-half cents per gallon.[143]

Effective January 1, 1985, the tariff on alcohol imported for use as fuel is increased to 60 cents per gallon.[144]

c. Other Provisions Related to Fuel

(1) Fuel Used in Taxicabs

The four cents per gallon exemption for qualified taxicabs is extended to October 1, 1985.[145]

(2) Chain Operators of Retail Gasoline Stations

Section 733 of the Act amends the definition of "wholesale distributor" in Code §4082 to include a person who

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purchases gasoline from a producer and distributes such gasoline to 10 or more retail gasoline stations which are under the common management of that person.[146] The effect of this provision is to delay the imposition of the gasoline excise tax until it is sold by the retail gasoline station recipient. The provision takes effect on October 1, 1984.[147]

3. Retail Tax on Trucks and Trailers

a. One Year Reduction in Certain Trailer Excise Taxes

For one year beginning on the date of enactment of the Act,[148] the 12 percent retail excise tax on piggyback trailers or semitrailers is reduced to six percent.[149] "Piggyback trailers or semitrailers" are defined as trailers or semitrailers which are designed principally for use in connection with trailer-on-flatcar service by rail and for which the seller has certified to the Service that the use, resale for use or other similar use of the trailer will be principally in connection with such service.[150] However, if the trailer or semi-trailer is actually used or resold for a nonqualified use, such use or resale is treated as original retail sale for which the offender must pay an additional six percent excise tax—effectively applying the full 12 percent tax from prior law.[151]

b. Calculation of Retail Tax Base

For purposes of determining the price in calculating the retail excise tax on truck trailers under Subchapter B, components used prior to being furnished by the first user of the component are excluded.[152]

4. Technical Amendments: Floor Stocks Refunds for Tires

Section 734(a) of the Act provides for floor stocks refunds for tires which are taxed at a lower rate after January 1, 1984 (but not repealed).[153] The dates on which tire dealers and tire manufacturers must submit claims (to the manufacturer and Service respectively) are extended to prior to January 1, 1985 and April 1, 1985, respectively.[154]

The floor stocks tread rubber is treated as a tax-repealed article for purposes of the floor stocks refund.[155] In addition, all provision of law, including penalties, applicable to §4081 tax or §4071(a) tax, are imposed on floor stocks taxes.[156]

Section 734 made numerous other small technical corrections to the Code, including provisions related to overpayment of tax on trucks and tires,[157] noncommercial aviation [158] and allowing wire transfers to Federal Reserve Banks where the extension of the payment due date for certain fuel taxes is involved.[159]

Amendments to the Highway Trust Fund were made by §911(d) of the Act to change the rate allocated to the Mass Transit Account to one cent per gallon and to enact conforming amendments to the income tax credit contained in §6427.[160] All of these amendments are effective on August 1, 1984.

5. Repeal of Obsolete Provisions of the Highway Revenue Act of 1982

Section 735 of the Act made numerous revisions in the Code based upon provisions which were made obsolete by the Highway Revenue Act of 1982. The major sections repealed were §§4061, 4062 and 4063, dealing with a 10 percent manufacturers' excise tax on trucks, buses, tractors and other highway vehicles, articles which would be classified as vehicle parts and exemptions for various vehicles such as ambulances.[161] The amendment takes effect as if it were included in the provisions of the Highway Act of 1982 to which they apply.

6. Studies

Five studies were ordered in conjunction with the enacted provisions described above. Three deal with the heavy vehicle use tax, one with taxicabs and one with piggyback trailer taxes.

a. Heavy Vehicles

The Secretary of Transportation is to conduct a study of whether highway motor vehicles with taxable gross weights of 80,000 pounds or more bear their fair share of the costs of the highway system.[162] This report must be submitted no later than October 1, 1987.

b. Transborder Trucking

The Secretary of Transportation is to conduct a study on the significance of Code §448 [163] on transborder trucking operations.[164] This report must be submitted no later than October 1, 1987.

c. Feasibility Study of Weight Distance Taxes

The Secretary of Transportation is to conduct a feasibility study on the ability of a weight distance truck tax to achieve the greatest equity among highway users, ease compliance costs (including an evaluation of evasion potential) and improve the efficiency of administration. The study is to include an assessment of the benefits to interstate commerce of replacing all Federal truck taxes (except fuel taxes) with a weight-distance tax.[165] It is to be submitted no later than October 1, 1987.

d. Reduced Fuel Taxes for Taxicabs

The Secretary of the Treasury (or his delegate) is to conduct a study of the reduced taxicab fuel tax rate created by the newly amended Code §6427(e).[166] The Secretary's report and recommendations are to be submitted to Congress no later than January 1, 1985.

e. Study of Piggyback Trailers

The Secretary of Transportation (in consultation with the Secretary of the Treasury) is to conduct a study of the appropriate application and level of tax imposed on piggyback trailers and semitrailers by amended Code §4051.[167] This report is to be submitted to Congress no later than May 1, 1985.

VII. Excise Tax on Sport Fishing Equipment (Act §1015)

A. Introduction

Prior to the Tax Reform Act of 1984, an excise tax of 10 percent of the sales price was imposed on the sale by a manufacturer, producer or importer of fishing rods, creels and reels, and artificial lures, files and baits (including parts and accessories).[168]

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Amounts equivalent to the revenues generated by this tax are allocated to the states in partial reimbursement for their costs incurred under the sport fish restoration program.[169]

Treasury regulations require manufacturer's excise tax returns to be filed quarterly. Quarterly returns are due on the last day of the first month after the end of the quarter.[170] However, Treasury regulations generally require monthly or semi-monthly payment of excise taxes.[171] If a taxpayer is liable in any month for more than $100 of manufacturer's excise tax, the taxpayer must deposit the amount on or before the last day of the next month in an authorized depository, *e.g.*, a Federal Reserve Bank. If excise tax liability is more than $2,000 in any month of a preceding calendar quarter, then tax deposits for the following quarter must be made semi-monthly. These taxes must be deposited by the ninth day following the semimonthly period for which they are deposited.[172]

B. Overview

1. Summary of Amendment

The 10 percent tax is extended to various additional articles of sport fishing equipment, supplies and accessories, including tackle boxes. A special 3 percent tax is imposed on electric outboard motors and certain fish finders (sonar devices suitable for finding fish, except graph recorders, digital type or meter readout devices, with a maximum tax of $30 per item).

The Act generally continues the imposition of the tax at the manufacturer's level.

The Act excuses manufacturers and importers from the prior-law excise tax deposit requirements, thereby enabling these manufacturers to pay the tax on a quarterly basis with their regular Federal excise tax return.

2. Effective Date

The provisions are effective for sales occurring and for payments of tax due after September 30, 1984.

C. Detailed Analysis

1. Imposition of Tax

Section 4161 of the Code is amended to extend the 10 percent excise tax to a broad range of sport fishing equipment, including parts and accessories thereof, defined in §4162(a).[173] Additionally, a special 3 percent tax is imposed on electric outboard motors and certain fish finders.[174],The special tax on sonar devices suitable for finding fish is not to exceed $30 per sonar device.[175]

2. Definitions

Sport fishing equipment is defined in §4162(a).

A "sonar device suitable for finding fish", subject to a three percent excise tax, excludes graph recorders, digital type or meter readout devices, or combinations thereof.[176]

3. Treatment of Certain Resales

In general, the excise tax on sport fishing equipment continues to be imposed at the manufacturer's (or importer's) level. However, the Act provides that tax pursuant to §4161(a)(1) will be imposed a second time, on the sale of an article subject to tax, by any wholesale distributor or retailer who (1) is a related person[177] to the manufacturer or importer of the article sold, and (2) acquires[178] the article from an unrelated person (*i.e.*, from a party other than the manufacturer or importer).[179]

If the tax is imposed a second time on any article, a credit for prior tax paid is available, provided the wholesale distributor or retailer can document the amount of tax previously paid.[180] This documentation requirement generally will be considered as satisfied only through submission of copies of actual records of the party that previously paid the tax.[181]

The conferees also expressed concern that certain manufacturers and importers of taxable sport fishing equipment are engaged in arrangements that are not covered under the related person rules described above, but that do not represent true arm's-length dealings.

Accordingly, the Act provides that, except as provided in Treasury regulations, in situations in which intermediaries or other devices are used to reduce the amount of tax imposed pursuant to §4161(a)(1), the tax is to be imposed on a later sale.[182]

These regulations generally are to provide that a sale by a manufacturer or importer is not to be treated as a "taxable first sale" for purposes of §4161(a)(1) unless the party selling the articles (1) conducts all manufacturing or importation transactions and related documentation in its own name; (2) assumes risks of late delivery and loss and pays freight, insurance costs, and customs duties (in the case of importers); (3) has on its payroll the employees who are engaged in the manufacturing process conducted by it or who are engaged in all aspects of the importation or other distribution of articles processed by it, including dealings with manufacturers with regard to quantity, quality control, design specifications and shipping; (4) finances the manufacture or purchase of previously manufactured articles on its own account; (5) maintains inventories of the articles in its own name; and (6) earns normal profits (determined by reference to industry standards) on its sales that are to treated as taxable first sales.[183]

4. Time of Payment

Section 6302 (relating to the time for collecting tax) is amended by inserting subsection (d), providing that the excise tax on sport fishing equipment is payable in full on the date established by the Treasury Department for filing of the quarterly return of the tax.

Note: All manufacturers and importers are excused from the deposit requirements in the case of the excise tax on sport fishing equipment.

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[1] §4251.
[2] §4251(b)(2).
[3] P.L. 96-223, 94 Stat. 229 (1980).
[4] §4986.
[5] §4988(a)(1)(A).
[6] For a detailed analysis of the application of the Crude Oil Windfall Profit Tax, *see*, 424 T.M., *The Crude Oil Windfall Profit Tax.*
[7] §4991(c).
[8] §4991(d).
[9] §4991(d).

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[10] §4987(b).
[11] P.L. 97-448.
[12] H.R.Rept. No. 97-794, at 42 (Sept. 8, 1982).
[13] Act §722(a)(6).
[14] Act §25(c)(1).
[15] The term "newly discovered oil" has the same meaning as given by the June 1979 energy regulations. §4991(e)(2). The IRS has issued proposed regulations conforming to the Department of Energy's most recent definition of newly discovered oil, which became effective January 1, 1981. The Tax Reform Act of 1984 makes no changes in this definition. As proposed, the regulations define newly discovered oil as crude oil produced from a newly discovered property or imputed newly discovered oil from a unitized property. A newly discovered crude oil property is (1) a new lease on the Outer Continental Shelf or (2) a property which did not produce crude oil in commercial quantities in 1978 and which is also not on the Outer Continental Shelf. A new lease is any lease of submerged acreage entered into after December 31, 1978, which did not produce crude oil in commerical quantities in 1978 and whose submerged acreage was not included in a lease which produced crude oil in commercial quantities during 1978. Crude oil produced in commercial quantities is defined as production which is sold, exchanged or retained for beneficial economic use by any operator or producer of that production. Proposed amendment to Regs. §51.4996-1(m) and (n), 47 Fed. Reg. 50306 (November 5, 1982).
[16] Act §722(a)(7)(A).
[17] *See* especially §6511(a) and (b).
[18] Act §722(a)(7).
[19] §5001(a).
[20] §5006(a).
[21] §5041(c).
[22] P.L.96-39, 93 Stat. 134.
[23] S. Rep. 249, 98th Cong. 2d Sess. at 217 *et seq.* (July 17, 1979).
[24] Act §27(a)(1).
[25] Act §27(a)(2).
[26] The term "person" includes any state or political subdivision thereof, or any agency or instrumentality of a state or political subdivision thereof. TRA §27(b)(7)(C).
[27] The term "distilled spirits" is defined in §5002(a)(8).
[28] Act §27(b)(2).
[29] The Conference Report states that such information would include a wine gallon inventory. H.R. Rep. 861, 98th Cong. 2d Sess. at 777 (June 23, 1984).
[30] Act §27(b)(3).
[31] Act §27(b)(4).
[32] Act §27(b)(5).
[33] Act §27(b)(7)(E).
[34] Code §5701(b).
[35] The term "cigarettes held for sale" includes promotional cigarettes, but not cigarettes in the process of withdrawal from the market on October 1, 1985. H.R. Rep. 432, Part II, 98th Cong. 2d Sess. at 1127-1128 (March 5, 1984).
[36] Act §1020.
[37] Act §1020(a)(1).
[38] This reimbursement may be in cash, by credit to a pre-existing account, or in kind.
[39] H.R. Rep. 98-432, Part II, 98th Cong. 2d Sess., at 1128, n. 13 (March 5, 1984).
[40] Act §1020(b). The Ways and Means Committee Report states the intention of the Committee that commercial records regularly maintained by manufacturers, importers, and wholesale distributors generally will be sufficient record to substantiate claims for floor stocks refunds. However, the Bureau of Alcohol, Tobacco, and Firearms is authorized to require physical inventories of products held on October 1, 1985, if it determines that such an inventory is necessary to ensure compliance with the law.
[41] Act §5061(a).
[42] Act §5001.
[43] Act §5041.
[44] Act §5051.
[45] S. Rep. 98-169, Vol. I, 98th Cong. 2d Sess. at 807 (April 2, 1984).
[46] *Ibid.*
[47] §5061(e) reads as follows:

> (e) PAYMENT BY ELECTRONIC FUND TRANSFER.—
> (1) IN GENERAL.— Any person who in any 12-month period ending December 31, was liable for a gross amount equal to or exceeding $5,000,000 in taxes imposed on distilled spirits, wines, *or* beer by §§5001, 5041, and 5051 (or 7652), respectively, shall pay such taxes during the succeeding calendar year by electronic fund transfer to a Federal Reserve Bank. (emphasis added).

[48] §5703(b) reads as follows:

> (3) PAYMENT BY ELECTRONIC FUND TRANSFER.— Any person who in any 12-month period, ending December 31, was liable for a gross amount equal to or exceeding $5,000,000 in taxes imposed on tobacco products *and* cigarette papers *and* tubes by section 5701 (or 7652) shall pay such taxes during the succeeding calendar year by electronic fund transfer (as defined in section 5061(e)(2)) to a Federal Reserve Bank. (emphasis added).

[49] S. Rep. 98-169, Vol. I, 98th Cong. 2d Sess. at 807 (April 2, 1984).
[50] §5134.
[51] §5132.
[52] 27 CFR §197.95, *et seq.*
[53] Act §456(a).
[54] Act §452.
[55] §5134(c)(2)(A).
[56] §5134(c)(2)(B).
[57] S. Rep. 169, Vol. I, 98th Cong. 2d Sess. at 800-801 (April 2, 1984).
[58] §5001(a).
[59] §5006(a).
[60] §5214.
[61] §5214(a)(5).
[62] Act §456(c).
[63] Act §455(a).
[64] Act §455(c).
[65] §5103.
[66] §5105.
[67] §5179.
[68] Act §456(a).
[69] §5101(a)(1).
[70] §5101(a)(2).
[71] §5101(b)(1).
[72] §5101(b)(2).
[73] Act §451(b)(2), (3).
[74] Act TRA §451(b)(3).
[75] §5205.
[76] 27 CFR §19.663.
[77] Title VIII of the Trade Agreements Act of 1979, P.L.96-39, 93 Stat. 134.
[78] §§5205, 5604).
[79] §5301(d).
[80] §5301(d); TRA §454(b).
[81] §5301(d); S.Rep. 98-169, Vol. I, 98th Cong. 2d Sess. at 805 (April 2, 1984).
[82] *Ibid.*
[83] §5206(d); Act §454(c)(5)(A).
[84] §5604(a). §5604(b) (relating to the authority of internal revenue officers to enforce subsection (a), makes cross reference to §§5203, 5557, and 7608.
[85] Act §454(c)(13) makes a conforming amendment to Code §6801(b) (relating to authority for establishment, alteration, and distribution).
[86] Act §454(c)(1).
[87] Act §454(c)(2).
[88] Act §454(c)(3).
[89] Act §454(c)(5)(B).
[90] Act §454(c)(6).
[91] Act §454(c)(7).
[92] Act §454(c)(8).
[93] Act §454(c)(9).
[94] Act §454(c)(10).
[95] /"Taxable gross weight" is defined as the sum of (1) the unloaded weight of the vehicle when fully equipped for service; (2) the unloaded weight of semitrailers and trailers, when fully equipped for service, which are customarily used in connection with vehicles of the same type; and (3) the weight of the maximum load customarily carried on vehicles, semitrailers and trailers of the same type. *See* Joint Committee on Taxation, "*Background and Alternatives Relating to the Tax on Use of Heavy Motor Vehicles*," JCS-6-84 at 5 (Feb. 23, 1984) (hereinafter "JCS").
[96] The rate for vehicles between 33,000 and 55,000 pounds is $50 plus $25 for each 1,000 pounds, or fraction thereof, over 33,000 pounds. The rate for vehicles over 55,000 pounds is $600, plus $40 per 1,000 pounds, or fraction thereof, in excess of 55,000 pounds, except that no additional tax is imposed on weight for vehicles exceeding 80,000 pounds. *Id.* at 6.
[97] *Id.*
[98] §4053.
[99] The taxable period begins July 1st, generally. JCS, *supra*, note 1 at 5.
[100] *Id.* at 6-7.
[101] *Id.* at 5-7.
[102] §4483(e).

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[103] §4041(a)(1).
[104] This amounted to one cent per gallon, based upon an nine cent diesel fuel tax, *see* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1229 (1984) (hereinafter Conf. Rep.).
[105] §4041.
[106] §4041 and S. Rep. No. 861, Vol. I, 98th Cong., 2d Sess. 662 (1984) (hereinafter S. Rep.). *See* text accompanying footnote below.
[107] Conf. Rep. at 1229.
[108] §§4041, 4081 and 6427.
[109] §4041.
[110] *Id.*
[111] §44E.
[112] §44E(b)(2).
[113] 19 U.S.C. §1202.
[114] §6427(e).
[115] §4481.
[116] Conf. Rep. at 664.
[117] "Alternatives to Tax on Use of Heavy Trucks," (January 25, 1984). This report, a result of the Highway Revenue Act of 1982, directed the Secretary of Transportation, in consultation with the Secretary of the Treasury and affected parties, to determine alternatives to the heavy vehicle use tax and is summarized in JCS, -6-84 at 8-12. The DOT Report recommended a use tax exemption for vehicles under 55,000 pounds, and a tax rate of $50 plus $24 per 1,000 pounds exceeding 55,000 pounds with a maximum tax of $650. The House Bill called for exemption for vehicles less than 55,000 pounds, a tax rate of $150 (plus $20 per 1,00 pounds or fraction thereof over 55,000 pounds) and a maximum tax of $500 for vehicles exceeding 72,000 pounds. H.R. 4170, *see* Conf. Rep. at 1229.
[118] Act §901(b)(2), setting the effective date of §513(b)(c) and (d) of the Highway Revenue Act of 1982 as July 1, 1984, notwithstanding §513(f) which sets it as July 1, 1985.
[119] Act §903(a), amending Code §4483(d) by inserting a new paragraph 5 and renumbering existing paragraph 5 as paragraph 6. This amendment is effective as if included in the amendments made by §513 of the Highway Revenue Act of 1982. §903(b).
[120] *See* 130 Cong.Rec. S4319 April 11, 1984 (Remarks of Sen.Trible).
[121] Act §902, amending §4483 of the Code by inserting subsection (e) and redesignating former subsection (e) as new subection (f).
[122] Conf. Rep. at 1230.
[123] *Id.*, at 1231.
[124] Act §902(b).
[125] Act §911(a) amending Code §4041(a).
[126] Act §915(a), amending Code §6427(b), by inserting a new paragraph 2 and redesignating former paragraph 2 as paragraph 3.
[127] Code §6427(b)(2)(B), as amended by Act §915(a).
[128] Act §915(b) of the Act.
[129] Act 911(b), amending Code §6427 by inserting subsection (g) and redesignating former subsection (g) through (m) as subsections (h) through (n) respectively.
[130] The DOT report raised the possibility of a "diesel differential tax" which, in effect, would not penalize the owners of lighter diesel-fueled vehicles and, taken in conjunction with a reduction in the heavy vehicle use tax, would treat all users more equitably. *See* statement of Robert Woodward, Tax Legislative Counsel, Dept. of Treasury before the House Ways and Means Committee (Feb. 23, 1984).
The general objective of the diesel fuel differential option was to reduce the significance of a tax that does not vary with mileage and correspondingly increase the significance of a tax which does vary with mileage. JCS -6-84 at 9. In testimony subsequent to delivery of the DOT Report, the Department of Transportation showed its preference for the DOT Report option which would increase the diesel fuel tax rate to 15 cents allowing users of diesel-powered vehicles weighing 10,000 pounds or less to recover the additional tax to them through an income tax refund.
The House Bill increased the tax to 14.5 cents per gallon while keeping partial exemptions at prior law levels and complete exemptions as complete exemptions. An "advanced rebate" of the diesel differential over the expected life of the vehicle was to be made available to original purchasers of diesel-powered vehicles weighing 10,000 pounds or less purchased after January 1, 1985 and before 1988 and to holders of such vehicles as of January 1, 1985. These qualifications, with declining rebates for earlier model years, were adopted in the final version of the law. The amount of rebate was set at $96 for a new car and $180 for a new truck, with proportionate reduction for older cars. *See* Conf. Rep. at 1230. The Senate amendment increased the diesel fuel tax to the full 15 cents, but would have imposed a July 1, 1984 effective date. The amendment also called for the additional 6 cents a gallon increase to be rebated for cars weighing less than 8,000 pounds, but this was dropped in Conference. The Senate amendment also would have granted full exemption for diesel fuel sold to state or local governments or to nonprofit educational organizations for their exclusive use, while maintaining the 9 cents a gallon tax for nongovernmental intercity, local or school buses (thus resulting in a 6 cents a gallon tax). *Id.*
The Conference Committee noted that it was their intent not to subject the diesel differential rebate to the P.L. 95-355 requirement that there be separate appropriation to effect payment of newly-enacted refundable tax credits.
[131] Under Code §6427(g)(6)(B), the table of fractions range from the full differential amount for 1984 or 1985 model year vehicles down to one-sixth for the 1979 model year.
[132] §6427(g)(7).
[133] Act §912(a), amending Code §4041.
[134] Act §912(f) amending Code §§40(d)(1)(A)(i) and 4081(c)(3). This is accomplished by inserting the parenthetical phrase "(including peat)" after the word "coal."
[135] Act §732(a) amending Code §4081(c)(1), effective as if included in the provisions of the Highway Revenue Act of 1982 to which the amendment relates.
[136] Act §912(g).
[137] Act §732(a)(3), amending Code §6427(f) and Act §732(b), amending §521(a) of the Highway Revenue Act of 1982.
[138] Act §912(g).
[139] Act §912(d), amending §6427(f)(1).
[140] Act §912(c) amending Code §40.
[141] *See* Code §40(b)(3) as amended by Act §912(c).
[142] Act §912(g).
[143] Act §913 amending Code §4041 by adding subsection (m).
[144] Act §912(e) amending Item 901.50 of the Tariff Schedules of the United States, 19 U.S.C. 1202. The Reagan Administration opposed this tariff hike since it particularly discriminates against alcohol imported from Brazil. *See* 130 Cong. Rec. 4550 (April 12, 1984) (Remarks of Sen. Danforth).
[145] Act §914 amending Code §6427(e)(3).
[146] Act §733(a) amending Code §4082(d).
[147] Act §733(b) of the Act. ("... shall take effect on the first day of the first calendar quarter beginning after the date of enactment of this Act.") The law was enacted on July 18, 1984.
[148] Enacted July 18, 1984. An earlier bill, S. 12131 would have provided a full exemption from excise tax for piggyback trailers and semitrailers, and included a provision for the buyer to certify to the seller that the trailer or semitrailer would be used in connection with trailer-on-flatcar service. Both the Treasury and Transportation Departments opposed the bill because of the ease of conversion to a piggyback trailer through special equipment and also because of the lack of evidence that most piggybacks travel less than 3,000 miles per year on the highway, as the bill's proponents argued. *See* Statement of Robert Woodward, Tax Legislative Counsel, Department of Treasury, before Subcommittee on Taxation and Debt Management of the Senate Finance Committee, at 18-20 (October 28, 1983).
[149] Act §921, amending Code §4051 by redesignating subsection (d) as subsection (e) and inserting a new subsection (d).
[150] Code §4051(d)(2)(A) and (B) as amended by Act §921. Specifically, the seller must certify that the "trailer or semi-trailer (i) will be used, or resold for use, principally in connection with such service, or (ii) will be incorporated into an article which will be so used or resold." §4051(b)(2)(B)(i) and (ii).
[151] Code §4051(d)(3).
[152] Act §731, amending Code §4052(b)(1)(B) by inserting clause (iv).
[153] Act §734(a), amending §523(b) of the Highway Revenue Act of 1982 by amending paragraphs (1) and (2) and adding a new paragraph (3).
[154] Act §734(a)(2).
[155] Act §734(d), amending §523(b) of the Highway Revenue Act of 1982.
[156] Act §734(e), amending §521(c) of the Highway Revenue Act of 1982.
[157] Act §734(b), amending Code §6416.
[158] Act §734(c), amending Code §4082.
[159] Act §734(i), amending Code §518(a) of the Highway Revenue Act of 1982.
[160] Act §911(d)(1) and (2), amending Code §§9503(e) and 6427.
[161] Act §735(a)(1), deleting Code §§4061, 4062 and 4063.
[162] Act §734(d), amending §523(b) of the Highway Revenue Act of 1982.
[163] Act §734(e), amending §521(c) of the Highway Revenue Act of 1982.
[164] Act §931.

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[165] Act §933. *See also* 130 Cong. Rec. S4516 - S4517 (April 12, 1984) (Statement of Sen. Hatfield).
[166] Act 932.
[167] Act §933.
[168] §4161(a).
[169] 16 U.S.C. §777b. The Conference Report states the intent of Congress in establishing an expanded funding source through the TRA, that the new revenues be added to existing state fishery program funds available from traditional sources and not as a substitute therefor. H. R. Rep. 861, 98th Cong. 2d Sess., at 1246 (June 23, 1984).
[170] Regs. §§48.6011(a)-1, 48.6071(a)-1.
[171] Regs. §8.6302(c)-1.
[172] S. Rep. 169, Vol. I, 98th Cong. 2d Sess. at 737(April 2, 1984).
[173] §4161(a)(1).
[174] §4161(a)(2)(A).
[175] §4161(a)(2)(B).
[176] §4162(b).
[177] §4162(c)(3) provides that "related person"has the same meaning given the term in §168(e)(4)(D).
[178] Tax will not be imposed a second time if the original manufacturer, importer, or producer transferred the articles in a sale subject to the constructive sale price rules of §4216(b). Section 4216(b) generally provides that, if an article is sold at retail, on consignment, or sold (otherwise than through an arm's length transaction) at less than fair market price, then the excise tax is to be computed on the price for which such articles are sold in the ordinary course of trade.
[179] §4162(c)(1).
[180] §4162(c)(2).
[181] H.R. Rep. 861, 98th Cong. 2d Sess. at 1245 (June 23,1984).
[182] §4162(c)(4).
[183] H.R. Rep. 861, 98th Cong. 2d Sess. at 1245-1246 (June 23, 1984).

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CHAPTER 79

TAXATION OF LIFE INSURANCE COMPANIES AND POLICYHOLDERS

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I. Introduction

A. Background

Title II of the Act constitutes the first comprehensive revision to the provisions of Part I of Subchapter L of the Code (former Code §§801-819A, now new Code §§801-818), which govern the taxation of life insurance companies, since enactment of the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"). Passage of this revision followed the enactment of so-called "stopgap" legislation as part of the Tax Equity and Fiscal Reponsibility Act of 1982 ("TEFRA"),[1] which provided a two-year period (1982-1983) during which to fashion permanent changes in Part I of Subchapter L as well as in certain related policyholder tax provisions. During that period (and continuing into 1984), the taxation of life insurance companies and their policyholders was studied extensively by Congress and the Treasury Department to address substantial perceived and real difficulties that had begun to develop in the operation of the 1959 Act in the late 1970's.

The advent of high nominal interest rates in the U.S. economy at that time led both to the search for new product designs, which would be as attractive to potential insurance policyholders as were the products offered by other financial intermediaries, and to a rising tax burden for a number of companies due to declining deductibility of dividends to policyholders. The latter condition arose from the fact that the 1959 Act's mechanism for computing a company's reserve interest deduction — in particular, the so-called "Menge" adjustment used to compute the "phase I" reserve interest exclusion — was extremely sensitive to the prevailing level of nominal interest rates. Hence, as rates rose steadily during the 1970's, a number of major companies began to experience declining reserve interest deductions and, consequently, a lower level of policyholder dividend deductions by virtue of former Code §809(f). As to the former development, it turned out that the tax treatment to be accorded the new products (such as "universal" life insurance) was not entirely clear: uncertainty arose about whether the death benefit under a universal life insurance policy was excludable from income under Code §101(a), and disputes arose as to what extent "excess interest" credited with respect to a contract would be allowable as a deduction in computing a company's taxable income under the 1959 Act.

B. Overview and Effective Dates

Title II of the Act attempts to remedy what Congress perceived to be deficiencies in the 1959 Act as well as in the related policyholder tax provisions of the Code.[2] The revised company tax provisions are generally applicable to taxable years beginning after December 31, 1983,[3] while the new policyholder tax rules have varying effective dates.

The new company tax rules retain many features in common with the 1959 Act. On these points, Congress clearly expressed its intention that the carryover provisions are to be interpreted in a manner consistent with interpretations under the 1959 Act. As observed in both the Report of the House Ways and Means Committee and the Report of the Senate Finance Committee on the new law (collectively referred to as the "Committee Reports"):

> "[W]here provisions of [the 1959 Act] are incorporated in [the new law], the committee expects that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions."[4]

On the other hand, the Act does make a variety of significant changes in the life insurance tax rules (not the least of which is the reshuffling of all but one of the section numbers in Part I of Subchapter L). Perhaps the most fundamental of these are:

(a) Replacement of the "three-phase" system of the 1959 Act with what is said to be a "single-phase" system based on a life insurance company's total income;

(b) Prescription of a uniform, statutorily defined method by which life insurance reserves are to be computed for purposes of calculating taxable income, entailing the repeal of former Code §818(c);

(c) Broadening the definition of policyholder dividends, but confinement of the limit on their deductibility only to mutual life insurance companies based on a system designed to tax such companies on at least a reasonable return on invested "equity" (rather than based on "free investment income");

(d) In lieu of certain aspects of the dividend deduction limit and the "special" items of deduction and

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deferral under the 1959 Act, moderation of the tax burden on life insurance companies by means of a 20 percent "special life insurance company deduction" and, where applicable, a "small life insurance company deduction"; and

(e) Definition of the term "life insurance contract" for federal tax purposes.

In brief, the new company tax provisions of the Code (as reshuffled) accomplish this by imposing (in new Code §801) tax at the normal corporate rates on "life insurance company taxable income," defined as "life insurance gross income" (specified in new Code §803) less "life insurance deductions." These deductions are defined in new Code §804 as the "general" deductions listed in new Code §805 and the special deductions prescribed in new Code §806. For purposes of the general deductions, the deductible amounts of reserves are described in new Code §807, the deductible policyholder dividends are defined in new Code §808 and limited for mutual companies in new Code §809, and the operations loss deduction is prescribed in new Code §810. The special accounting rules for life insurers are collected in new Code §811, and the formula for "proration" appears in new Code §812. Domestic branch operations of foreign insurers are addressed in new Code §813, and new Code §814 deals with certain foreign branch operations of U.S. companies. The so-called "phase III" tax base is preserved (as frozen at year-end 1983) by new Code §815. The rules for qualification to be taxed as a life company (including the definition of "life insurance reserves") are preserved in new Code §816, although variable contracts are now separately treated in new Code §817. The remaining definitional and transitional rules are either collected in new Code §818 or appear uncodified in Act §§216-219. Broad new authority for the IRS to reallocate, recharacterize, or otherwise adjust items involved in reinsurance transactions (not limited to those between life insurers) is granted in new Code §845.

The changes in the policyholder tax rules consist of the comprehensive definition of "life insurance contract" appearing as new Code §7702 (per Act §221), additional requirements relating to annuities under Code §72 (per Act §222), a narrowing of the favorable treatment of group-term life insurance under Code §79 (per Act §223), and a liberalization of the scope of the tax-free exchange rules of Code §1035 (per Act §224). (A House proposal to restrict further the deductibility of policy loan interest was not enacted.)

Finally, Act §231 calls for annual reports to Congress on revenue from the life insurance industry, as well as a five-year study of the new law.

II. Company Tax Provisions

A. Section 801 — Tax Imposed

Under former Code §802, a life insurance company was taxed on what was described as its "modified total income." Generally, a company was taxed on its income from all sources after allowance of deductions (referred to as its "gain (or loss) from operations"). If, however, a company's gain from operations exceeded a specified, net investment income base (known as its "taxable investment income"), its taxable income consisted of its taxable investment income plus one-half of the excess of gain from operations over taxable investment income. Taxation of the other one-half of such "excess" was deferred, in the case of stock-holder-owned ("stock") life insurance companies, through the operation of the "policyholders surplus account." Thus, life insurance companies were taxed under the 1959 Act on the basis of a so-called "three-phase" system. Generally speaking, "phase I" referred to "taxable investment income"; "phase II" referred to "gain (or loss) from operations" — *i.e.*, total income or loss from all sources; and "phase III" referred to subsequent taxation of previously deferred amounts deemed withdrawn from a company's policyholders surplus account.[5]

New Code §801 replaces this "three-phase" design with a system that imposes current tax, at normal corporate rates, on the company's total net income — its "life insurance company taxable income" ("LICTI"). Abolition of the phase system is accomplished by restricting the reach of the policyholder dividend deduction limit to mutual life insurance companies, eliminating the deferral of one-half of the excess of gain from operations over taxable investment income, and also eliminating the "special" items of deduction. New Code §801(a)(2) preserves the availability of the alternative tax for net capital gains (comparable to former Code §802(a)(2)). LICTI is defined in new Code §801(b) simply as "life insurance gross income" minus "life insurance deductions." (*See* also the discussion under new Code §815, *infra.*)

B. Section 803 — Life Insurance Gross Income

Under new Code §803(a), "life insurance gross income" consists of the following items:

1. Premiums

New Code §803(a)(1) and (b) includes in gross income all "premiums and other consideration" received under insurance and annuity contracts, thus preserving the provisions of former Code §809(c)(1). Specifically included are fees, deposits, assessments, advance or prepaid premiums, and consideration received for reinsurance. Also included are premiums for supplementary contracts, policy proceeds left on deposit with the company, and the amount of policyholder dividends reimbursed to the taxpayer by another company under a reinsurance agreement. A company may reduce its gross premiums by the amount of any "return premiums" (premiums returned by reason of policy cancellation or errors in determining premiums) and premiums paid to other companies under indemnity reinsurance agreements.[6]

2. Net Decrease in Reserves

Like former Code §809(c)(2), new Code §803(a)(2) requires a life insurance company to include in income any net decrease in its insurance reserves for the taxable year (as described in the discussion under new Code §807, *infra*). As explained in the discussion of new Code §809, *infra*, the amount of income under new Code §803(a)(2) may be increased in the case of a mutual life insurance company.

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3. Other Amounts

New Code §803(a)(3), like former Code §809(c)(3), requires a company to include in its gross income all amounts, not included under the two categories described above, which, under Subtitle A of the Code, are "includible in gross income." This "catch-all" provision brings into a company's gross income all of its investment income as well as its capital gains (separately dealt with in former Code §§804 and 809(b)).

C. Section 805 — General Deductions

Under new Code §804, the "life insurance deductions" allowed in computing a company's taxable income are listed as (1) the "general deductions" described in new Code §805, (2) the "special life insurance company deduction" as set forth in new Code §806(a), and, if applicable, (3) the "small life insurance company deduction" of new Code §806(b). The general deductions essentially are the same deductions (with some modifications) that were allowed under the 1959 Act. In fact, the only 1959 Act deductions not allowed to any degree under the new law are the "special" deductions previously allowed for "nonparticipating" contracts under former Code §809(d)(5) and for certain accident and health ("A&H") and group life insurance contracts under former Code §809(d)(6), together with the "small business" deduction of former Code §809(d)(10). These and certain other provisions of the 1959 Act are replaced by the new Code §806 deductions.

The "general deductions" allowed by new Code §805 are as follows:

1. Death Benefits, etc.

New Code §805(a)(1) allows the same deduction for death benefits, claims, losses, etc., under insurance and annuity contracts that was allowed by former Code §809(d)(1).[7]

2. Net Increase in Reserves

The deduction for the annual net increase in insurance reserves (as listed in new Code §807(c)) allowed by new Code §805(a)(2) is essentially similar to that allowed by former Code §809(d)(2). It does differ formally in two respects, however. First, the deduction for reserve increases now includes increases due to assumed interest. That is, in contrast with the 1959 Act, the new law does not require closing reserves to be reduced by the "required interest," nor is this required interest separately excluded from the company's income. Second, for purposes of determining the net increase (or decrease) in insurance reserves, the closing reserve balance is now reduced by the "policyholders' share" of tax-exempt interest (this "share" in defined by the so-called "proration" formula of new Code §812). This treatment replaces former Code §809(d)(8)(A)(i), which allowed a deduction for the "company's share" of tax-exempt interest. Instead, under the new law, only the "policyholders' share" is ever taken into account in computing the company's income (via the reduction in the closing reserve balance), and no deduction for the "company's share" is necessary.

3. Policyholder Dividends

Under new Code §805(a)(3)(as under former Code §809(d) (3)), life insurance companies are allowed a deduction for dividends to policyholders during the taxable year, as defined in new Code §808. Stock life insurance companies are allowed an unlimited deduction for the full amount of such dividends, thereby eliminating the so-called "excess interest" controversy under the 1959 Act.[8] The policyholder dividend deduction remains limited in the case of mutual life insurance companies, however, pursuant to the provisions of new Code §809.

It should be noted that the new law effects one significant change in the basic standard for determining the extent to which, *before* application of the limitation on such dividends, they meet the test for deductibility. Under former Code §811, a company could include in policyholder dividends the amount of its annual statement "reserve" for dividends payable during the following year. Under the new law (as prescribed in new Code §808), such amounts are deductible *only* if they are actually paid or are properly *accrued* under the general accrual accounting standards imposed on life insurance companies. However, as part of the "fresh start" rules (described in connection with new Code §807, *infra*), any difference in the dividend deduction from 1983 to 1984 due to this change that would otherwise result in income is not taken into account.

The new Code §805(a)(7) deduction for policyholder dividends reimbursed under a reinsurance agreement is essentially the same as the deduction under former Code §809(d)(12) (as added by TEFRA), and is similarly not subject to the dividend deduction limit generally applicable to mutual companies.

4. Dividends Received

As under former Code §809(d)(8)(A)(ii), new Code §805(a)(4) allows a life insurance company a limited version of the deduction for intercorporate dividends received, otherwise allowable under Code §§243, 244, and 245. In general, it may deduct the "company's share" of such dividends.[9] However, in the case of "100 percent dividends" — defined generally in new Code §805(a)(4)(C) as dividends that would be fully deductible under §§243 or 244 of the Code — the company is allowed a deduction for the full amount of the dividends, except to the extent that the dividend is itself attributable to tax-exempt interest or intercorporate dividends (*i.e.*, as received by the controlled subsidiary). The manner in which non-100 percent dividends are divided between the company and its policyholders, and the "tracing" rule for 100 percent dividends, are discussed below in connection with the "proration" formula of new Code §812.

5. Operations Loss Deduction

The operations loss deduction allowed under new Code §§805(a)(5) and 810 is essentially the same as, and is treated as a continuation of, that allowed under former Code §§809(d)(4) and 812 (modified only to take account of certain definitional changes under the new law).

6. Assumption Reinsurance

The deduction allowed under new Code §805(a)(6) for consideration paid to another insurance company for assuming liability under insurance and annuity contracts is the same as that allowed under former Code §809(d)(7).

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7. Other General Corporate Deductions

As under the 1959 Act, a life insurance company is entitled under new Code §805(a)(8) to "all other deductions" allowed by Subtitle A of the Code for purposes of computing taxable income, subject to certain modifications. The "modifications" under new Code §805(b) are nearly identical to those under former Code §809(e). Since life insurance companies are taxed on a "single-phase" system under the new law, no specific deduction is allowed for investment expenses, unlike the case with the 1959 Act. Instead, such expenses fall within the new Code §805(a)(8) "catch-all" provision.

D. Section 806 — Special Deductions

Under the 1959 Act, a life insurance company's net taxable income for any year was determined, in the case of a mutual life insurance company, after allowance of the deductible portion of policyholder dividends, and in the case of a stock company, after taking into account the deductible portion of policyholder dividends (if any), the deductible portion of the "special" deductions under former Code §809(d)(5) and (6), and the 50 percent deferral of any excess of gain from operations over taxable investment income. One of the principal objectives of these provisions was to moderate the tax burden imposed on the life insurance industry.

Like the 1959 Act, the new law was fashioned with an eye to moderating the tax burden on life insurance companies so that they would not be taxed in a way that was disproportionate in comparison with the taxation of other financial institutions.[10] Under the new law, this is accomplished by allowing a company to take two special deductions under new Code §806: the "special life insurance company deduction," and (if applicable) the "small life insurance company deduction."

In setting forth the rules pertaining to these new special deductions, new Code §806(c)(3)(C) makes a significant substantive change in the way that "bottom line" taxable income is computed in the case of a life insurance company that (1) operates a "noninsurance business" (within the meaning of the rules discussed next) and (2) incurs a loss with respect to that business for the taxable year. In such a situation, in contrast to the result under the 1959 Act, the loss incurred on that business is not permitted to offset and reduce the company's insurance-related taxable income in full. Rather, by analogy to the treatment of the losses of nonlife subsidiaries that are consolidated with life company income for tax purposes (as provided under Code §1503(c)), such a noninsurance business loss may be "absorbed" by the insurance-related income in an amount not exceeding 35 percent of the lesser of the loss or the income.[11] Hence, unlike other corporations, life insurance companies — at least those with noninsurance business losses — may show taxable income and losses in the same taxable year.

1. The Special Life Insurance Company Deduction

Under new Code §§804(2) and 806(a), a life insurance company is entitled to a "special life insurance company deduction" equal to 20 percent of the excess of its "tentative LICTI" for the taxable year over the amount (if any) of its "small life insurance company deduction" for the year. For this purpose, "tentative LICTI" equals a company's LICTI (otherwise computed) with two modifications. First, under new Code §806(c)(1), the special life insurance company deduction and the small life insurance company deduction are not taken into account in determining tentative LICTI. Second, items attributable to noninsurance businesses are similarly excluded by new Code §806(c)(2).

A "noninsurance business" is defined in new Code §806(c)(3)(A) as "any trade or business which is not an insurance business." While that definition is hardly illuminating, the Report of the House Ways and Means Committee sheds a little more light:

> "Generally, insurance business refers to the business activity of issuing insurance and annuity contracts, together with investment activities and administrative services that are required to support or are substantially related to the contracts issued or reinsured by the taxpayer. Thus, for example, if a life insurance company ran a manufacturing business directly (rather than owning stock in the company), any income or deduction items attributable to the manufacturing business would not be taken into account in computing tentative LICTI. Likewise, if a life insurance company acted as a broker, buying and selling securities directly for the public, such activities would not be investment activities that are necessary to support contractual obligations to policyholders in the insurance business, and would be noninsurance business." [12]

Further, new Code §806(c)(3)(B) treats an "activity" as an insurance business for this purpose if:

> (a) it is of a "type traditionally carried on by life insurance companies for investment purposes," and
>
> (b) either the activity (other than one involving real estate) does not rise to the level of an "active trade or business" or it involves the performance of administrative services in connection with plans providing life insurance, pension, or A&H benefits.[13]

The adoption of this distinction between insurance and noninsurance business may well have been necessary to prevent the unlimited acquisition of unrelated operating businesses by insurance companies solely to avoid a portion of the tax otherwise applicable to the incomes of those businesses.[14] Nonetheless, the distinction may well prove to be difficult to interpret and administer, for both the insurance industry and the IRS.[15]

A special rule applies, under Act §217(c), in computing the tentative LICTI of a corporation domiciled or having its principal place of business in one of four states [16] and which acquired the assets of one or more life insurance companies after 1979 and before April 1, 1983, the basis of such assets having been determined under Code §334(b)(2) or §338. In such a case, the tentative LICTI of the corporation is increased by deductions allowable for amortization of acquired insurance in force (and any attributable operations loss deduction), and such deductions are then taken *after* allowance of the special (or small) life insurance company deduction. The effect of this provision is to allow those deductions against income at the standard corporate rate of 46 percent (rather than at the 36.8 percent rate which

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would otherwise apply because of the special deduction, *i.e.*, 46 percent minus (20 percent times 46 percent) equals 36.8 percent).

To summarize, "tentative LICTI" generally equals LICTI disregarding the special and small life insurance company deductions and any items attributable to noninsurance businesses. After subtracting any small life insurance company deduction from tentative LICTI, a company is allowed a deduction equal to 20 percent of the remaining amount. However, under new Code §806(d), all *life insurance companies* which are members of a *controlled group* are treated as a single life insurance company for this purpose.[17] Thus, the "overall" tentative LICTI of all life insurance company members of the group is computed — with the result that any loss members lower that tentative LICTI figure — and a group special or small life insurance company deduction is determined.[18] That group deduction is then allocated among the life insurance companies in the group according to their respective individual tentative LICTIs.

Finally, it should be noted that, when the alternative tax computation under new Code §807(a)(2) is applicable, tentative LICTI is also reduced by the amount of any net capital gain (determined without regard to any items attributable to a noninsurance business).

2. The Small Life Insurance Company Deduction

In line with the historically favorable treatment accorded small companies in the Code, new Code §§804(3) and 806(b) provide for smaller life insurance companies an additional, special "small life insurance company deduction." [19] This deduction equals 60 percent of a life insurance company's tentative LICTI up to $3,000,000; thus, the small life insurance company deduction can never exceed $1,800,000. If a life insurance company's tentative LICTI exceeds $3,000,000, the amount of the small life insurance company deduction is reduced (phased-out) by an amount equal to 15 percent times the tentative LICTI in excess of $3,000,000. Hence, if a company's tentative LICTI is $15,000,000 or more, the company is not entitled to any small life insurance company deduction.

Tentative LICTI is determined for the small life insurance company deduction in the same manner as for the special life insurance company deduction. However, in keeping with the congressional desire to benefit small companies, the small life insurance company deduction, unlike the special life insurance company deduction, is available only to a life insurance company the assets of which for the taxable year do not exceed $500,000,000.[20] Further, the small life insurance company deduction, like the special life insurance company deduction, is determined on a controlled group basis for life insurance companies in the group. In addition, for purposes of the small life insurance company deduction asset test, all members of the controlled group (whether life companies or not) are treated as one company.

E. Section 807 — Reserves

Since 1909, a life insurance company has been allowed a deduction for additions to its insurance reserves. Under the "total income" approach in effect during the period 1909-1920, a net increase in reserves was deductible by a life insurance company and a net decrease in reserves was includible in its income. From 1921 through 1957, on the other hand, life insurance companies were taxed only on their "free" investment income, and were allowed to deduct only the interest additions to their reserves. Beginning in 1958, under former Code §§809 and 810, increases and decreases in reserves were treated in two steps: (1) any net increase or net decrease in reserves, aside from "required interest," gave rise to an item of deduction or income (as appropriate); and (2) required interest was excluded from the company's income. In a similar fashion, under new Code §§803, 805, and 807, a net increase in reserves (including interest additions) is deductible, and a net decrease gives rise to income.[21] The precise impact of these rules depends on a variety of factors, including the reserves taken into account and the manner in which they are computed.

1. Reserves Taken Into Account

Under new Code §807(c) the insurance reserves giving rise to income (if there is a net decrease) or a deduction (if there is a net increase) are listed as follows:

(a) Life insurance reserves, as defined in former Code §801(b);

(b) Unearned premiums and unpaid losses included is "total reserves";

(c) Discounted liabilities for insurance or annuity contracts not currently involving life, health, or accident contingencies;

(d) Dividend accumulations and other amounts held at interest under insurance or annuity contracts;

(e) Advance premiums and premium deposit fund liabilities; and

(f) Reasonable retired lives and premium stabilization reserves.

As explained in the Report of the House Ways and Means Committee:

> "The six items specified in the bill generally are the same items as under present law [the 1959 Act]. However, the bill requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. Also, the bill requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies." [22]

Further, both Committee Reports make clear that a net increase or decrease in the new Code §807(c)(1) "life insurance reserves" is to be taken into account as such, regardless of whether those reserves are "properly" computed. Finally, the Reports clarify that certain types of liabilities are included in the Code §807(c) list of reserves:

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liabilities for new Code §816(f) "guaranteed investment contracts" with temporary mortality guarantees are said to constitute Code §807(c)(3) or (4) reserves, and liabilities for life insurance contracts failing the requirements of new Code §7702 are classified as Code §807(c)(4) reserves.[23]

2. Reserve Amounts

Under the 1959 Act, the amounts of a company's insurance reserves at the end of the taxable year (with respect to which any net increase or decrease was determined) generally were the amounts as reported to state regulators on the company's annual statement for that year in accordance with the requirements of State law. A significant exception appeared as former Code §818(c). To neutralize the tax consequences of a company's use of "preliminary term" reserves (which produce "weaker" reserves because they make allowance for initial expenses of writing new business) in lieu of net level reserves for annual statement purposes, former Code §818(c) permitted a company to elect to "revalue," solely for tax purposes, its preliminary term reserves on a net level basis.

Under new Code §807(d), the amount of the life insurance reserves taken into account for tax purposes under Code §807(c)(1) may differ from the amounts as reported for State regulatory accounting purposes. As explained below, in determining the deduction for any net increase in reserves (or the income resulting from any net decrease), the new law, in essence, requires an insurance company (whether or not taxed as a life company) to compute its life insurance reserves using prescribed methods, interest rates, and mortality tables. These features of the new law reflect the view of the government that, under the 1959 Act, life insurance reserves were in many cases economically overstated, principally because of the low assumed interest rates which could be used under State law in valuing reserves.[24] It should be noted that these new requirements apply *only to life insurance reserves, and only to the computation* of the deductible amount of such reserves. As such, they have no bearing for purposes of determining life company qualification, and they do not apply to the other types of reserves listed in new Code §807(c)(2)-(6).

a. Reserve Computation Rules—In General

Under new Code §807(d)(1), the amount of the "life insurance reserve" for any contract is the *greater* of (1) the "net surrender value" of the contract, or (2) the reserve as computed under new statutorily prescribed ("Federal") standards. In no event is this amount permitted to exceed the annual statement reserve figure for the taxable year.[25] This comparison is generally to be made on a policy-by-policy basis (though "grouping" of policies is permitted at least for purposes of determining the greater of the net surrender value/Federal-standard-reserve). In performing this operation, the reserves for all benefits under a policy are to be aggregated before comparison with the policy's net surrender value. As the Committee Reports state:[26]

> "Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on a [sic] aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualifying supplemental benefit or qualifying substandard risk (*see* discussion below on special rules). Also, the comparison of contract cash surrender values and Federally prescribed reserves can be done on a group basis (*i.e.*, grouping contracts that are identical as to plan of insurance, date of issue, age of issue, etc.) or on an individual contract basis."

For purposes of this comparison, new Code §807(e)(1) defines the "net surrender value" of any contract as its cash value reduced by any surrender penalty or charge (except that any market value adjustment required on surrender is not taken into account). In the case of a "pension plan contract" (defined in new Code §818(a)), the net surrender value equals the year-end balance in the "policyholder's fund," with such balance being reduced by any surrender penalty or forfeiture (except that any market value adjustment is, again, not taken into account).

As set forth in new Code §807(d)(2), the reserve as computed under the new Federal standards is an amount determined in accordance with the methods and assumptions used in calculating the life insurance reserves shown on a company's annual statement, though modified to take account of (1) a prescribed reserve method, (2) a "prevailing" interest rate, and (3) a "prevailing" mortality or morbidity table. In addition, in computing this amount, new Code §811(c) and (d) specify that net "deferred and uncollected premiums" and any reserve in respect of "excess interest" guaranteed beyond the end of the taxable year are to be eliminated. The purpose of this calculation is to restrict the amount of the life insurance reserves (for deduction purposes) to the "minimum reserve that most States would require," with such amount being computed in a fashion that "avoid[s] State-by-State variations."[27]

(i) Reserve Method

The reserve method that must be used under new Code §807(d)(3) is:

- The Commissioners' Reserve Valuation Method ("CRVM") for life insurance contracts;
- The Commissioners' Annuity Reserve Valuation Method ("CARVM") for annuity contracts; and
- A two-year full preliminary term method for noncancellable A&H contracts.[28]

In each case, the method to be used is the NAIC-prescribed method that applies to the contract when it is issued.[29] If a contract does not fall within one of the above categories, the method to be used is (similarly) the NAIC-prescribed method that applies to the contract on its issue date, and if there is no such method, then the "most appropriate" method that is "consistent with" one of the above-described methods on the issue date is to be used. Since the precise details of any such method probably will not be known in all respects, the Report of the Senate Finance Committee notes that while the reserve computation "should take into account any factors specifically recommended by the NAIC," if in any respect "specific factors are not prescribed by the NAIC recommended reserve method, the prevailing State interpretation of such method should be considered . . ." More specifically, with respect to the computation of annuity reserves, the Conference Report observes that "the practices of the various States differ on whether surrender charges should be taken

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into account . . ." It then states, as an exception to the general rule, that "if the NAIC in 1984 clarifies what surrender charge factors are to be disregarded (and not to reduce the amount of the reserve) under the CARVM, then this clarification is to be considered in effect on the date of issuance" of the annuity contracts involved.[30]

Although, as described later, the 1959 Act definition and exclusion of "deficiency reserves" are eliminated from new Code §816(b), such amounts remain excluded — under an updated definition — from deductible reserves by virtue of new Code §807(d)(3)(C). Specifically, under that provision, the prescribed reserve methods are deemed not to incorporate any rule which increases a reserve because the net premiums with respect to a contract (recomputed in accordance with the requirements of Code §807(d)(2)) exceed the contract's actual or gross premiums. This definition of an excludable amount in the nature of a deficiency reserve was intended to comport with the description of a comparable amount under the Standard Valuation Law as modified by the 1976 Amendments.

Because new Code §807(d)(3) mandates the use of a preliminary term method (the CRVM) in computing the deductible reserves for life insurance contracts, the elective revaluation of preliminary term reserves to net level for tax purposes provided under former Code §818(c) is rendered obsolete and does not appear in the new law. Any income that would arise from a reduction in reserves due to its elimination is generally forgiven by virtue of the "fresh start" rules, discussed below.

(ii) Assumed Interest Rate

Under new Code §807(d)(4), the assumed interest rate (denominated the "prevailing State assumed interest rate") to be used in computing life insurance reserves under the Federal standards is the *highest* assumed interest rate which at least 26 States permit to be used in computing reserves for life insurance or annuity contracts (whichever is appropriate).[31] As a general matter, this prevailing rate is determined as of January 1 of the year in which the contract was issued. However, except in the case of annuity contract reserves, a company may elect to use the rate prevailing as of the beginning of the calendar year preceding the year of issue; the time and manner of electing this one-year delay is to be prescribed in regulations. Since there may be no prevailing State assumed interest rate applicable to noncancellable A&H contracts when issued (for want of sufficient State "adoptions"), new Code §807(d)(4)(D) specifies that the rate to be used in such cases is the rate for whole life insurance contracts issued at the same time.

(iii) Mortality and Morbidity Table

New Code §807(d)(5) provides that the mortality or morbidity tables to be used in the new computation (denominated as the "prevailing commissioners' standard tables") are the *most recent* standard tables prescribed by the NAIC which at least 26 states permit to be used in computing reserves for the type of contract involved at the time of issue. For this purpose, a state is understood to "permit" the use of a new table with respect to a contract as soon as it allows a company subject to its regulatory authority to value the liability for that contract on the basis of such table. However, new Code §807(d)(2)(C) specifically provides that in making the new computation, a "prevailing" table may be adjusted "as appropriate" to reflect the risks (such as substandard risks) insured under the contract if the nature of those risks is not otherwise taken into account. As noted in the Report of the House Ways and Means Committee:

> "Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred . . . not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health. Also, adjustment to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks); or because the insureds reside in a foreign country known to be experiencing strife." [32]

If there are no applicable commissioners' standard tables, the regulations are to prescribe the tables that are to be used.[33] If more than one table (or more than one option, such as a projection) is simultaneously "prevailing," the one "generally" yielding the *lowest* reserves is to be used. However, if a prevailing commissioners' standard table as of any January 1 (the "year of change") differs from the prevailing table as of the preceding January 1, the "old" table may be used with respect to contracts issued during the three-year period beginning on January 1 of the year of change.

(iv) Deferred and Uncollected Premiums

New Code §811(c)(1) (as discussed *infra*) provides that the reserve computed under the Federal standards may not contain any amount in respect of deferred and uncollected premiums. Accordingly, the net deferred and uncollected premiums (computed under the Federal standards) are to be subtracted from what otherwise is a mean reserve computation. This requirement has no application to reserves in respect of premiums actually paid during the taxable year.

(v) Interest Guaranteed Beyond Year-End

Under former Code §818(h), as added by TEFRA, with respect to contracts guaranteeing "excess interest" beyond the end of the taxable year, reserves for such contracts were required to be computed as if the excess interest were guaranteed only until year's end. New Code §811(d) preserves that rule, defining "excess interest" for this purpose as interest at a rate exceeding the prevailing state assumed interest rate for the contract involved. As noted in the Report of the House Ways and Means Committee:

> "Any amount in the nature of interest that is credited under any contract for any period at a rate in excess of the prevailing State assumed interest rate for the contract for such period and is guaranteed beyond the end of the taxable year can only be taken into account in computing reserves as if it were guaranteed to the end of the taxable year. Under this rule, 'amounts in the nature of interest' include both implicit and explicit guarantees for determining contractual benefits. Thus, 'amount in the nature of interest' refers

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to amounts credited to policyholder reserves as assumed interest or interest paid on such items." [34]

b. Exception to the General Rules

As a general matter, then the life insurance reserve for any contract under the new law is computed using the Federal standards, and the greater of that reserve or the net surrender value (not exceeding the annual statement reserve) is the reserve figure taken into account for tax purposes (other than for determining life company qualification). There are, however, exceptions to these rules:

(i) Supplemental Benefits

Despite the general rule that life insurance reserves must be computed using the new Federal standards, the statutory or annual statement reserve is accepted as the reserve amount in the case of certain "supplemental benefits" enumerated in new Code §807(e)(3).[35] These benefits (presumably with reserves that are de minimis in amount) are —

- Guaranteed insurability;[36]
- Accidental death or disability benefit;[37]
- Convertibility; and
- Disability waiver of premium.

In addition, any other benefit so denominated in regulations will be considered to be one of the enumerated supplemental benefits.

While the amount of the reserve for any such supplemental benefit is that shown on the annual statement, it must be kept in mind that the deductible reserve for tax purposes is the greater of the reserve for *all* benefits under a contract or the contract's net surrender value. However, in the case of any "qualified" supplemental benefit, the reserve for that benefit is added in separately, after the reserve/surrender value comparison is made for the "basic" contract, as if such qualified benefit were provided under a separate contract. For this purpose, a qualified supplemental benefit is one for which there is a separately identified premium or charge which may not be funded out of any net surrender value attributable to other benefits.[38]

(ii) Substandard Risks

New Code §807(e)(5) requires that, as with a qualified supplemental benefit, the amount of the life insurance reserve for any "qualified substandard risk" be computed separately. For such a risk to be "qualified," the company must maintain a separate reserve for the risk; there must be a separately identified premium or charge for the risk; and the net surrender value may neither increase nor decrease in amount due to the risk, or be used "systematically" to pay premiums for the risk.[39] In contrast with a reserve for a qualified supplemental benefit, however, the reserve for a qualified substandard risk, although computed separately, still must be computed using the new Federal standards, and in no event may that reserve exceed the separately identified premiums for the risk, plus interest, less mortality charges for the risks. As a final limitation, the Code §807(e)(5) rule applies only to an aggregate amount of insurance in force which does not exceed 10 percent of the company's insurance in force under life insurance contracts (other than term).

(iii) Other Exceptions

There are several other exceptions that are worthy of note. First, under new Code §807(e)(6), the reserve for a term insurance or annuity benefit under a contract may be computed separately (but still using the new Federal standards) if (1) there is a separately identified premium or charge for the benefit; (2) any net surrender value attributable to other benefits cannot fund the benefit; and (3) the plan of insurance involved was on file in at least one state before January 1, 1984. This rule applies, however, only to life insurance contracts issued before January 1, 1989. Second, certain small life insurance companies may elect to have their Code §807(c)(1) reserves for contracts issued after the beginning of their first taxable year commencing after December 31, 1983, and before January 1, 1989, equal their annual statement reserves for the contracts (with a modification in the interest rate). This provision is available only to a company with tentative LICTI at or below $3,000,000 and assets (taking affiliates into account) at or below $100,000,000.[40]

3. Changes In Reserve Bases

Under former Code §810(d), if a life insurance company changed its basis for computing reserves during a taxable year, the income or deductions attributable to the change were taken into account ratably over a 10-year period. New Code §807(f) preserves the 1959 Act rule. Moreover, if a company ceases to be taxed as a life insurance company, and if Code §381(c)(22) does not apply, all adjustments not yet made under the 10-year rule are taken into account in the last full taxable year of life company status.

4. "Fresh Start"

Under Act §216(a), a life insurance company (except for purposes of qualification) must compute its reserves for its first taxable year beginning after December 31, 1983, as if the Federal reserve standards under the Act applied with respect to all then-existing contracts when they were issued.[41] In other words, for tax purposes the company must recompute those reserves, as of January 1, 1984, under the new Federal standards. In the absence of special relief, this provision would cause virtually all companies to experience income (from the reserve decrease). To avoid this problem, Act §216(b) provides, as a general rule, that any change in reserve (or accounting) methods attributable solely to the new rules is not to be treated as a change in reserve (or accounting) method.[42] Thus, a "fresh start" is provided, and the potential flow into gross income is precluded.[43] Under a special election provided in Act §216(c), a small company (with not more than $100,000,000 in assets on a consolidated basis) is allowed to forego this "fresh start" in order to avoid the administrative problems connected with the recomputation with respect to its "in force."

There are, however, certain reserves to which this "fresh start" rule does not apply:

(a) Any reserve transferred pursuant to a reinsurance agreement entered into after September 27, 1983, and before January 1, 1984;

(b) Any reserve transferred pursuant to any modification of a reinsurance agreement made after September 27, 1983, and before January 1, 1984; and

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(c) Any reserve subject to a "reserve strengthening" reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.[44]

These rules are designed to prevent companies from securing unintended benefits from the fresh start rule. Also in connection with these rules, no election made under former Code §818(c) after September 27, 1983, will be allowed to take effect.[45]

Where the fresh start is disallowed, the resulting income is taken into account under new Code §807(f) ratably over a 10-year period if it would have been subject to such spread treatment under former Code §810(d). Otherwise, the full income amount is recognized, pursuant to Act §216(b)(3)(C), in the company's first taxable year beginning after December 31, 1983. Thus, where reserves subject to former Code §818(c) revaluation were transferred in a new reinsurance transaction in the last quarter of 1983, the spread rule does not apply. Moreover, under Act §216(b)(3)(D) and (E) no special or small life insurance company deduction is allowed under the new law with respect to such amounts, nor is the former Code §809(d)(5) or (6) deduction allowed for 1983.

Finally, under Act §216(b)(5), where the fresh start does apply with respect to reserves transferred under a reinsurance arrangement entered into in 1982 or 1983, the benefit of the fresh start is, in effect, allocated between the ceding company and the reinsurer when the former "recaptures" the reinsured contracts after 1983. As the Report of the Senate Finance Committee explains:

"Generally, the "fresh start" benefit would be allocated by income recognition or deductions for recaptured reserves upon termination of the reinsurance agreement, making the amounts under the allocation reflect the post-1983 duration of the agreement between the parties. . . . If the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) that the reinsurer would have taken into account under present law exceeds the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) taken into account by the reinsurer under the bill, such excess will be taken into account by the reinsurer, in computing life insurance company taxable income, over a 10-year period commencing with the taxable year of termination. However, the excess taken into account by the reinsurer cannot exceed the amount of such excess if computed on January 1, 1984. The same amount of excess, if any, shall be taken into account by the ceding company over a ten-year period commencing with the taxable year of recapture." [46]

F. Section 808 — Policyholder Dividends

Reacting to the 1959 Act "excess interest" controversy, the new law significantly expands the definition of a policyholder dividend. Under new Code §808(a) and (b), a policyholder dividend is defined as "any dividend or similar distribution to policyholders in their capacity as such," and specifically includes excess interest, premium adjustments, experience-rated refunds, and (as under the 1959 Act) any amount not fixed in the contract which is dependent on company experience or management discretion. To provide consistency in treatment, new Code §808(e) treats policyholder dividends consisting of increases in cash surrender value or other benefits and premium reductions as if the policyholder had received a dividend and returned it to the company as additional premium. As explained in the Report of the House Ways and Means Committee:

"The term excess interest means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract (*i.e.*, the rate used under the bill for purposes of determining the amount of the company's Federally prescribed reserve under the rules contained in new section 807(d)). Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest such as the increase in reserves attributable to assumed or guaranteed interest rates rather than premium contributions. Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest. The term premium adjustment means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment. Finally, the term experience-rated refunds means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience rated refund." [47]

Also, as noted previously in the discussion of new Code §805(a)(3), the deductibility in any taxable year of such policyholder dividends is premised (by virtue of new Code §808) on the fact that such amounts are "paid or accrued" by the end of the year.

G. Section 809 — Limit on Deductions of Mutual Companies

New Code §809, which limits the deductibility of policyholder dividends and benefit reserves by mutual companies, essentially performs two functions. First, on its face, it attempts to ensure that mutual company taxable income is not reduced below a minimum "return on equity" by virtue of deductions for distributions to policyholders. Second, implicitly, the new provisions regulate the distribution of the life insurance industry's tax burden between the stock and mutual segments of the industry, implementing a

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congressional judgment that the two segments should share the burden on the basis of a 45 percent/55 percent split, respectively, for the 1984 taxable year. These two functions are carried out by requiring each mutual company's post-dividend gain from operations to be increased by an amount derived by multiplying the company's "equity base" by a rate of return, initially fixed in the statute and then varied over time as a function of the difference between stock and mutual *segment* rates of return.

The 1959 Act had also imposed a limit on the deductibility of policyholder dividends, which was principally (but not exclusively) significant to mutual life insurance companies. This limit was imposed by former Code §809 (incorporating the rules of former Code §§804-805), which provided that the deduction for policyholder dividends (except for the 1982-1983 "stopgap" period) could not exceed $250,000 plus the amount by which a company's "gain from operations" (before deducting such dividends) exceeded its "taxable investment income."

The new law technically imposes its limit first by providing, under new Code §808(c)(2), that the deduction for policyholder dividends otherwise allowable for a mutual life insurance company is "reduced by the amount determined under section 809." New Code §809(a)(1) provides in turn, that a mutual company's dividend deduction must be reduced (though not below zero) by a "differential earnings amount computed for the taxable year." Further, if a company's dividends are less than its differential earnings amount for any year, new Code §809(a)(2) provides that the excess of the differential earnings amount over such dividends will be treated, first, as a reduction in the company's deduction for and increase in reserves under new Code §807, and, then, as a net decrease in reserves giving rise to income. The differential earnings amount is defined in new Code §809(a)(3) as the product of a mutual life insurer's "average equity base" for the taxable year multiplied by a segment-based "differential earnings rate" for the year.

1. Average Equity Base

Under new Code §809(b)(1), a company's "average equity base" is simply the average of its "equity base" as of the beginning and the close of any taxable year. The company's "equity base," as defined in new Code §809(b)(2)-(6), is intended to approximate the financial equity of a mutual life insurer, and is determined in a manner that may be compared with the procedure for computing stock company surplus under GAAP. To accomplish this, the statute starts with a company's "surplus and capital" as computed for purposes of annual statement accounting, and then proceeds to make four specific adjustments:

a. Non-Admitted Financial Assets

Company surplus is required to be increased by the amount of any non-admitted assets consisting of bonds, stocks, real estate, real estate mortgage loans, and other "invested assets."

b. Difference Between Tax and Statutory Reserves

Generally speaking, the aggregate life insurance reserves carried on a company's annual statement to date can be expected to exceed the amount of its "tax" reserves computed under new Code §807(d). Given the government's apparent belief that statutory reserves were too conservative to be used it is not surprising that the excess of a mutual life insurer's statutory reserves over its tax reserves is required to be added to its "equity." Of course, to the extent that the reserve for any policy equals its "net surrender value," as will be the case for many older blocks of business, this adjustment will have no impact.

c. Other Reserves

In addition to the adjustment for the difference between statutory and tax reserves, the new law treats certain other items, technically carried as liabilities for regulatory accounting purposes, as part of a mutual company's "equity." The statute specifically requires "equity" to include the amount of the company's mandatory securities valuation reserve, the amount of "any deficiency reserve," as well as the amount of any other "voluntary reserve or similar liability." [48]

d. Policyholder Dividend Reserve

Finally, a company's equity is required to be increased by 50 percent of the amount carried as a reserve for policyholder dividends payable in the following year.[49]

2. Differential Earnings Rate

The single most complex aspect of new Code §809 is the computation of the "differential earnings rate." New Code §809(c)(1) provides that, for any taxable year, the "differential earnings rate" equals the difference between (i) the "imputed earnings rate" for that year and (ii) the "average mutual earnings rate" for "the *second calendar year preceding*" that year. (Emphasis added.) To facilitate the filing of estimated tax declarations and the actual computation of the Code §809 limitation for 1984, a transitional rule is provided in Code §809(c)(2) that fixes the "average mutual earnings rate" to be used in the initial differential earnings rate computation for 1984 at 7.8 percent. (For the rules governing the subsequent adjustment of this number, *see* the discussion of "average mutual earnings rate," below.)

a. Imputed Earnings Rate

Code §809(d)(1)(A) initially fixes the "imputed earnings rate" at 16.5 percent for 1984 to achieve the predetermined mutual/stock segment balance. So that this "plug" rate will fluctuate to reflect changes in stock segment earnings over time, Code §809(d)(1)(B) provides for it to be adjusted annually to reflect changes in stock segment earnings rates (referred to as the "current stock earnings rate") over stock segment earnings during a base period, 1981-1983 (the "base period stock earnings rate"). Consistent with the fact that the stock "base period" is a three-year period, the "current stock earnings rate," used to index the plug rate, is a rolling average of stock company earnings for the three calendar years preceding any computation year. Thus, for example, in adjusting the plug rate for use in 1985, stock company earnings during the period 1982-1984 will be compared with stock company earnings during the "base period" 1981-1983, and the 16.5 percent rate will be adjusted accordingly. This device was adopted to avoid sharp changes in the Code §809 limitation as the result of abrupt fluctuations in stock company earnings.

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In computing the stock company earnings rate for both the base period and subsequent adjustments, Code §809(d)(4) calls for the use of a stock company's post-dividend, pre-tax gain (or loss) from operations, as computed for annual statement accounting purposes, expressed as a percentage of the company's "average equity base," computed in accordance with the rules for mutual companies set out above. The actual "current stock earnings" rate is the numerical average of the results of this computation for the 50 largest stock life insurance companies (and their affiliates), as determined by the Secretary of the Treasury.[50]

b. Average Mutual Earnings Rate

Under new Code §809(c), the "average mutual earnings rate" is the weighted average of the rate determined by expressing aggregate mutual, post-dividend statement gain from operations as a percentage of aggregate mutual equity. As already noted, however, the "average mutual earnings rate" actually used in computing the initial Code §809 limitation is, for any year, the rate computed under Code §809(e) for the second calendar year *preceding* the computation year. As a result, the Code §809 limitation for any taxable year, when initially computed, does not accurately reflect the extent to which mutual life insurers, through the distribution of policyholder dividends, may (or may not) have reduced their post-dividend gain from operations below the imputed earnings rate (as indexed).

New Code §809(f) corrects this by providing that any difference between the average mutual earnings rate used in the initial Code §809 computation for any taxable year, and the actual "average mutual earnings rate" as subsequently computed for that taxable year, is to be "trued-up" or taken into account in the following year. Specifically, Code §809(f) defines the "recomputed differential earnings amount" as the "differential earnings amount" for any taxable year substituting the actual mutual earnings rate in that taxable year for the mutual earnings rate used in the initial Code §809 computation for the year.[51] Code §809(f) contemplates that the "recomputed differential earnings amount" may be either higher or lower than the initially computed "differential earnings amount." If higher, the excess is includible in the mutual company's income in the taxable year following the year for which the initial Code §809 computation was made. Where it is smaller, the difference is allowable as a deduction in the following taxable year. No interest is payable to the government or to the mutual life insurer by reason of a disparity between the initial differential earnings amount for any taxable year and the recomputed differential earnings amount, as taken into account in the following taxable year.

3. Special Rules

Under new Code §809(g)(1)-(4), the "equity base," the "average mutual earnings rate," and the "stock earnings rate" are all generally computed on the basis of statutory accounting. New Code §809 contains several other special rules, two of which merit special mention:

a. Treatment of Mutual Affiliates

One item that was subject to substantial dispute before finalization of new Code §809 was the treatment to be accorded a stock life insurance company that was a wholly-owned, or controlled, subsidiary of a mutual life insurance company.[52] In effect, Code §809(h)(2)-(3) resolves this question in favor of treating stock subsidiaries of mutual companies as themselves being mutual companies. Where the parent and subsidiary are members of an affiliated group, stock of the subsidiary is disregarded in computing the mutual parent's equity, and dividends received from the subsidiary are disregarded in computing the parent's gain from operations. Instead, new Code §809(h)(2)(B) provides that the two companies are treated "as though they were one mutual life insurance company." On the other hand, where the stock subsidiary and its parent are not members of an affiliated group, Code §809(b)(3)(A) requires that, under regulations, adjustments will be made to the average equity base of the mutual parent (or parents) to reflect the equity in the subsidiary.

b. Transition Rule for Certain "High Surplus" Mutuals

In fashioning the Code §809 limitation, Congress was cognizant of the fact that some mutual life insurers carried more surplus in relation to their assets than was characteristic of the mutual segment of the industry and that, for such companies, the limitation might operate in an unduly burdensome fashion. To alleviate any difficulties for these so-called "high surplus" mutual life insurers, new Code §809(i) contains a special transition rule, which defines a "high surplus" mutual life insurer's "excess equity" in relation to its assets, and provides that no "differential earnings amount" will be computed with respect to a portion of the company's "excess equity." A "high surplus" mutual is defined in Code §809(i)(2)(C) as one whose equity, in 1984, exceeded 14.5 percent of its assets. This special relief is phased down after 1984 and expires after 1988.

H. Section 810 — Operations Loss Deductions

As noted above, in connection with the discussion of new Code §805(a)(5), a company is allowed to deduct the amount (if any) of the "operations loss deduction" as determined under new Code §810, which carries forward the provisions of former Code §812 with only the modifications needed to conform them with the "single phase" approach of the new law. New Code §810, like former Code §812, allows a life insurance company to deduct this specially computed carryover amount in lieu of an amount determined under the general net operating loss provisions of Code §172, partly to avoid the technical problems that would be involved in modifying the latter to take the rules of Part I of Subchapter L into account. (As a result, under new Code §805(b), life companies are denied the Code §172 deduction.) Since this provision of the new law largely preserves the 1959 Act rule, it is not surprising that subsection (g) of new Code §810 specifically states that the section "shall be treated as a continuation" of former Code §812.

I. Section 811 — Accounting Rules

The taxable income of a life insurance company is determined through the application of special rules, principally because of the long-term nature of its liabilities. In many respects, however, a life insurance company is treated for tax purposes in the same fashion as any other type of

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business corporation. In particular, it is subject to the general rules of the accrual method of accounting, and to this, former Code §818(a) provided:

> (a) "METHOD OF ACCOUNTING. — All computations entering into the determination of the taxes imposed by this part shall be made —
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

This language arguably was interpreted by the courts as giving precedence to annual statement accounting. For example, in *Comr. v. Standard Life and Accident Insurance Co.*,[53] the Supreme Court held that net deferred and uncollected premiums were to be taken into account for tax purposes even though such amounts were not properly accruable under general principles.

New Code §811(a) contains a provision identical to former Code §818(a) except for the concluding sentence (the revised language is emphasized):

> *"To the extent not inconsistent with the preceding sentence or any other provision of this part,* all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

This slight change in language is intended to work a potentially significant (if ill-defined) substantive change. As noted in the Report of the House Ways and Means Committee:

> "The bill retains the general rule in present law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the bill makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The *change* from present law was *intended to reinforce the primacy of the Federal tax rules* and *not impose a new method of tax accounting* on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized). [Emphasis added.]" [54]

In addition, while new Code §811(c) preserves the old Code §818(e) prohibition against deducting any item more than once, it expands on that theme to prohibit both counting any item more than once for reserve purposes, and establishing of a reserve for any item unless the premiums (or other consideration) attributable to that item are required to be included in income. This specifically focuses on, and reverses, the tax treatment of net deferred and uncollected premiums called for by the decision in *Standard Life.*[55]

On a more general note, new Code §811(b) and (e) preserves, without substantive change, the former Code §818(b) and (d) accounting rules concerning amortization of premium, accrual of discount, and short taxable years. New Code §811(d) is discussed in connection with Code §807, *supra.*

J. Section 812 — Proration Formula

As part of the basic pattern of taxing life insurance companies, interest required to be credited to reserves is allowable as a deduction. Where a company's portfolio includes investments in "tax-favored" assets,[56] some part of that "required interest" is, at least theoretically, attributable to earnings on those assets. Congress has long taken the view that, if a life insurance company may exclude (or deduct) such amounts from its income and also deduct all of the interest credited to reserves, the company is effectively excluding (or deducting) the same amounts twice.

Under the 1959 Act, Congress' solution to this perception of double deductions (or exclusions) with respect to tax-favored income consisted of two steps. First, under Code §§804 and 809(a) and (b), a life insurance company was required to include in its income the so-called "company's share" of net investment income, including tax-exempt interest and dividends received. Second, under Code §809(d)(8), the company was allowed a deduction for the "company's share" of tax-favored amounts (tax-exempt interest and the dividends received deduction). In other words, the tax-favored income was "prorated" between the life insurance company and its policyholders, and the life insurance company was directly allowed to exclude only "its" share of tax-exempt interest and to deduct only "its" share of any dividends received deduction.

Under the new law, a life insurance company may exclude tax-exempt interest from gross income, but must include in income any dividends received. The company then is allowed to take "the company's" share of any intercorporate dividends received deduction (Code §805(a)(4)); but it must reduce, under Code §807(a) and (b), its deduction for any net increase in reserves (or increase its income from any net decrease in reserves) by the "policyholders' share" of any tax-exempt interest. The effect of the new provisions generally is the same as the corresponding 1959 Act provisions: the company is allowed to benefit from "its" share of these tax-favored items, while the balance is treated as being credited directly to the policyholders (and, indirectly, deducted by the company). Under the new law, however, the method of determining the "policyholders'" and the "company's" shares has been changed.

New Code §812 was considered to be an exercise in "tax simplification." Under it, tax-exempt interest and the 85 percent dividends received deduction (see the separate discussion of the 100 percent dividends received deduction, below), are prorated between the company and its policyholders by reference to the company's "net investment

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income," defined in new Code §812(c) as "90 percent gross investment income." [57] The term "company's share" — which is used solely to determine the life insurance company's allowable deduction for dividends received — is defined in new Code §812(a)(1) as the company's share of net investment income divided by the total net investment income. In turn, the company's share of net investment income is defined as total net investment income minus the sum of "policy interest" plus the "gross investment income's proportionate share of policyholder dividends."

The subtraction of these two amounts is an attempt to "back out" of gross investment income those amounts considered to have been applied to fund reserve additions or policyholder dividends. "Policy interest," defined in new Code §812(b)(2), includes all required interest credited with respect to insurance reserves (except unearned premiums and unpaid losses not included in life insurance reserves); the deductible part of "excess interest" as defined in new Code §808;[58] and the deductible part of *any* other amount credited to a policyholder's fund under a pension plan contract for employees (except retired employees) or to a deferred annuity contract before the annuity starting date.[59] The "gross investment income's proportionate share of policyholder dividends," defined in new Code §812(b)(3), is a more complicated concept, on which it perhaps is best to let the Report of the Senate Finance Committee attempt to speak for itself:

> "[This item is] a fraction of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under [required interest], or of any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year). . . . The deductible portion of any policyholder dividend is that portion remaining after a pro rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable). Finally, the fraction of the deductible portion of policyholder dividends to be included will be determined by applying a mini-fraction. The numerator of the mini-fraction is gross investment income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities. . . . The denominator of the mini-fraction is gross income (including tax-exempt income), less net increases in reserve items. The application of this mini-fraction to the deductible portion of policyholder dividends recognizes that some portion of traditional policyholder dividends consist of redundant premiums (*i.e.*, rebates of mortality and expense charges). In so recognizing this, the assumption is made that, except for those items specifically allocated to be paid out of investment income (*i.e.*, amounts generally in the nature of interest), all other sources of income are available to pay all other expenses ratably." [60]

The Report concludes with the observation that, at bottom:

> "The company's share is the amount of net investment income that remains after paying or crediting amounts to policyholders."

The "policyholders' share" — which is used to determine the portion of tax-exempt interest considered to belong to the policyholders and, therefore, subtracted from the company's closing reserve balance in computing its deduction (or income) for a net increase (or decrease) in reserves — is simply 100 percent minus the company's share. In short, the company may directly deduct, or exclude, only the "company's share" of tax-exempt interest and the "85 percent" intercorporate dividends received.

On the other hand, "100 percent dividends" *are not* subject to the proration formula described above. In general, these are dividends received from subsidiaries more than 80 percent owned by the life insurance company. The basic theory for exempting them from proration is to treat the earnings from the subsidiaries' businesses as though they had been received directly by the parent. Thus, the dividends are fully excluded from "gross investment income," for purposes of the proration formula, and the deduction in respect of such dividends is allocated entirely to the company *unless* those dividends themselves are derived (wholly or in part) from tax-exempt interest or 85 percent dividends at the paying subsidiary's level. As explained in the Report of the Senate Finance Committee:

> "However, 100 percent dividends (*i.e.*, dividends that would be allowed a 100 percent deduction under sections 243 or 244, and certain dividends received by foreign corporations that would be 100 percent dividends but for the foreign recipient) are not subject to proration except to the extent they are funded with tax-exempt interest or with dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. For these purposes, a distribution would be considered to be funded ratably out of tax-exempt income, dividends that would not qualify as 100 percent dividends to the taxpayer, and all other taxable income of the distributing corporation. Also for purposes of applying the exception, multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.
>
> ". . . Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income which it could distribute to the parent as dividends. . . . The bill also prevents a group from using multi-tier corporations to pass dividends comprised of tax-exempt income up to a parent life insurance company." [61]

The Conference Report further explains this "tracing" rule by reference to standard earnings and profits concepts:

> "The conferees wish to clarify that in determining how much of a dividend has been paid out of tax-exempt interest, or dividends other than 100-percent dividends, or out of other taxable income items, a comparison should be made between the amount that previously undistributed tax-exempt interest and dividends other than 100-percent dividends have contributed to a company's current and post-1983 accumulated earnings and profits and all such earnings and profits immediately prior to the distribution. The conferees believe that this interpretation of the dividends-received proration provision is consistent with the definition of a dividend as a distribution out of earnings and profits

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(and not out of other amounts). Any other interpretation either would require the establishment of a unique set of earnings and profits accounting provisions, or would result potentially in year-to-year distortions because of annual variations in the proration formula." [62]

K. Sections 813-814 — Foreign Branch Operations

1. U.S. Branch Operations of Foreign Life Insurance Companies

As a general rule, foreign corporations are subject to U.S. income tax only on their income which is either U.S. source income or is effectively connected with a trade or business in the United States. Under both the 1959 Act and the new law, a foreign corporation operating a U.S. insurance business is taxed like a domestic life insurance company on its income effectively connected with that business if, considering only that business, it would have qualified as a life insurance company if it were a domestic company.[63] However, former Code §819 provided for the reduction of certain deductions of such a branch operation of a foreign corporation if its surplus attributable to U.S. business fell below a specified minimum level (designed to approximate the average surplus that a domestic life insurance company would maintain with respect to the same level of business). New Code §813 generally preserves this rule, although, in lieu of decreasing the deductions of the U.S. branch, the new section increases the amount of its income deemed "effectively connected" with its U.S. insurance business by an amount equal to its surplus "deficit" multiplied by its current investment yield.[64] As under the 1959 Act, the new law permits any resulting tax increase to offset the flat-rate tax, if any, imposed under Code §881.[65]

2. Foreign Branch Operations of U.S. Companies

As a general rule, domestic corporations are taxed on their worldwide income, including income from foreign branch operations. However, in the case of a domestic mutual life insurance company operating a branch in a country "contiguous" with the United States, former Code §819A (beginning in 1976), in recognition of the fact that income from such operations was locally oriented, permitted such a company to elect to exclude from U.S. taxable income the income earned by that branch, unless it was repatriated to the United States. New Code §814 carries that rule forward, with some technical modifications. In addition, by virtue of Act §217(a), an old Code §819A election will be treated as an election under new Code §814.

L. Section 815 — "Phase III" Amounts

Under the 1959 Act, a life insurance company was allowed to defer tax on one-half of the excess of its gain from operations over its taxable investment income, and was allowed special deductions with respect to certain nonparticipating contracts and certain A&H and group life insurance contracts. The premise of so-called "phase III" was to return to taxable income those amounts that were not taxed currently (because they might have been needed for policyholders) when it became clear they were not required for policyholders.

As a result, each stock life insurance company was required to set up two memorandum tax accounts — a "Shareholders Surplus Account" and a "Policyholders Surplus Account." The Shareholders Surplus Account, defined by former Code §815(b), represented amounts that had been taxed or that were never intended to be taxed. The annual addition to the Shareholders Surplus Account was the amount by which the sum of (1) life insurance company taxable income, computed without regard to any phase III tax, plus (2) the excess of any net capital gain over the amount in (1), plus (3) the full amount of the intercorporate dividends received and the tax-exempt interest, plus (4) the "small business deduction," exceeded the tax imposed for the taxable year, again without regard to any phase III tax. The Policyholders Surplus Account, defined under former Code §815(c), represented amounts that were not taxed previously because they might be needed for policyholders. The annual addition to the Policyholders Surplus Account equalled the amounts (referred to above) deferred for the taxable year.

Under former Code §815(a), post-1958 distributions to shareholders were deemed first to be made from the Shareholders Surplus Account (with no tax effect other than to reduce the balance in that account) and, only thereafter, were deemed to be made from the Policyholders Surplus Account, thereby triggering a phase III tax. However, distributions were nonetheless deemed to be made from the latter account where certain limits, keyed to life insurance reserves and premiums as set forth in former Code §815(d)(4), were exceeded.

Under the "single-phase" system of the new law, there is no longer a need to add amounts to a Policyholders Surplus Account. However, rather than either immediately taxing balances remaining in companies' Policyholders Surplus Accounts or permanently forgiving any such tax, new Code §815 requires stock life insurance companies to continue to maintain those Accounts. Under the new provisions, a company's LICTI may be increased by any distributions from the Policyholders Surplus Account, largely determined in accordance with the rules of former Code §815.[66] Technically, new Code §815 requires that the company's tax be recomputed as if tax were imposed on LICTI (not less than zero) plus any Policyholders Surplus Account distributions. Thus, for example, such distributions would not increase LICTI for purposes of computing the special and small life insurance company deductions.

A life insurance company's carried-over Policyholders Surplus Account under new Code §815 equals the balance in such Account as of December 31, 1983, and no amounts are added to that Account after 1983. On the other hand, a company's carried-over Shareholders Surplus Account is increased annually by the excess of the sum of its LICTI (not less than zero), its special and small life insurance company deductions, the company's share of its dividends received deduction,[67] and its excluded tax-exempt interest over the tax imposed for the year (without regard to new Code §815).

M. Section 816 — Qualification as a Life Insurance Company

As was true under the 1959 Act, the provisions of revised Part I of Subchapter L apply only to "a life insurance company." Like other corporate enterprises, the income of a life insurance company is taxed at normal corporate rates, but, under Subchapter L, its taxable income is computed somewhat differently than that of other

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corporations, reflecting the specialized nature of its business and the make-up of the insurance industry.[68] For this purpose, a "life insurance company" is defined in new Code §816(a), comparable to the provisions of former Code §801, as an "insurance company" that issues certain types of contracts (*i.e.*, life insurance, annuity or noncancellable A&H contracts) more than 50 percent of the reserves of which are "life insurance reserves" plus unearned premiums and unpaid losses (whether or not ascertainable) on noncancellable A&H policies not included in life insurance reserves. Further, "life insurance reserves" are defined in new Code §816(b) (continuing the tests of former Code §801(b)) as amounts that are actuarially computed or estimated (on the basis of interest assumptions and recognized tables) and required by State law to be "set aside" for future claims under life insurance, annuity, or noncancellable A&H contracts involving life, health, or accident contingencies. The amount of these reserves under new Code §816 continues to be that shown on a company's annual statement, rather than the recomputed reserves described in new Code §807(d).[69]

While new Code §816 thus preserves most of the 1959 Act rules affecting qualification, it does make several important changes. First, it refines and incorporates in statutory language (in new Code §816(a)) the definition of an "insurance company" that appears in Regs. §1.801-3(a)(1). The new language reads:

> "For purposes of the preceding sentence [defining a "life insurance company"], the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

As explained in the Report of the Senate Finance Committee:

> "[F]or purposes of qualifying as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risk [sic] underwritten by insurance companies. By requiring more than that the 'primary and predominant business activity' be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies under present law. Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities . . .
>
> "Because the definition of a life insurance company, under the bill, looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company or as a property and casualty company on the basis of its activities for the entire year. . ."[70]

Second, as enacted by Act §221, new Code §7702 contains a definition of "life insurance contract" for all purposes of the Code, including the life company qualification rules. (As under prior law, the term "annuity contract" is not comprehensively defined by statute.)[71] Third, unlike former Code §801(b), new Code §816 does not include a provision excluding deficiency reserves from the definitions of "life insurance reserves" and "total reserves." (Although under new Code §807(d)(3)(C), amounts in the nature of deficiency reserves are still excluded for purposes other than determining life company qualification.)

Finally, new Code §816 specifically addresses the treatment of liabilities for so-called "guaranteed investment contracts." Under the 1959 Act, a company issuing group contracts out of its general account as funding vehicles for qualified pension plans was allowed an exclusion, for tax purposes, in respect of the interest credited under such contracts. This exclusion was equal to the "pension plan reserves" for the contracts multiplied by the company's current yield on its total investment portfolio (*see* former Code §805(a)(2)). As interest rates rose during the 1960's and 1970's, the amount of interest credited at the then current market rates (as needed to remain competitive) frequently exceeded the exclusion as so computed. To obtain former Code §805(e) "interest paid" treatment for the amount so credited and thereby rectify this problem, companies began issuing pension funding contracts which contained only temporary annuity purchase rate guarantees and, in some instances, which contained no such guarantees ("guaranteed investment contracts" or "GICs").

While the IRS agreed with these companies, in published and private rulings, that "interest paid" treatment was proper in such cases because the related liabilities were not "life insurance reserves,"[72] it also took the position that the liabilities might well be insurance reserves includible in the denominator of the qualification fraction. Thus, some companies were in danger of losing their tax status as life companies by reason of the issuance of these contracts. As a temporary response, in TEFRA §260(c) Congress prohibited the reclassification of companies for tax purposes solely on this basis.

Now, under new Code §816(f), amounts set aside and held as interest under contracts which do not contain permanent guarantees as to life (or A&H) contingencies are counted neither as life insurance reserves nor as total reserves in determining life company qualification. This provision thus resolves any qualification question in respect of guaranteed investment contracts based on the reserve ratio test. The Committee Reports note that, if a guaranteed investment contract contains insurance or annuity purchase rate guarantees for some duration (though not permanent guarantees), the premiums constitute income and the related funds are treated as reserves under new Code §807(c)(3) or (4).[73] On the other hand, with respect to liabilities for contracts that contain no purchase rate guarantees, the Reports observe:

> "The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction is not intended to have any effect on the characterization of the contracts or of the company issuing the contracts. Rather, whether a contract with less than a

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permanent guarantee should be considered an insurance or annuity contract would depend on the terms of the contract. That is, it will depend on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would give rise to an insurance liability."[74]

Thus, if a given guaranteed investment contract were determined not to be an insurance contract, a company primarily issuing such contracts might fail to qualify as an insurance company for tax purposes.

N. Section 817 — Variable Contracts

Former Code §801(g) (enacted in 1962 and amended in 1976) prescribed rules for a "separate accounting," for tax purposes, with respect to "contracts with reserves based on segregated asset accounts." Such contracts consisted of nonqualified variable annuities as well as former Code §805(d) pension plan contracts — those accounted for in state law separate accounts, under which the amounts paid in or paid out reflected the investment return and market value of the assets in the separate account. Variable life insurance contracts, which were first sold in the United States in the 1970's, were not addressed.

Among the special rules prescribed by former Code §801(g) were those governing the tax treatment of increases (or decreases) in reserves and of the disposition of assets with respect to separate account liabilities. As discussed earlier, a life insurance company generally may deduct any annual net increase in its reserves and must include in income any annual net decrease in those reserves. In the early 1960s, however, when variable annuities first were introduced to the insurance market, the investment company community expressed concern that the deferral inherent in the tax treatment of annuity holders, when coupled with the customary corporate-level deduction of reserve increases reflecting the appreciation in value of assets in variable annuity separate accounts, would afford variable annuity writers a competitive advantage in the financial marketplace. Reflecting this concern, former Code §801(g)(6) denied issuers of variable annuities any deduction for increases in required reserves reflecting appreciation in value of the separate account assets; at the same time, the 1959 Act subjected the issuer to tax on the asset gains giving rise to those reserves when the gains were realized. This treatment, in effect, placed a tax on the "inside build-up" with respect to the contracts involved.

On the other hand, since there could be no such perceived competitive advantage with regard to variable contracts funding qualified pension plans, old Code §801(g)(7) permitted issuers of variable annuities used in connection with such plans to adjust the basis of the separate account assets to reflect appreciation (or depreciation) of those assets. Thus, although issuers of such contracts did not benefit from the usually permitted deductions for increases in their reserves, they were not subject to capital gains tax on the appreciation giving rise to those increases.

As a general matter, new Code §817 carries forward the rules of former Code §801(g), with modifications appropriate to the abolition of the phase system. Thus, under new Code §817(a), neither appreciation nor depreciation in the separate account assets (whether or not realized) is counted in computing the company's deduction or income item resulting from a net increase or decrease in reserves, respectively. The new law does, however, make three significant changes in the variable contract rules.

First, variable life insurance contracts are accorded specific statutory recognition (as noted in the discussion of new Code §7702) and are made subject to the Code §817 rules. In this regard, the definition of "variable contract" in Code §817(d)(3)(B) incorporates both the "traditional" variable life policy ("the amount of the death benefit ... is adjusted") and its proposed "universal" version ("the amount of the death benefit (or the period of coverage) is adjusted"). The Committee Reports clarify that, for variable life insurance, the amount of the reserve adjustment under Code §817(a) is keyed to the appreciation or depreciation in the separate account assets and not to any greater change in the amount of the contractual death benefit.[75]

Second, under Code §817(b), the basis of each asset in a separate account is increased or decreased to reflect appreciation or depreciation of that asset. Accordingly, on disposition of the asset, the company will not be taxed on any realized appreciation (and cannot reduce its tax with respect to other capital gains by virtue of any realized depreciation). This is intended to eliminate the corporate-level capital gains tax that former Code §801(g) had imposed.

Third, new Code §817(h) requires "adequate diversification" of the investments made by a separate account underlying *nonqualified* variable contracts, as a prerequisite to those contracts being treated as variable life insurance or annuity contracts (as the case may be) for corporate and policyholder tax purposes. The requisites of "adequate diversification" are to be spelled out in regulations. In this regard, the second sentence of Code §817(h)(1) "looks through" a separate account organized as a unit investment trust to determine whether the diversification requirements have been satisfied, *i.e.*, the investments made by the underlying funding vehicle(s), not the shares or units held by the separate account, are tested for compliance with the diversification requirements. This "look-through" rule is binding on the Treasury, however, only if *all* shares or units of the underlying funds are owned by one or more separate accounts of insurance companies.[76] This provision, to the extent it limits "access" to the underlying funding vehicles to purchasers of variable contracts from insurance companies,[77] is consistent with Rev. Rul. 81-225, 1981-2 C.B. 12, which held that because the underlying funds were also publicly available, the variable contract there involved would be considered a "wrap-around" arrangement, and the policyholder, not the insurance company issuing the contract, would be treated as the owner of the funds for tax purposes.[78] The Conference Report indicates, however, that the public availability of a "similar" fund will not in itself cause an underlying fund to be treated as publicly available, thus laying to rest the "clone fund" controversy that arose in the wake of Rev. Rul. 81-225.

The regulations to be issued under new Code §817(h)(1) might reasonably be expected to carry forward the diversification standards currently being applied in

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private letter rulings issued by the IRS. Should these standards be changed in any respect, the Report of the Senate Finance Committee notes that:

"The committee anticipates that any regulations prescribing diversification standards changing current practice will have a prospective effective date." [79]

In light of this statement, it may be assumed that, in the case of a contract for which the IRS previously issued a letter ruling based on its diversification representations, the ruling might properly be relied on as indication of compliance with new Code §817(h) until such time as definitive regulations are promulgated. A judgment that such reliance is appropriate should, however, be made in light of the minimum diversification standards prescribed in the Conference Report itself:[80]

"In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment would be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (*e.g.*, stocks, bonds, or certificates of deposits of a single issuer); (2) that invest in one or a relatively small number of publicly available mutual funds; (3) that invest in one or a relatively small number of specific properties (whether real or personal); or (4) that invest in a nondiversified pool of mortgage type investments. This new diversification authority is not intended to allow the imposition of any requirement that the investment fund reflect a diverse range of investment goals (*e.g.*, short-term/long-term, or fixed income/equity securities need not be mixed in a single fund)."

New Code §817(h)(2) provides a "safe harbor," under which any fund is deemed to be adequately diversified so long as (1) its investments meet the requirements of Code §851(b)(4) (relating to "regulated investment companies"), and (2) not more than 55 percent of its total assets consists of cash, cash items, Government securities, and securities of "other regulated investment companies." The application of this rule may be somewhat narrow in scope. Further, new Code §817(h)(3) provides a general exception to the diversification requirements for funds underlying *variable life insurance* contracts (in the context of a unit investment trust arrangement) where the funds invest in securities issued by the United States Treasury. This special rule will permit a variable life policy to be based on a fund which invests solely in such securities if such fund is owned exclusively by the separate account of the company issuing the policy.

New Code §817(h)(4) clarifies that an insurance company may use an independent investment advisor with respect to the segregated assets underlying its variable contracts, thus settling a possible controversy arising under Rev. Rul. 81-225 in a manner consistent with the subsequent private letter ruling position of the IRS.

With respect to underlying funds which are not "adequately diversified" in accordance with new Code §817(h), the statute in effect codifies the result reached in Rev. Rul. 81-225 by specifying that a variable contract based on such a fund will not be treated as a life insurance or annuity contract for purposes of Subchapter L, and Code §§7702 and 72.

O. Section 818 of the Code, and §§217, 218, and 231 of the Act — Other Definitions, Special Rules, and Studies

New Code §818 collects a variety of definitional and other special rules pertaining to Part I of Subchapter L. Several of its provisions preserve rules of the 1959 Act: subsection (a) repeats (with minor modifications) the definition of "pension plan" contracts of former Code §805(d), and subsections (b) and (c) carry forward the rules of former Code §817 concerning the treatment of capital gains and losses. (In connection with the latter, the Committee Reports note that the regulations promulgated under former Code §817 with respect to assumption reinsurance transactions are expected to be carried over under the new law.) [81] The provisions of subsections (d) (relating to supplementary contracts) and (e) (relating to consolidated returns) were mentioned previously. Finally, for purposes of the Code §904 foreign tax credit limitation, new Code §818(f) provides that, under regulations, a company's deductions for policyholder dividends, reserve increases, and death benefits are to be treated as not allocable to one item or class of gross income.[82]

A number of other special and transitional rules (often affecting only one or a few companies) appear, outside of the Code, in Act §217. For example, under subsection (b), income with respect to an installment obligation under a pre-1984 Code §453B(e)(2) election is to be treated as noninsurance business income for purposes of new Code §806, and under subsection (f), rules are provided for companies that operate on an assessment basis. Finally, Act §217(i) provides a special election, solely for purposes of determining life company qualification, whereby a mutual life insurance company may treat all of its individual noncancellable (or guaranteed renewable) A&H insurance contracts as though they were cancellable. This provision was added for the benefit of a number of smaller mutual companies writing primarily this class of contract that had been taxed as Part I companies under the 1959 Act. By permitting them to be taxed under Part II of Subchapter L, it allows them to avoid the impact of new Code §809. Such election must be made on the company's return for its first taxable year beginning after December 31, 1983, and, if such an election is made, it will apply to all future years. Further, if the common parent of an affiliated group makes this election, any stock life company in the group will be treated as if it were a mutual life company, and the electing company's taxable income will be counted in computing the phase-out of any small life insurance company deduction available to other members of the same group.

To avoid imposition of an estimated tax penalty under Code §6655 due solely to a change in a company's tax liability resulting from the retroactive application of the new law, Act §218 provides a waiver of the penalty with respect to any underpayment of tax required to be paid prior to the enactment of the new law. The penalty is waived so long as the underpayment is paid in full prior to the date of the first installment prescribed under Code

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§6655 that occurs after July 18, 1984 (meaning September 15, 1984, in the case of calendar year taxpayers).

The final "miscellaneous" provision worthy of note is Act §231, which calls for certain studies and reports to be submitted regarding revenue, "segment balance," and other issues arising under the new law. First, reports on tax revenues collected from the life insurance industry are to be submitted by the Treasury Department to the House Ways and Means Committee and the Senate Finance Committee on July 1 each year, beginning in 1985. Second, detailed studies are to be prepared by the Treasury, in consultation with the Ways and Means Committee, the Finance Committee, and the Joint Committee on Taxation, concerning the operation of the new law during 1984-1986. The final report in this respect is due January 1, 1989, with interim reports scheduled for July 1 of 1986, 1987, and 1988. In preparing these reports, the Treasury is directed to give "specific attention to the revenue impact of allowing consolidated returns to be filed by life insurance companies with nonlife or noninsurance companies" and to collect information on the volume and use of policyholder loans.[83]

P. Section 845 — Reinsurance

The 1959 Act recognized the consequences of reinsurance transactions for tax purposes and, in certain instances, provided special rules governing them. Although some of those rules could best be described as accounting rules,[84] under former Code §818(g) (added by TEFRA on a temporary basis) the IRS was granted authority to reallocate and/or recharacterize income, deductions, assets, reserves, credits, and other items arising from a reinsurance agreement between related persons (as defined in Code §1239) if it determined that doing so was necessary to reflect the proper source and character of the taxable income of the parties. While the new law generally preserves this treatment, it significantly expands the rule of former Code §818(g). Thus, under new Code §845 — which applies to insurance companies taxed under Part I of Subchapter L as well as to nonlife companies taxed under Part II or Part III — the IRS is granted authority to reallocate, recharacterize, or otherwise adjust items arising under reinsurance agreements, whether or not they involve related parties. This sweeping grant of authority was at least partly a congressional response to continuing Treasury concern that reinsurance transactions could be employed by the parties, whether or not they were "related," to obtain tax benefits that the Treasury considered to be unwarranted. It arose in its ultimately expanded form during the Conference.

More specifically, new Code §845(a) preserves the former Code §818(g) related-party rule, though adding to its scope reinsurance transactions not involving life companies and transactions between unrelated parties if one party is "in effect" an agent of another party or a conduit between related parties. Further, the actions that the IRS may take to achieve a proper reflection of income are expanded to include "mak[ing] any other adjustment." In addition, whether parties are "related" for purposes of new Code §845(a) is determined under the more stringent rules of Code §482. As noted in the Report of the Senate Finance Committee:

> "[A]lthough one party may not have de facto control over the business of the other party (as required by sec. 482), it may have unilateral control over the profit levels for both parties with respect to specific lines of business covered by a reinsurance agreement, which can be used to distort the income of the parties. The bill also makes it clear that the reallocation and recharacterization authority can be used when one party to the reinsurance transaction acts as a conduit between related parties. The committee believes that whether a party is an agent of, or conduit between, other parties must be determined in light of all the facts and circumstances. An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured."[85]

Under Act §217(d)(1), new Code §845(a) applies to any "risk reinsured" on or after September 27, 1983.[86]

Next, new Code §845(b) grants the IRS broad authority to make "proper adjustments" any time it determines that *any* reinsurance contract (regardless of whether the parties are related in any sense) has a "significant tax avoidance effect." That provision, which Act §217(d)(2) applies to risks reinsured after December 31, 1984, was added in its entirety during the Conference. The Conference Report discussion of new Code §845[87] is quite detailed and should be reviewed carefully and at length by any taxpayer contemplating a future reinsurance transaction. In brief, that discussion makes mention of the following points:

> (a) The IRS may make adjustments under new Code §845 regardless of any party's motivation in entering into a reinsurance transaction, whether or not there is a legitimate business purpose for the transaction, and whether or not the IRS ultimately treats it as involving the transfer of insurance risk.
>
> (b) A "tax avoidance effect" — such as reduction of a mutual company's "equity", change in the character or source of an item, deferral of tax, elimination of the "SRLY taint" of a previous loss, extension of a loss carryover period, transfer of tax benefits between taxpayers in different brackets, etc. — is "significant" (triggering application of the new provision) when, as to either party, the tax benefit is "disproportionate" to the risk transferred, a determination to be made by the IRS based on the "economic substance" of a transaction and taking into account these factors (no one of which is to be conclusive):
>
> > (1) Duration age of the business reinsured ("coinsurance of new contracts may carry a risk of lapse . . .; thus, there may be a significant risk . . . [to] the reinsurer");
> >
> > (2) Character of the business reinsured ("coinsurance of yearly renewable term life insurance will generally not have significant tax avoidance effect");
> >
> > (3) Structure for determining potential profits, including provisions for experience rating;
> >
> > (4) Duration of the reinsurance agreement ("a longstanding agreement for automatic reinsurance . . . would tend to indicate that there is no signifi-

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cant tax avoidance effect", though there may be exceptions);

(5) The parties' rights to terminate the agreement and the consequences flowing therefrom ("a payback provision which allows a reinsurer to recover all its losses ... would indicate that the transaction is merely a financing arrangement");

(6) The parties' relative tax positions (with an eye to "bracket shifting," profit and loss companies, and life and nonlife companies); and

(7) The parties' financial situations generally (*e.g.*, an otherwise insolvent company may properly make use of surplus relief reinsurance).

(c) Until regulations are reissued under new Code §845, certain transactions will be considered to fall within a "safe harbor" — *e.g.*, reinsurance of yearly renewable term coverage that does not involve sharing of expenses or transfer of long term reserves, or coinsurance of new business (or, in some circumstances, existing business) where income and expenses are allocated proportionately to the risks transferred.

(d) Under new Code §845(b), the IRS may make adjustments to either or both of the unrelated parties to eliminate the tax avoidance effect, and such adjustments may include treatment of an agreement as terminated at each year-end and reinstated the following day.

(e) All transactions that permit the IRS to make adjustments under new Code §845(b), but for the fact that related parties are involved (or an agency or conduit situation exists), are subject to the authority granted under new Code §845.

III. Policyholder Tax Provisions

A. Definition of "Life Insurance Contract"

1. Background

Since 1913, death benefits received under life insurance contracts have been excluded from gross income, and the IRS has consistently treated increments to the cash value of such contracts as not includible in income until the maturity or surrender of the contract while the insured is alive. Before TEFRA, the definition of "life insurance contract" for tax purposes was at best rudimentary. Judicial interpretations of the term turned on whether a given contractual arrangement involved any element of risk shifting and risk distribution, principally in connection with efforts to distinguish between life insurance policies and annuity contracts.[88]

With the 1970's and early 1980's, the life insurance industry began to develop a number of new products that incorporated features designed to make life insurance more flexible and attractive to consumers. By 1981, the IRS had addressed the tax treatment of a number of these products. For example, in Rev. Rul. 79-87, 1979-1 C.B. 73, the IRS held that variable life insurance policies would be treated for tax purposes in the same manner as other cash value life insurance contracts. Further, a "universal" life insurance policy was accorded the same tax treatment as other cash value life insurance policies by private rulings issued in January and February, 1981,[89] and in a private ruling issued in May, 1981,[90] an "interest-sensitive" whole life insurance policy was similarly treated.

By the spring of 1981, the IRS began to encounter substantial criticism over its ruling position on universal life insurance. This criticism was premised in part on tax policy considerations, particularly the prospect that the net amount at risk could be quite small in relation to the cash value under a universal life insurance policy even at early policy durations. In response, the IRS undertook a year-long reconsideration of its ruling position, culminating in General Counsel's Memorandum 38934 in the summer of 1982. In that Memorandum, the Chief Counsel recommended that a typical universal life policy be viewed for tax purposes as a combination of term insurance and a savings arrangement.

Partly in reaction to this situation and partly to obtain a degree of certainty on the point, the life insurance industry supported the enactment of Code §101(f) as part of the "stopgap" legislation in TEFRA. That subsection provided for the first time, a statutory definition of "life insurance contract" for federal income tax purposes, albeit on a temporary basis (expiring after 1983) and applicable only to a limited class of policies (those with "flexible premiums"). Among other things, Code §101(f) confirmed that the universal life policy was eligible to be treated as an integrated contract of life insurance for tax purposes. It also addressed the concerns associated with the sufficiency of the risk element in such policies by imposing maximum premium and minimum risk limitations, designed to require the presence of at least a minimum risk amount and thereby foreclose the availability of life insurance tax treatment to policies used primarily for investment purposes.[91] The provision was expressly made temporary and limited in scope because prompt action was needed with respect to the universal life policy, while a more far-reaching effort was anticipated in a succeeding Congress.

As it happened, Code §101(f) established the conceptual basis for what became, pursuant to Act §221, a definitional provision applicable to all forms of life insurance — new Code §7702. As the Report of the House Ways and Means Committee observed:

> "In light of the significant tax advantages associated with life insurance products, the committee undertook a review of those products and their treatment. ... [I]n recent years, companies have begun emphasizing investment oriented products that maximize the advantages of the deferral provided in the Code. When compared to traditional products, these products offer greater initial investments or higher investment returns or both. In response the committee adopted a definition of life insurance that treats as currently taxable investments, those life insurance policies that provide for much larger investments or buildups of cash value than traditional products." [92]

2. New Section 7702 in Detail

a. The Scope of the New Definition

New Code §7702 begins by stating that, for all purposes of the Code, a "life insurance contract" is any

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contract which is a life insurance contract under applicable state law and which meets the mathematical tests of either paragraph (1) or paragraph (2).[93] For this purpose, a contract:

> "Does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Thus, an insurance arrangement written as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a life insurance contract for purposes of the guidelines because all of the elements of the contract are not treated under state law as providing a single integrated death benefit. As a result, only the term portion of any such contract can meet the tests and be treated as life insurance proceeds upon the insured's death. However, any life insurance contract that is treated under state law as a single, integrated life insurance contract and that satisfies these guidelines will be treated for federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits." [94]

b. Satisfying the "Cash Value Accumulation Test"

The first of the two alternative tests, denominated the "cash value accumulation test" of Code §7702(a)(1) and (b), is directed primarily to "traditional" policies which have cash values that accumulate in a predictable fashion in relation to the death benefit provided.[95] To meet this test, the "cash surrender value" of a contract, *by the contract's own terms,* must not at any time be capable of exceeding the "net single premium" at that time with respect to the "future benefits" under the contract (including any additional coverage purchased by means of dividends or excess interest credits). For this purpose "cash surrender value" is defined in Code §7702(f)(2)(A) as the cash value of the contract determined without regard to any surrender charge, policy loan, or "reasonable" termination dividend.[96] Further, as specified in Code §7702(b), the "net single premium" is to be computed using an interest assumption — the greater of an annual effective rate of 4 percent or the rate or rates "guaranteed" on issuance of the contract — and the mortality charges specified in the contract (if such charges are not explicitly stated, then the mortality charges implicit in the annual statement reserve for the contract are to be used). Significantly in this regard, the Report of the Senate Finance Committee states that the "rate or rates guaranteed on the issuance of the contract" means the rate or rates reflected in the contract's nonforfeiture values assuming use of the method in the Standard Nonforfeiture Law.[97] Finally, the term "future benefits" is defined in Code §7702(f)(4) to mean death benefits and endowment benefits; under this test, these are the actual benefits guaranteed from year to year. Any "additional" benefits are not taken into account as future benefits, but, as discussed further below, the separately specified *charges* for "qualified additional benefits" are treated as future benefits in computing the net single premium (and the guideline premiums, as described next).

c. Satisfying the "Guideline Premium" and "Cash Value Corridor" Requirements

As an alternative to the cash value accumulation test, a contract may qualify under the two-part test of Code §7702(a)(2), (c), and (d). Both elements of this test must be met. The "guideline premium limitation" of this test is intended to distinguish contracts under which the policyholder makes traditional levels of premium payments (*i.e.*, within the "guidelines"), as in the case of a whole life policy, from those under which larger investments are made by the policyholder for savings purposes.[98] The "cash value corridor" aspect of the test regulates the minimum relationship between the cash value and the death benefit, regardless of the effect of the guideline premium limit. This two-part test, which is expected to be used primarily in connection with flexible premium policies, applies only if the cash value accumulation test is not met.

A contract will satisfy the requirements of the guideline premium limitation if, in fact (rather than by the terms of the contract), the sum of the "premiums paid" under the contract does not at any time exceed the greater of the "guideline single premium" or the sum of the "guideline level premiums" at that time. For this purpose, the sum of the "premiums paid" is defined in Code §7702(f)(1) as the total of the actual premium payments less (1) distributions (such as dividends) to which Code §72(e) applies, (2) any amounts (such as overpayments) returned "with interest" within 60 days of the end of the policy year in order to comply with the guideline premium limit (interest on such returned amounts is currently includible in the recipient's gross income), and (3) any other amount specified in regulations.[99] The "guideline single premium" is defined in Code §7702(c)(3) as the premium at issue for the future benefits at issue (subject to "adjustments") under the contract, computed on the basis of (1) the mortality charges specified in the contract (or, if none is specified, those used in determining the annual statement reserve for the contract), (2) other charges specified in the contract,[100] and (3) an interest rate which is the greater of an annual effective rate of 6 percent or the minimum rate or rates guaranteed on issuance of the contract. The "guideline level premium" under Code §7702(c)(4) is the annual premium version of the guideline single premium, computed assuming a premium payment period extending at least to age 95 and substituting "4 percent" for "6 percent" as the minimum interest assumption.

The "cash value corridor" requirement of Code §7702(d) will be satisfied if the death benefit under the contract at any time in fact at least equals the then "applicable percentage" of the contract's cash surrender value. This figure is 250 percent until the insured attains age 40, and then declines through nine age brackets, as follows:

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If the insured's age at the beginning of the policy year is:		Then the applicable percentage decreases ratably for each full year:	
More than	But not more than	From	To
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

d. Computation of "Future Benefits"

The so-called "computational rules," the purpose of which is to provide assumptions and preclude manipulation in the calculations under the tests, appear in Code §7702(e). Subsection (e)(1) requires that in making the determinations under the statute, first, the amount of the death benefit (and any qualified additional benefits) is deemed not to increase (*i.e.*, the premium computations are made assuming level benefits in the future). Second, the contract's maturity date (including the date on which any endowment benefit is paid) is to occur no earlier than when the insured attains age 95 and no later than age 100.[101] Third, any endowment benefit (or sum of endowment benefits, including the cash surrender value as of the maturity date) is deemed not to exceed the least amount payable as a death benefit at any time under the contract. Code §7702(b)(2)(C) specifically provides that, in applying the first and third of these rules under the cash value accumulation test, the "no increase" assumptions control the net single premium computation at each duration based only on the then level of benefits, without regard to any lower past benefits; this is not the case under the guideline premium test, absent an "adjustment" (as described below).[102]

As a result of these rules, a contract's cash value at its maturity date, as developed from the net single premium or the guideline premiums on the required interest, mortality, and (under the guideline premium test) expense assumptions, cannot exceed the level (or decreased) amount of the death benefit permitted to be assumed under the first computational rule — with any excess interest or dividends adding a greater maturity amount. Arrangements with a greater degree of "investment orientation" are generally not permitted, meaning that (among others) the single premium policy with a guaranteed increasing face amount, the endowment-at-age-65, and the retirement income endowment contract will no longer be classified as "life insurance contracts" for tax purposes.

Code §7702(e)(2) provides an alternative to the first computational rule permitting the funding of a death benefit equal to the cash surrender value at death plus a level amount of pure insurance protection (the so-called return-of-cash-value or "option 2" death benefit). Under this alternative, for purposes of computing the guideline level premium (but not the guideline single premium), an increasing death benefit may be recognized to the extent necessary to prevent a decrease in this level pure insurance amount. A comparable provision applies under the cash value accumulation test, where the "net level reserve" for this increasing death benefit is substituted for the net single premium.

e. Adjustments

A change in the terms of a contract may permit or necessitate an adjustment of the guideline premiums or the net single premium previously computed for a contract. Under Code §7702(f)(7)(A), such computations are to be prescribed in regulations. According to the Report of the Senate Finance Committee, the guideline premiums may be adjusted only when a policyholder initiates a change in benefits or when a scheduled change occurs that the guideline premiums could not previously reflect because of the computational rules. Such adjustments are based on the benefit changes when they occur and are added to the prior guideline premiums. The net single premium, on the other hand, is to be adjusted whenever any change in benefits occurs, and it is entirely recomputed at the insured's then attained age.[103]

Pursuant to Code §7702(b)(7)(B), any change in the terms of a contract which results in a reduction of the future benefits under the contract is to be treated as an exchange for purposes of Code §1035. The purpose of this significant new rule is to tax the policyholder in such an instance to the extent of any cash received (or to the extent of the gain in the contract, if less) in accordance with the "boot" rules of Code §1031(b). Hence, if a partial surrender is made, the cash distributed with it may be taxable.[104]

f. Additional Benefits

Under Code §7702(f)(5), the charges for "qualified additional benefits" are taken into account in determining the guideline premiums or net single premium. These benefits are defined as: (1) guaranteed insurability benefits, (2) accidental death or disability benefits, (3) "family" term coverage, (4) disability waiver benefits, and (5) any other benefits prescribed by regulation. According to the Committee Reports, the guideline level premiums may be computed so as to reflect the actual period that any qualified additional benefits are in effect, producing "bi-level" premiums but avoiding post-funding.[105] Additional benefits which do not meet the definition of qualified additional benefits and which are not "prefunded" (*i.e.*, cannot be funded by withdrawals or subtractions from the contract's cash value) are disregarded in computing premiums and future benefits under Code §7702.[106]

g. Variable Contracts

Under Code §7702(f)(9), in the case of a variable life insurance contract as defined in new Code §817, the determinations under Code §7702(a) are not made "at any time" but, rather, only when the death benefit changes. Nevertheless, these determinations must occur at least once a year (and, if they are made only once a year, they must be made at the same time each year). Further, since a variable life contract typically contains no interest rate guarantee with respect to nonforfeiture values, the rate to be used for purposes of Code §7702(b) and (c) is the minimum 4 percent rate (6 percent for the guideline single premium).[107]

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h. Contracts Which Fail to Meet the Definition

If a contract fails to satisfy one of the alternative tests due to reasonable error, the IRS is authorized under Code §7702(f)(8) to waive the failure if it is shown that satisfactory steps are being taken to remedy the error. If, despite this, a contract still fails the tests, then under Code §7702(g), only the difference between the net surrender value and the face amount of the contract will be subject to the death benefit exclusion of Code §101(a). For such a "failed" contract, the "income on the contract" will be treated as ordinary income received or accrued by the policyholder during the taxable year. The term "income on the contract" is defined as the amount by which the increase in the "net surrender value" of the contract (*i.e.*, its cash value less any surrender charge) during the taxable year, together with the cost of life insurance protection provided during the year, exceeds the amount of premiums paid (less any policyholder dividends received during the taxable year). If the cost of insurance is not identified in the contract, then it is to be determined for this purpose under regulations. Income on the contract for all prior years will be treated as received by the policyholder in the year a contract fails to meet the definition. According to the Committee Reports, income treated as received under a failed contract will be subject to the withholding and recordkeeping requirements applicable to commercial annuities. Finally, a contract that fails to meet the definition will nevertheless be treated as an "insurance contract" for company tax purposes, thus ensuring that the premium payments will continue to be included in the issuing company's taxable income and that the company will, at a minimum, continue to qualify as an insurance company for purposes of Subchapter L.

i. Regulations

As under Code §101(f), Code §7702(i) provides authority for the issurance of such legislative regulations "as may be necessary or appropriate to carry out the purpose" of the new statute.

3. Effective Date and Transitional Rules

Generally, under Act §221(d), the provisions of Code §7702 apply to contracts issued after December 31, 1984. According to the Report of the Senate Finance Committee, a new contract issued after that date in exchange for a pre-1985 contract will be considered as newly issued for this purpose, as will a post-1984 change made in a pre-1985 contract that affects the values of the contract.[108] With respect to group insurance, the date taken into account is the first date on which a participant is covered under the contract. Because Code §7702 generally does not take effect until 1985, temporary Code §101(f) is extended to apply to "flexible premium" contracts sold before January 1, 1985.

Several special rules that vary the general effective date should be noted. First, under Code §7702(i), contracts which require at least 20 "non-decreasing" annual premiums, and are sold pursuant to a plan of insurance filed with at least one state insurance commissioner before September 28, 1983, will be deemed to meet the requirements of Code §7702 in 1985 and years thereafter if they can meet the cash value accumulation test by substituting "3 percent" for "4 percent" as the minimum interest rate. (According to the Committee Reports, the purchase of paid-up additions will not violate the 20-pay requirement so long as the additions are "modest and reasonable as compared with the basic benefit provided under the contract.") Second, a special advance effective date, under Act §221(d)(2), applies Code §7702 to contracts issued after June 30, 1984, that provide increasing death benefits and which have "premium funding more rapid than 10-year level premium payments." This provision does not apply to (1) contracts which satisfy the provisions of Code §101(f) (whether or not they are flexible premium contracts), (2) contracts which would satisfy Code §7702 by substituting certain alternative interest or maturity date assumptions, and (3) so-called "irreplaceable life" policies.[109]

B. Distributions from Annuity Contracts

In TEFRA, Congress made a number of changes in the tax treatment of annuity contracts to limit the perceived attractiveness of such products as short-term investment vehicles. First, changes were made in the rules of Code §72(e) to provide that amounts received under an annuity contract before the "annuity starting date" would first be viewed as withdrawals of income credited to the contract to the extent of such investment income (a "LIFO" rule). Also, any loan against the cash value of an annuity contract, or an assignment or pledge of such a contract, was to be treated as an amount "not received as an annuity" and thus subject to the LIFO rule governing withdrawals. These provisions applied with respect to contracts entered into, and amounts allocable to investments made, after August 13, 1982. The pre-TEFRA rules continued to apply to withdrawals of any earnings on investments from contributions made before August 14, 1982, and to contracts purchased in connection with qualified plans.

Second, Congress added Code §72(q), which imposed a penalty tax on certain "premature" distributions from an annuity contract. The penalty, which was effective for distributions after December 31, 1982, is equal to five percent of the amount includible in income, to the extent such amounts are allocable to an investment made within 10 years before the receipt of the distribution (the so-called "10 year look-back rule"). This penalty does not apply, however, to a distribution that is (1) made after the policyholder reaches age 59½; (2) made to a beneficiary on or after the death of the annuitant; (3) attributable to the policyholder becoming disabled; (4) one of a series of substantially equal periodic payments for life or at least five years; (5) from a qualified pension plan; or (6) allocable to an investment before August 14, 1982. The Conference Report accompanying TEFRA provided that annuity policies received in a tax-free exchange under Code §1035 would retain the character of the contract given up in the exchange for purposes of applying the new penalty tax and LIFO provisions.[110]

Act §222 amends Code §72(q) to eliminate the 10 year look-back rule. Thus, the five percent penalty tax will now be applicable to the amount of any "premature" distribution that is includible in income, whether or not the amount is allocable to an investment made during the preceding 10 years. The other exceptions to the application of the penalty tax fashioned in TEFRA, however, will continue to apply. For example, distributions made after the policyholder attains age 59½, or made in a series of substantially equal

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periodic payments for life or at least five years, will not be subject to the five percent penalty tax. The new law also makes a "technical" modification to Code §72(q): for purposes of applying the 10 year look-back rule, an investment in a multiple premium annuity contract (entered into before January 19, 1985) will be deemed to have been received on January 1 of the year of the investment.

Further, Act §222 adds new Code §72(s) which provides that, for an annuity contract to be treated as such under the Code, it must contain language specifying certain methods of distribution in the event of the contract-holder's death.[111] Under this new rule, the contract must provide that, if the contract-holder dies before the annuity starting date, the entire interest will be distributed within five years after the date of death of the contract-holder, or will be annuitized within one year after the date of death over a period equal to the life of the designated beneficiary (or over a period not exceeding the life expectancy of such beneficiary). In the event that the contract-holder dies after the annuity starting date but before the entire interest in the contract has been distributed, the contract must provide that the remaining portion of such interest will be distributed at least as rapidly as the distribution method in effect as of the time of the contract-holder's death. The new distribution requirements of Code §72(s) do not apply, however, in the case of a spousal beneficiary who, in effect, steps into the shoes of the deceased contract-holder.

Code §72(q), as amended, and Code §72(s) apply with respect to an annuity contract issued after the day which is six months after the date of enactment of the new law (*i.e.*, a contract issued after January 18, 1985).[112] In contrast to TEFRA, the new law generally does not permit an annuity contract received in a tax-free exchange under Code §1035 to retain the character of the contract given up in the exchange for purposes of applying the new rules. As noted in the Conference Report:

> "The new provisions will be effective for contracts issued more than 6 months after enactment. For these purposes, an annuity contract issued in exchange for another will be considered a new contract subject to the new penalty and distribution at-death rules. The grandfather provisions granted in TEFRA for amounts invested in or credited to investments in annuity contracts prior to August 13, 1982, continue in effect for purposes of applying the distribution of income-first rules applicable to annuity contracts." [113]

C. *Group-Term Life Insurance*

Code §79(a), as originally enacted in 1964, generally permits an employer to purchase up to $50,000 of group-term life insurance for an employee without causing the cost of such coverage to be included in the employee's gross income. The cost of any greater amount of coverage is imputed to the employee under the so-called "Table I" rates as set forth in Regs. §1.79-3(d)(2). Even this inclusion, however, has not been applied to employees who have terminated due to retirement or disability. Hence, an employer could provide an unlimited amount of group-term life insurance to these terminated employees without causing the imputation of income under Code §79. Under Code §79(d) (as added by TEFRA), in the event that a group-term life insurance plan is discriminatory in favor of active key employees, the exclusion for the cost of the first $50,000 of group-term coverage is not available to such key employees.

Act §223 further amends Code §79 to extend the Code §79(a) $50,000 limitation to retired employees.[114] In addition, correcting apparent technical shortcomings in the nondiscrimination rule added by TEFRA, the Act applies that rule to retired employees as well as active employees and, in the case of a discriminatory plan, denies use of the favorable Table I rates as the measure of the income to be included for tax purposes. Further, a conforming amendment is made to Code §83(e) to clarify that the cost of group-term life insurance will be included in the income of a retired employee for the year in which the insurance coverage is provided, whether or not the benefit vests upon retirement.

In general, these amendments apply to all taxable years beginning after December 31, 1983. The new rules are not applicable, however, to individuals covered by a plan in existence on January 1, 1984 (or by any comparable successor plan) who have attained age 55 on or before January 1, 1984, and who were either employed during 1983 by the employer having the plan or who retired from employment with such employer on or before January 1, 1984. On the other hand, in the case of an existing group-term plan which is discriminatory (as defined in Code §79(d)) after December 31, 1986, the amendments will apply to any individual retiring after that date, irrespective of the fact that such individual was "grandfathered" under the above-described rule.

D. *Exchanges Under Section 1035*

Prior to the 1984 Act, Code §1035 provided that no gain or loss would be recognized on the exchange of a life insurance contract, endowment contract, or annuity contract for a similar contract. For purposes of this rule, however, the contracts subject to the rule were defined as being contracts issued by a *life insurance company* taxed under Part I of Subchapter L. Act §224 alters this definition to include under Code §1035 any contract issued by *an insurance company* taxed under Subchapter L of the Code.[115] The provision is retroactively effective, as if it had been included in the Code when originally enacted in 1954.

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* The authors wish to express their appreciation for the contributions made by Theodore S. Sims, Associate Professor of Law at George Washington University, and Barbara J. Groves, an associate at Sutherland, Asbill & Brennan, in the preparation of this chapter.

[1] The "stopgap" provisions were reviewed in detail in Chapter 52 of Tax Management Portfolio No. 982: *TEFRA*.

[2] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1396-1399 (1984); S. Rep. No. 169, 98th Cong., 2d Sess. 520-523 (1984).

[3] Act §215.

[4] H.R. Rep. No. 432, *supra*, at 1401; S. Rep. No. 169, *supra*, at 524.

[5] The three-phase system, including computation of a company's "taxable investment income," could be regarded as simply providing a mechanism for determining how much of a company's gain from operations would be taxed currently, and how much of it would be deferred. From this standpoint, a life insurance company (generally a mutual company) was said to be "in phase I" if its total income or gain from operations

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before the limited deductions for policyholder dividends and "special" items exceeded its taxable investment income but, because of the limit on such deductions, its taxable gain from operations could not be reduced much below that taxable investment income figure. In contrast, a company (generally a stock company) was said to be "in phase II positive" if its gain from operations, even after claiming full deductions for the otherwise limited items, still exceeded its taxable investment income. (As noted, tax on one-half of the excess was deferred.) On the other hand, a company (again, generally a stock company) whose taxable investment income exceeded its gain from operations *before* claiming the limited deductions was said to be "in phase II negative." Such a company clearly was taxed on its "total income."

[6] The Committee Reports specifically note that certain language changes in new Code §803 are not to be construed as having any substantive impact. For example, S. Rep. No. 169, *supra*, states at 529:

> "The use of the term 'indemnity reinsurance' in the bill, instead of 'reinsurance ceded' under present law, is not intended to be a substantive change from present law. Likewise, the reference to 'insurance and annuity contract' rather than to 'insurance and annuity contracts (including contracts supplementary thereto)' is not a substantive change from present law. A general provision, applicable to the life insurance company part of the Code only, states that any reference to insurance and annuity contracts includes any contracts supplementary thereto (new sec. 818(d))."

[7] Although the former Code §809(d)(1) reference to "supplementary contracts" has been deleted, new Code §818(d) provides that all references to "insurance and annuity contracts" automatically include any "contracts supplementary thereto."

[8] This controversy, and its temporary resolution in TEFRA, was described in Chapter 52 of T.M. Portfolio No. 982.

[9] Under new Code §805(a)(4)(B), the Code §246(b) limitation is computed in a manner similar to that under former Code §809(d)(8)(B), which limited the aggregate dividends received deduction to 85 percent of the company's "gain from operations," as modified. In turn, the new law limits that aggregate deduction to 85 percent of "LICTI," computed without regard to the special life insurance company deduction, the small life insurance company deduction, the operations loss deduction, any capital loss carryback, and the dividends received deductions. As under the 1959 Act, no limit applies in a loss year.

[10] *See, e.g.*, H.R. Rep. No. 432, *supra*, at 1407.

[11] This restriction was adopted to provide parity of tax treatment between companies operating noninsurance businesses through subsidiaries and those operating such businesses through branches.

[12] H.R. Rep. No. 432, *supra*, 1408; *see also* S. Rep. No. 169, *supra*, at 531.

[13] *See* S. Rep. No. 169, *supra*, at 531-532. As the Conference Report on the new law further explained (Rep. No. 861, 98th Cong., 2d Sess. 1046-1047 (1984)):

> "[T]he conferees believe that the distinction drawn between passive investment activities and an active conduct of a trade or business will be more administrable and provide more guidance and certainty for the industry as it further refines the 'traditional investment' standard . . ."

[14] Note that the characterization of an activity as an insurance or a noninsurance business applies solely for purposes of computing the special and small life insurance company deductions. *See* Rep. No. 861, *supra*, at 1047-1048.

[15] Consider, for example, the conflicting interests facing both insurers and the IRS depending on whether a particular noninsurance business is experiencing income or is incurring a loss (subject to the restriction of new Code §806(c)(3)(C)).

[16] Alabama, Arkansas, Oklahoma, and Texas.

[17] As provided in new Code §818(e), a special rule applies to corporations joining in the filing of a consolidated federal income tax return. Under this rule, no items of income or loss of nonlife members of the affiliated group joining in the return are taken into account for purposes of computing tentative LICTI.

[18] To address the situation of a life company member of an affiliated group that cannot join in the filing of a consolidated return but that has a loss, thereby (effectively) causing the reduction of the group's overall tentative LICTI twice by virtue of the same loss, under new Code §806(d)(5) regulations are to be issued to "eliminate any excessive detriment or benefit (from year to year) arising from the operation of the controlled group tentative LICTI computation . . ." S. Rep. No. 169, *supra*, at 532. In the alternative, under new Code §806(d)(4), a life insurance company member of a controlled group which does not file a consolidated return may elect to have its loss from operations in any year not taken into account for purposes of determining the group special life insurance company deduction. If such an election is made, the electing company is restricted in its use of that loss from operations. As noted in S. Rep. No. 169, *supra*, at 532-533:

> "Where this election is made, a limitation is imposed on the ability to utilize losses of the electing loss company against nonlife company income. This limit is equal to 80 percent of the life company losses that, but for the election, would have reduced the controlled group's tentative income. Life company losses subject to the 80 percent limitation will be considered to be used in full when applied against nonlife company income; that is, there will be no carryover of the remaining 20 percent of life company loss."

[19] H.R. Rep. No. 432, *supra*, at 1410; S. Rep. No. 169, *supra*, at 535.

[20] "Assets" include all assets of the company, both admitted and nonadmitted. For purposes of this rule, assets are valued at their adjusted bases, except that real property and stock are taken at their fair market value. In the case of an interest in a partnership or trust, the interest itself is not treated as an asset; however, the life insurance company is treated as owning its share of the underlying assets held by the partnership or trust. *See* new Code §806(b)(3).

[21] New Code §817, discussed *infra*, provides special rules in this regard for variable contracts.

[22] H.R. Rep. No. 432, *supra*, at 1413; *see also* S. Rep. No. 169, *supra*, at 539.

[23] *See, e.g.*, H.R. Rep. No. 432, *supra*, at 1403, n. 7, 1413 and 1414.

[24] *See, e.g., id.* at 1414.

[25] This figure is cross-referenced from new Code §807(d)(1) to new Code §809(b)(4)(B). There is no instruction to reduce this figure by the amount of any deficiency reserves.

[26] H. R. Rep. No. 432, *supra*, at 1414; S. Rep. No. 169, *supra*, at 540.

[27] *Id.*

[28] An exception is made in this respect by Act §217(n), which permits a company to use the net level method for noncancellable A&H contracts for which it has held net level annual statement reserves since the end of 1982. *See* Rep. No. 861, *supra*, at 1052 (which refers to year-end "1983").

[29] The issue date of a contract is the date appearing on the policy form. In the case of reinsurance, the issue date is taken as that of the reinsured policy, not of the reinsurance contract. *See* H. R. Rep. No. 432, *supra*, at 1415; S. Rep. No. 169, *supra*, at 540-541. Group contracts are treated as issued on the date the master plan is issued; however, if a benefit is guaranteed to a participant after that date, the issue date with respect to that benefit is the date the benefit is guaranteed. *See* new Code §807(e)(2).

[30] S. Rep. No. 169, *supra*, at 541; Rep. No. 861, *supra*, at 1052.

[31] The effect of any State nonforfeiture laws on interest rates for reserves is to be ignored.

[32] H.R. Rep. No. 432, *supra*, at 1416; *see also* S. Rep. No. 169, *supra*, at 542. The Report of the House Ways and Means Committee specifically identifies "credit life insurance" as a type of insurance for which an adjustment to the standard table would be appropriate. *See* H.R. Rep. No. 432, *supra*, at 1415, n.15.

[33] For pre-1948 contracts for which there were no standard tables when those contracts were issued, the tables used to compute annual statement reserves may be used. *See* new Code §807(d)(5)(C).

[34] H.R. Rep. No. 432, *supra*, at 1429.

[35] Again, this discussion is relevant only to items that qualify as "life insurance reserves."

[36] The Committee Reports note that a "guaranteed insurability" benefit is intended to include a "guaranteed annuability" benefit.

[37] In line with the "de minimis" rationale, the Committee Reports note that a disability income provision, other than one that provides for income payments to carry the premium or some other incidental expense of the insured, is not intended to fall within the enumerated supplemental benefits. *See, e.g.*, H.R. Rep. No. 432, *supra*, at 1417, n.17.

[38] Hence, this provision is not intended to apply with respect to benefits eligible to be provided under a policy employing an "account value" computation, since the funding for such benefits would presumably already be reflected in the net surrender value of such policy. The Committee Reports note, however, that use of a loan provision to pay premiums or charges for supplemental benefits is not to be construed as violating this requirement. *See, e.g.*, H.R. Rep. No. 432, *supra*, at 1418.

[39] The Report of the House Ways and Means Committee notes in this regard that:

> "For example, the committee expects that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not

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actually used on a regular and automatic basis would not result in disqualification of the substandard risks."
H.R. Rep. No. 432, *supra*, at 1418.

[40] In limited circumstances, "tax" reserves with respect to certain contracts covering foreign risks issued by a noncontiguous foreign country branch of a domestic life insurance company may be at least equal to the reserves required by the foreign country. *See* new Code §807(e)(4).

[41] In the case of a group contract (the issue date of which is taken to be that defined in Code §807(e)(2)) for which the issue date is unknown, the date is to be approximated in accordance with regulations. The Conference Report indicates that such regulations are to approximate the issue date based on the pattern of business growth. *See* Rep. No. 861, *supra*, at 1053.

[42] Furthermore, the new law, in essence, forgives for taxable years beginning after 1983 the balance of any former Code §810(d) income adjustment attributable to a pre-1984 taxable year reserve weakening. *See* Act §216(b)(2)(A). With respect to any pre-1984 taxable year reserve strengthening, which under former Code §810(d) would have resulted in a deduction spread ratably over 10 years, the new law permits the company to continue taking the spread deductions *to the extent* the total post-1983 deductions do not exceed the fresh start adjustment attributable to the contracts with respect to which the reserve strengthening occurred. However, to the extent the spread deduction is disallowed by this rule, any directly related premium is excluded from the company's income. *See* Act §216(b)(2)(B) and (C).

[43] Via a "technical and conforming" amendment to Code §832(b), the new law reserve computation rules are applicable to nonlife insurance companies. Likewise, the "fresh start" rules apply to those companies.

[44] For this purpose, the "reserve strengthening" rule is defined (inferentially) to include the establishment of reserves on a stronger basis for year-end 1983 than was used for comparable contracts for year-end 1982.

[45] This "cut-off" with respect to former Code §818(c) elections does not apply if more than 95 percent of the reserves that would be revalued in accordance with such an election is attributable to risks under contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983 — an exception designed to allow newly-organized companies to secure the advantage of such an election.

[46] S. Rep. No. 169, *supra*, at 567.

[47] H.R. Rep. No. 432, *supra*, at 1421.

[48] The Conference Report points out that the reference to voluntary reserves "is not limited to reserves for potential or unaccrued liabilities relating to insurance contracts." The Report specifically notes that a reserve "for Federal taxes may be in whole or in part a voluntary reserve," and contemplates the provision of additional guidance through regulations. *See* Rep. No. 861, *supra*, at 1058.

[49] It is interesting to note that new Code §809(b)(6), on its face, is limited to dividends "payable in *the following* taxable year." (Emphasis added.) It is possible that a company might establish a reserve for dividends payable 13 months after the close of the taxable year, which might be interpreted to fall outside the ambit of this provision. Such a result apparently was not intended, since the thrust of Code §809(b)(6) was to limit the exclusion from mutual company "equity" of 50 percent of the reserve for policyholder dividends only with respect to those to be paid during the following year.

[50] The Conference Report indicates that, in compiling the list of the 50 largest stock life insurers, the Secretary of the Treasury will have authority to exclude companies which are "aberrational." *See* Rep. No. 861, *supra*, at 1058. In computing stock earnings rates, as well as in determining the "average mutual earnings rate," Code §809(h)(1) requires that any stock life insurance company 80 percent or more owned by one or more mutual life insurance companies be classified as a mutual rather than as a stock life insurance company.

[51] Thus, each company's actual equity base for a taxable year, as computed under Code §809(b), is used in both the initial computation and the recomputation.

[52] For these purposes, new Code §809(h)(1), consistently with other provisions of the Code, defines "control" as ownership of 80 percent or more of both the "total combined voting power" and "total value" of the shares of another company.

[53] 433 U.S. 148 (1977).

[54] H.R. Rep. No. 432, *supra*, at 1428.

[55] *See, e.g., id.* at 1429.

[56] This would include investments in municipal bonds, the interest on which is tax-exempt under Code §103, and corporate equity investments giving rise to dividends as to which the company is entitled to an 85 or 100 percent intercorporate dividends received deduction under Code §§243-246.

[57] Thus, the common disputes under the 1959 Act about what expenses were deductible in computing net investment income will not arise under the new law. "Gross investment income" is defined exactly as it was under former Code §804(b), and includes tax-exempt interest. *See* new Code §812(d). (However, *see* the discussion of 100 percent dividends, below.) Note that the definition of a "noninsurance" business for purposes of the special and small life insurance company deductions *does not* apply for purposes of determining "gross investment income." Instead, the same interpretation as that applicable under the 1959 Act should apply.

[58] The addition of excess interest to the numerator of the fraction may be viewed as an extension of the treatment of "qualified guaranteed interest" under the 1959 Act (as amended by TEFRA).

[59] Hence, the inclusion of "interest paid" with respect to such liabilities under former Code §804 (though not non-policyholder indebtedness) is carried forward into the new law.

[60] S. Rep. No. 169, *supra*, at 558-559.

[61] S. Rep. No. 169, *supra*, at 529-530.

[62] Rep. No. 861, *supra*, at 1045. The Senate version of the new law included an exception to the "tracing" rule, that would have permitted 100 percent dividends from insurance subsidiaries (primarily property/casualty insurers) to avoid proration regardless of the subsidiaries' tax-favored earnings. The provision was deleted in Conference.

[63] The Committee Reports observe that foreign source investment income attributable to domestic required reserves is income effectively connected with the conduct of a United States business, and they specifically note, without comment, the holding in *Great-West Life Assurance Co. v. United States*, 82-1 USTC ¶9374 (Ct. Cl. 1982), that Canadian source passive investment income is not exempt from U.S. tax under the U.S.-Canada tax treaty. *See, e.g.*, S. Rep. No. 169, *supra*, at 562.

[64] While new Code §813 alters somewhat the 1959 Act method for calculating the minimum level of surplus, the Report of the Senate Finance Committee notes:

> "The bill requires the calculation of required surplus in a manner similar to the calculation of the 'minimum figure' under present law. The Secretary of the Treasury is to calculate the percentage used in the taxpayer's calculation in a manner similar to the manner of present law."

S. Rep. No. 169, *supra*, at 563.

[65] New Code §813(b) provides a special rule for the determination of a foreign mutual life insurance company's equity base for purposes of Code §809, essentially increasing that base by the company's surplus "deficit."

[66] In this regard, the Committee Reports specifically state that the reference to "reserves" in the former Code §815(d) limitation, as carried forward into the new law, is to be taken to mean "reserves computed in a manner consistent with the provisions of the 1959 Act." *See* H.R. Rep. No. 432, *supra*, at 1411; S. Rep. No. 169, *supra*, at 537.

[67] The policyholders' share of this deduction, which had also been an addition item under the 1959 Act, was eliminated under the new law "in order to prevent some of the double counting that existed under the 1959 Act." *See* H.R. Rep. No. 432, *supra*, at 1411; S. Rep. No. 169, *supra*, at 537.

[68] *Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies*, prepared by the Staffs of the Joint Committee on Taxation and the Senate Committee on Finance (Oct. 3, 1983), at 5-6.

[69] S. Rep. No. 169, *supra*, at 525-526 (1984).

[70] *Id.*

[71] New Code §817(g) does provide that a variable annuity contract, as defined therein, is to be treated as an annuity contract, preserving a rule similar to that of former Code §801(g). Also, subsection (h) of new Code §817, and new Code §72(s), introduce requirements of a definitional nature for annuity contracts.

[72] *See* Rev. Rul. 77-286, 1977-2 C.B. 228.

[73] H.R. Rep. No. 432, *supra*, at 1403, n.7; S. Rep. No. 169, *supra*, at 527, n.7.

[74] H.R. Rep. No. 432, *supra*, at 1404; S. Rep. No. 169, *supra*, at 527.

[75] H.R. Rep. No. 432, *supra*, at 1419, n.18; S. Rep. No. 169, *supra*, at 546, n.15.

[76] To the extent that fund shares or units are owned by a company's general account or, for that matter, by any other party, the availability of the "look through" will be dependent on regulations.

[77] *See* Rep. No. 861, *supra*, at 1055.

[78] Because Code §817(h), by its terms, applies only to nonqualified contracts, it may be viewed as reversing Rev. Rul. 81-225 insofar as that ruling affected separate accounts involving qualified plans.

[79] S. Rep. No. 169, *supra*, at 546.

[80] Rep. No. 861, *supra*, at 1055.

[81] H.R. Rep. No. 432, *supra*, at 1439; S. Rep. No. 169, *supra*, at 566.

[82] A special irrevocable election available under new Code §818(f)(2) until September 15, 1985, permits a company (again under regulations) to allocate such deductions among items of gross income.

[83] Rep. No. 861, *supra*, at 1081.

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[84] For example, under former Code §809(c)(1), indemnity reinsurance consideration paid by the ceding company reduced its premium income and under former Code §809(d)(7), assumption reinsurance consideration paid by the ceding company was deductible.

[85] S. Rep. No. 169, *supra*, at 556.

[86] Precisely when a risk is first considered reinsured is not explained in the statute, though Rep. No. 861, *supra*, notes at 1065 that "a risk is not considered reinsured prior to the time it arises under the contracts covered by the reinsurance agreement."

[87] Rep. No. 861, *supra*, at 1062-1065.

[88] For example, in *Helvering v. LeGierse*, 312 U.S. 531 (1941), the Supreme Court concluded that "historically and commonly insurance involves risk shifting and risk distribution." In that case, the Court denied an estate tax exclusion for insurance where the simultaneous issuance of a life insurance contract and a nonrefundable annuity contract on an 80-year-old insured foreclosed, as a practical matter, the insurer's assumption of any mortality risk.

The *LeGierse* definition of insurance has consistently been applied in the interpretation of the phrase "life insurance contract" in Code §101(a)(1). The IRS somewhat expanded the definition in Rev. Rul. 66-322, 1966-2 C.B. 123, where it held that a retirement income endowment contract, in which the cash surrender value exceeded the face amount of the contract, would be treated as providing life insurance because the contract, for substantial periods in the past, had involved an insurance risk. However, in *Evans v. Comr.*, 56 T.C. 1142 (1971), the Tax Court disagreed with this conclusion, holding that a contract would be treated as life insurance only during such time as a risk element was present in the contract.

[89] PLR's 8116073 and 8121074.

[90] PLR 8132119.

[91] The specific rules of Code §101(f) are described in Chapter 1 of T.M. Portfolio 982.

[92] H.R. Rep. No. 432, *supra*, at 1399.

[93] While this definition is directed to commercial life insurance policies, it presumably does not adversely affect life insurance arrangements such as those considered in *Ross v. Odom*, 401 F.2d 464 (5th Cir. 1968), and *Treganowan v. Comr.*, 183 F.2d 288 (2nd Cir. 1950).

It should also be noted that, under new Code §7702(h), endowment contracts are equated with life insurance contracts.

[94] H.R. Rep. No. 432, *supra*, at 1443; S. Rep. No. 169, *supra*, at 572. To clarify that paid-up additions are considered to be part of the "basic" contract for purposes of the new Code §7702 effective date and transition rules, the Report of the Senate Finance Committee continues at 572:

> "For example, for purposes of this definition, a whole life insurance contract that provides for the purchase of paid-up or deferred additions will be treated as a single life insurance contract."

[95] This test is derived, in part, from Code §101(f)(1)(B). It now appears as the first of the two tests because of the expectation that it will be applicable to a broader class of contracts. The cash value accumulation test under Code §7702 differs from Code §101(f)(1)(B) test in that: (1) the net single premium may now reflect amounts for qualified additional benefits, (2) it may also now fund a return-of-cash-value death benefit, and (3) the maturity date under the computational rules of Code §7702(e) applies equally to the cash value accumulation test and the guideline premium test. Further discussion of these rules appears below.

[96] S. Rep. No. 169, *supra*, at 573, defines a "reasonable termination dividend" with reference to the historical practice of the industry, under which termination dividends "have been modest in amount." It also indicates that the cash value of a contract is interpreted as the amount to which a policyholder is entitled upon surrender and against which the policyholder may borrow, and specifically states that the term "cash surrender value" will not include the refund of unearned premiums under a credit life insurance policy.

[97] S. Rep. No. 169, *supra*, at 574.

[98] H.R. Rep. No. 432, *supra*, at 147. The guideline premium test under Code §7702 differs from the Code §101(f)(1)(A) test as follows: (1) the guideline level premium under Code §7702 is defined as the level amount payable to age 95 or beyond (eliminating the minimum 20-year provision contained in Code §101(f)); (2) the applicable percentage "corridor" is increased over that of Code §101(f); and (3) the computational rules no longer permit either the assumption of endowments before age 95 or the funding of return-of-cash-value or "option 2" death benefits on a single premium basis.

[99] This third reduction element was included to permit otherwise taxable disbursements (such as those made in connection with a partial surrender) to reduce the "premiums paid." As under Code §101(f), Code §7702(f)(6) provides that a premium payment which would cause the sum of the premiums paid to exceed the guideline premium limitation will not result in disqualification of the contract if such payment is required to prevent termination of the contract with no cash value on or before the end of the taxable year.

[100] Such charges include "loading" but presumably do not include surrender charges. A charge not identified as such in the contract is taken to be "zero."

[101] The Committee Reports indicate that this rule merely "deems" the maturity date to fall between ages 95 and 100, rather than requiring that the contract so provide.

[102] Compare Code §7702(c)(3)(C).

[103] S. Rep. No. 169, *supra*, at 577-578.

[104] This provision should not apply in the case of a policy loan where, under the terms of a contract, a loan is a lien against the death benefit but does not specifically reduce it.

[105] *See, e.g.*, S. Rep. No. 169, *supra*, at 575, n.24.

[106] It is unclear whether a second or third life covered under a "joint life" policy would be considered subject to the additional benefit rules, though nothing in Code §7702 or its history suggests that there should be a problem with the continued provision of joint life coverage.

[107] The Committee Reports refer to the triggering death benefit change as one in "amount," distinguishing it from a change in the duration of the death benefit. This is intended to provide parity of treatment as between "traditional" and "universal" variable life products. *See, e.g.*, S. Rep. No. 169, *supra*, at 572-573. Also, recall that new Code §817(h) provides "diversification" requirements that the funds underlying a variable life contract must meet in order for the contract to be treated as complying with the tests of Code §7702.

[108] S. Rep. No. 169, *supra*, at 579.

[109] Special transitional relief, specific to the situations of several companies, is also provided under Act §221(d)(2)(C) and (3).

[110] Rep. No. 760, 97th Cong., 2d Sess. 647.

[111] New Code §72(s) thus applies to both qualified and nonqualified contracts.

[112] For contracts issued before January 19, 1985, and for investments made after January 18, 1985, on contracts existing as of that date, the 10-year look-back rule (as modified) will continue to apply.

[113] Rep. No. 861, *supra*, at 1077-1078.

[114] The exclusion with respect to disabled employees is retained.

[115] According to S. Rep. No. 169, *supra*, at 581, this change recognizes that the focus of the exchange rule should be on the character and benefits of the contract rather than the tax status of the company issuing the contract.

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WORKING PAPERS

Item Description Sheet

B-1 Item Description Sheet

B-2 Legislative History of the Tax Reform Act of 1984 (Summary)

B-101 Worksheet One: Selected Legislative History of Amendments to the Internal Revenue Code of 1954 made by the Tax Reform Act of 1984

- B-101 Conference Report on H.R. 4170 (Conference statutory language), H.R. Rep. 98-861, 98th Cong., 2d Sess. (June 23, 1984)
- B-262 Joint Explanatory Statement of the Committee of Conference, H.R. Rep. 98-861 (Accompanying H.R. 4170)
- B-407 House Concurrent Resolution 328 (H. Con. Res. 328), Correcting Technical Errors in the Enrollment of H.R. 4170, Vol. 130 Cong. Rec. H. 7524 (June 29, 1984)

Editors Note: See the Table of Internal Revenue Code sections added, amended or repealed by the Tax Reform Act of 1984, beginning at page C-1, *infra*, for page references to the Conference Report (Conference statutory language), the Joint Explanatory Statement of the Committee of Conference, and House Concurrent Resolution 328.

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LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1984 (SUMMARY)

The Tax Reform Act of 1984, introduced as H.R. 4170 on October 20, 1983, was comprised of 13 previously introduced bills on which separate hearings had been held: H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, H.R. 3110, H.R. 3173, H.R. 3475, H.R. 3525, H.R. 3592, H.R. 3593, H.R. 3805, and H.R. 4065. The Ways and Means Committee Report on H.R. 4170 (H.R. Rep. 98-432, Vol. I and II) was filed the following day, October 21, 1983.

Some of the major provisions of the original version H.R. 4170 were derived from:

H.R. 3110, introduced May 24, 1983, which included tax-exempt entity leasing provisions. Hearings were held before the House Ways and Means Committee on June 8, 1983, and July 26 and 27, 1983.

H.R. 3475, the Tax Simplification and Improvement Act of 1983, introduced June 30, 1983. Hearings were held before the House Ways and Means Committee on July 25, 1983.

H.R. 1635, introduced on February 24, 1983, and H.R. 1176, introduced on February 2, 1983, which contained tax-exempt bond provisions. Hearings were held before the House Ways and Means Committee on June 15-16, 1983.

H.R. 3525, introduced July 12, 1983, which contained provisions relating to the tax treatment of fringe benefits. Hearings were held before House Ways and Means Subcommittee on Select Revenue Measures on August 1, 1983.

H.R. 4065, the Life Insurance Tax of 1983, introduced October 5, 1983. Hearings were held before the House Ways and Means Subcommittee on Select Revenue Measures on May 10-11, and July 28, 1983.

Progress on H.R. 4170 in the First Session of the 98th Congress proved slow. After being reported by the Ways and Means Committee, the bill was sent to the House Rules Committee where it was subject to political maneuvering over the proposed limitations on tax-exempt bonds. On November 15, 1983, a compromise on the rules for debate on the floor was reached. But on November 17, 1983, the House rejected the rule (H. Res. 376) by a vote of 214-204.

Senator Robert Dole (R-Kan.), Chairman of the Senate Finance Committee, at the same time was attempting to assemble a "deficit reduction" package that would include tax increases and spending reductions in government programs. Although a mark-up on November 16 and 18, 1983, failed to produce specific legislation, the Senate Finance Committee did agree to the need for a deficit reduction proposal.

President Reagan's 1984 State of the Union address in January proved to be a catalyst for Congressional action on a "down payment on the deficit."

On February 22 and 28, 1984, hearings were held before the House Ways and Means Committee on proposals advocated by the Treasury Department on tax shelters and other tax reform provisions. These proposals were the subject of a Ways and Means mark-up on April 29, and March 1, 1984. The revised bill produced a significantly broader revenue raising measure than the original H.R. 4170. This was then added as an amendment in the nature of a substitute to H.R. 4170; a supplemental report (H.R. Rep. 98-432, Part 2) was filed on March 5, 1984.

The House of Representatives passed the bill on April 11, 1984, and the legislation was sent to the Senate for consideration.

On February 23, 1984, as the House worked on its version of the tax bill, the Senate Finance Committee began mark-up of a broad-based deficit reduction plan. This included, among other provisions, revenue raising and spending reduction recommendations from Title I of S. 2062, the Omnibus Reconciliation Act of 1983, which had been approved by the Finance Committee on October 31, 1983, in compliance with the budget process. S. 2062 was favorably reported by the Senate Budget Committee on Nocember 4, 1983 (S. Rep. No. 98-300).

The Finance Committee mark-up continued through much of March and concluded on March 21, 1984, with the adoption of the plan by a vote of 21-0. In anticipation of attaching the Committee-passed language as a Committee Amendment to a House-passed vehicle, the Senate Finance Committee took the unusual step of issuing its statutory and legislative history language as a Senate "Print," rather than a Report. (S. Prt. 98-169, Vol. I and II) on April 2, 1984. Debate began April 5, 1984, on H.R. 2163, the Sport Fishing Restoration Revenue Act of 1983.

On April 12, 1984, the statutory language of this print was added as a Senate Finance Committee amendment, with floor amendments, to H.R 2163. Debate continued in the Senate on other non-tax related amendments to the bill and concluded with passage of H.R. 4170 in lieu of H.R. 2163 on May 17, 1984 (this procedure was made possible by the passage in the House, in the intervening period, of H.R. 4170, and enabled the differences between the two proposals to be settled in Conference). In anticipation of a conference on the bill, the Senate also agreed to a conference and named its conferees.

The Senate version of H.R. 4170, the Deficit Reduction Act of 1984, (DRA) was then returned to the House on May 23, 1984, whereupon the House insisted on its version of H.R. 4170, the Tax Reform Act of 1984, and agreed to a conference.

The Conference Committee began consideration of the bill on June 6, 1984, and concluded its action on June 22, 1984. The Conference report (H.R Rep. 98-861) was filed by the Committee on June 23, 1984. The House and Senate approved the Conference version on June 27, 1984. On the same day, the House agreed to H. Con. Res. 328, directing the Clerk to make certain corrections in the enrollment of H.R. 4170. On June 29, 1984, the Senate agreed to the Resolution, with amendments in which the House concurred. President Reagan signed the Deficit Reduction Act of 1984 into law on July 18, 1984. The DRA became Public Law No. 98-369.

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SELECTED LEGISLATIVE HISTORY OF AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1954 MADE BY THE TAX REFORM ACT OF 1984

Conference Report on H.R. 4170
H.R. Rep. 98-861, 98th Cong., 2d Sess. (June 23, 1984)

Editor's Note: The Deficit Reduction Act of 1984 consists of two parts: Division A, the Tax Reform Act of 1984, and Division B, the Spending Reduction Act of 1984. Full text of the Conference Report on Division A of H.R. 4170, as it appeared in the Congressional Record on June 22, 1984, begins on this page. Technical errors contained in that version, however, were subsequently corrected by House Concurrent Resolution 328, which appeared in the Congressional Record on June 29, 1984. House Concurrent Resolution 328 is reproduced in full, beginning at page B-407, *infra*.

For details of the 1984 Act's legislative history, see page B-2, *supra*.

CONFERENCE REPORT ON H.R. 4170

Mr. ROSTENKOWSKI submitted the following conference report and statement on the bill (H.R. 4170) to provide for tax reform, and for other purposes:

CONFERENCE REPORT (H. REPT. No. 98-861)

The committee of conference on the disagreeing votes of the two Houses on the amendment of the House to the amendments of the Senate to the bill (H.R. 4170) to provide for tax reform, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its disagreement to the amendment of the House to the amendment of the Senate to the text of the bill and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the House amendment insert the following:

SECTION 1. SHORT TITLE.

(a) SHORT TITLE.—This Act may be cited as the "Deficit Reduction Act of 1984".

(b) ACT DIVIDED INTO 2 DIVISIONS.—This Act consists of 2 divisions as follows:

(1) DIVISION A.—Tax Reform Act of 1984.

(2) DIVISION B.—Spending Reduction Act of 1984.

DIVISION A—TAX REFORM ACT OF 1984

SEC. 5. SHORT TITLE, ETC.

(a) SHORT TITLE.—THIS DIVISION MAY BE CITED AS THE "TAX REFORM ACT OF 1984".

(b) AMENDMENT OF 1984 CODE.—Except as otherwise expressly provided, whenever in this division an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

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PART I—INCOME TAX PROVISIONS

SEC. 11. AMOUNT OF USED PROPERTY ELIGIBLE FOR INVESTMENT TAX CREDIT.

(a) GENERAL RULE.—Subparagraph (A) of section 48(c)(2) (relating to dollar limitation on amount of used section 38 property) is amended—

(1) by striking out "$150,000 ($25,000 for taxable years beginning in 1981, 1982, 1983, or 1984)" and inserting in lieu thereof "$125,000 ($150,000 for taxable years beginning after 1987)", and

(2) by striking out "$150,000 (or $25,000" each place it appears and inserting in lieu thereof "$125,000 (or $150,000".

(b) TECHNICAL AMENDMENT.—Subparagraph (B) of section 48(c)(2) is amended by striking out "$75,000 ($62,500 for taxable years beginning in 1981, 1982, 1983, or 1984)" and inserting in lieu thereof "$62,500 ($75,000 for taxable years beginning after 1984)".

SEC. 12. FINANCE LEASE PROVISIONS.

(a) FOUR-YEAR DEFERRAL OF FINANCE LEASE PROVISIONS.—

(1) IN GENERAL.—Subparagraph (A) of section 209(d)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by striking out "December 31, 1983" and inserting in lieu thereof "December 31, 1987".

(2) FINANCE LEASE PROVISIONS CONTINUE TO APPLY TO FARM PROPERTY.—Clause (i) of section 209(d)(1)(B) of such Act is amended by striking out "January 1, 1984" and inserting in lieu thereof "January 1, 1988".

(3) TECHNICAL AMENDMENTS.—

(A) Subclause (I) of section 168(f)(8)(D)(ii) (relating to requirement that only 40 percent of lessee's property may be treated as qualified), as amended by section 209 of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "1986" and inserting in lieu thereof "1990".

(B) Paragraph (4) of section 168(f) (relating to limitations), as so amended is amended by striking out "1985" each place it appears and inserting in lieu thereof "1989".

(b) TERMINATION OF SAFE HARBOR LEASING RULES.—Paragraph (8) of section 168(f) of the Internal Revenue Code of 1954 (relating to special rules for leasing), as in effect after the amendments made by section 208 of the Tax Equity and Fiscal Responsibility Act of 1982 but before the amendments made by section 209 of such Act, shall not apply to agreements entered into after December 31, 1983. The preceding sentence shall not apply to property described in paragraph (3)(G) or (5) of section 208(d) of such Act.

(c) TRANSITIONAL RULES.—

(1) IN GENERAL.—The amendments made by subsection (a) shall not apply with respect to any property if—

(A) a binding contract to acquire or to construct such property was entered into by or for the lessee before March 7, 1984, or

(B) such property was acquired by the lessee, or the construction of such property was begun, by or for the lessee, before March 7, 1984.

(2) SPECIAL RULE FOR CERTAIN AUTOMOTIVE PROPERTY.—

(A) IN GENERAL.—The amendments made by subsection (a) shall not apply to property which is placed in service before January 1, 1988—

(i) which is automotive manufacturing property, and

(ii) with respect to which the lessee is a qualified lessee (within the meaning of section 208(d)(6) of the Tax Equity and Fiscal Responsibility Act of 1982).

(B) $150,000,000 LIMITATION.—The provisions of subparagraph (A) shall not apply to any agreement if the sum of—

(i) the cost basis of the property subject to the agreement, plus

(ii) the cost basis of any property subject to an agreement to which subparagraph (A) previously applied and with respect to which the lessee was the lessee under the agreement described in clause (i) (or any related person within the meaning of section 168(e)(4)(D) of the Internal Revenue Code of 1954),

exceeds $150,000,000.

(C) AUTOMOTIVE MANUFACTURING PROPERTY.—For purposes of this paragraph, the term "automotive manufacturing property" means—

(i) property used principally by the taxpayer directly in connection with the trade or business of the taxpayer of the manufacturing of automobiles or trucks (other than truck tractors) with a gross vehicle weight of 13,000 pounds or less,

(ii) machinery, equipment, and special tools of the type included in former depreciation range guideline classes 37.11 and 37.12, and

(iii) any special tools owned by the taxpayer which are used by a vendor solely for the production of component parts for sale to the taxpayer.

(3) SPECIAL RULE FOR CERTAIN COGENERATION FACILITIES.—The amendments made by subsection (a) shall not apply with respect to any property which is part of a coal-fired cogeneration facility—

(A) for which an application for certification was filed with the Federal Energy Regulatory Commission on December 30, 1983,

(B) for which an application for a construction permit was filed with a State environmental protection agency on February 20, 1984, and

(C) which is placed in service before January 1, 1988.

SEC. 13. ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS.

Paragraph (1) of section 179(b) (relating to dollar limitation) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"If the taxable year begins in:	The applicable amount is:
1983, 1984, 1985, 1986, or 1987...	$5,000
1988 or 1989.....	7,500
1990 or thereafter.....	10,000."

SEC. 14. EMPLOYEE STOCK OWNERSHIP CREDIT.

Subparagraph (B) of section 44G(a)(2) (relating to employee stock ownership credit), as in effect before the amendments made by title IV of this Act, is amended by striking out the table contained therein and inserting in lieu thereof the following:

"For aggregate compensation paid or accrued during a portion of the taxable year occurring in calendar year:	The applicable percentage is:
1983, 1984, 1985, 1986, or 1987.....	0.5
1988 or thereafter.....	0."

SEC. 15. COST-OF-LIVING ADJUSTMENTS IN PENSION PLAN LIMITATIONS.

(a) GENERAL RULE.—Paragraph (3) of section 415(d) (relating to freeze on adjustment to defined contribution and benefit plan limits) is amended by striking out "January 1, 1986" and inserting in lieu thereof "January 1, 1988".

(b) TECHNICAL AMENDMENT.—Subparagraph (A) of section 415(d)(2) (defining base periods), as amended by section 235(b)(2)(B) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "October 1, 1984" and inserting in lieu thereof "October 1, 1986".

SEC. 16. REPEAL OF PARTIAL INTEREST EXCLUSION.

(a) GENERAL RULE.—Subsections (a) and (c) of section 302 of the Economic Recovery Tax Act of 1981 are hereby repealed, and the Internal Revenue Code of 1954 shall be applied and administered as if such subsections (and the amendments made by such subsections) had not been enacted.

(b) CONFORMING AMENDMENT.—Paragraph (1) of section 57(a) is amended to read as follows:

"(1) EXCLUSION OF DIVIDENDS.—Any amount excluded from gross income for the taxable year under section 116."

SEC. 17. FOREIGN EARNED INCOME OF INDIVIDUALS.

Subparagraph (A) of section 911(b)(2) (relating to limitation on foreign earned income) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"In the case of taxable years beginning in:	The annual rate is:
1983, 1984, 1985, 1986 or 1987.....	$80,000
1988.....	85,000
1989.....	90,000
1990 and thereafter.....	95,000."

SEC. 18. EFFECTIVE DATE.

(a) GENERAL RULE.—The amendments made by this part shall apply to taxable years ending after December 31, 1983.

(b) SPECIAL RULE FOR SECTION 14.—The amendment made by section 14 shall not apply in the case of a tax credit employee stock ownership plan if—

(1) such plan was favorably approved on September 23, 1983, by employees, and

(2) not later than January 11, 1984, the employer of such employees was 100 percent by such plan.

PART II—ESTATE AND GIFT RATES

SEC. 21. MAXIMUM RATE.

(a) GENERAL RULE.—Paragraph (2) of section 2001(c) (relating to phase-in of 50 percent maximum rate) is amended—

(1) by striking out "1985", in subparagraph (A) and inserting in lieu thereof "1988", and

(2) by striking out "1984" each place it appears in subparagraph (D) and inserting in lieu thereof "1984, 1985, 1986, or 1987."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to the estates of decedents dying after, and gifts made after, December 31, 1983.

PART III—EXCISE TAXES

SEC. 25. TAX RATE ON NEWLY DISCOVERED OIL.

(a) GENERAL RULE.—Subparagraph (B) of section 4987(b)(3) (relating to rate of tax on newly discovered oil) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"For taxable periods beginning in:	The applicable percentage is:
1984, 1985, 1986, or 1987	22½
1988	20
1989 and thereafter	15."

(b) CONTINUATION OF PERCENTAGE DEPLETION FOR OIL AND GAS FROM SECONDARY OR TERTIARY PROCESS.—

(1) Paragraph (2) of section 613A(c) (relating to exemption for independent producers and royalty owners) is amended by striking out the last sentence.

(2) Subparagraph (A) of section 613(c)(3) (defining depletable oil quantity) is amended by adding at the end thereof the following new sentence:

"Clause (ii) shall not apply after December 31, 1983."

(3) Subparagraph (E) of section 613A(c)(7) is amended by adding at the end thereof the following new sentence: "This subparagraph shall not apply after December 31, 1983."

(4) Subparagraph (A) of section 613A(c)(9) (relating to transfer of oil or gas property) is amended by striking out "paragraph (1)" and inserting in lieu thereof "this subsection".

(c) Effective Dates.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable periods beginning after December 31, 1983.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall take effect on January 1, 1984.

SEC. 26. EXCISE TAX ON COMMUNICATIONS SERVICES.

Paragraph (2) of section 4251(b) (relating to rate of tax on communications services) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"With respect to amount paid pursuant to bills first rendered:	The applicable percentage is:
During 1983, 1984, 1986, or 1987	3
During 1988 or thereafter	0."

SEC. 27. EXCISE TAX ON DISTILLED SPIRITS.

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—Paragraphs (1) and (3) of section 5001(a) (relating to rate of tax on distilled spirits) are each amended by striking out "$10.50" and inserting in lieu thereof "$12.50".

(2) TECHNICAL AMENDMENT.—Paragraphs (1) and (2) of section 5010(a) (relating to credit for wine content and for flavors content) are each amended by striking out "$10.50" and inserting in lieu thereof "$12.50".

(b) FLOOR STOCKS TAXES ON DISTILLED SPIRITS.—

(1) IMPOSITION OF TAX.—On distilled spirits on which tax was imposed under section 5001 or 7652 of the Internal Revenue Code of 1954 before October 1, 1985, and which were held on such date for sale by any person, there shall be imposed a tax at the rate of $2.00 for each proof gallon and a proportionate tax at the like rate on all fractional parts of a proof gallon.

(2) EXCEPTION FOR CERTAIN SMALL WHOLESALE OR RETAIL DEALERS.—No tax shall be imposed by paragraph (1) on distilled spirits held on October 1, 1985, by any dealer if—

(A) the aggregate liquid volume of distilled spirits held by such dealer on such date does not exceed 500 wine gallons, and

(B) such dealer submits to the Secretary (at the time and in the manner required by the Secretary) such information as the Secretary shall require for purposes of this paragraph.

(3) CREDIT AGAINST TAX.—Each dealer shall be allowed as a credit against the taxes imposed by paragraph (1) an amount equal to $800. Such credit shall not exceed the amount of taxes imposed by paragraph (1) for which the dealer is liable.

(4) LIABILITY FOR TAX AND METHOD OF PAYMENT.—

(A) LIABILITY FOR TAX.—A person holding distilled spirits on October 1, 1985, to which the tax imposed by paragraph (1) applies shall be liable for such tax.

(B) METHOD OF PAYMENT.—The tax imposed by paragraph (1) shall be paid in such manner as the Secretary shall by regulations prescribe.

(C) TIME FOR PAYMENT.—

(i) IN GENERAL.—Except as provided in clause (ii), the tax imposed by paragraph (1) shall be paid on or before April 1, 1986.

(ii) INSTALLMENT PAYMENT OF TAX IN CASE OF SMALL OR MIDDLE-SIZED DEALERS.—In the case of any small or middle-sized dealer, the tax imposed by paragraph (1) may be paid in 3 equal installments due as follows:

(I) The first installment shall be paid on or before April 1, 1986.

(II) The second installment shall be paid on or before July 1, 1986.

(III) The third installment shall be paid on or before October 1, 1986.

If the taxpayer does not pay any installment under this clause on or before the date prescribed for its payment, the whole of the unpaid tax shall be paid upon notice and demand from the Secretary.

(iii) SMALL OR MIDDLE-SIZED DEALER.—For purposes of clause (ii), the term "small or middle-sized dealer" means any dealer if the aggregate gross sales receipts of such dealer for its most recent taxable year ending before October 1, 1985, does not exceed $500,000.

(5) CONTROLLED GROUPS.—

(A) CONTROLLED GROUPS OF CORPORATIONS.—In the case of a controlled group—

(i) the 500 wine gallon amount specified in paragraph (2),

(ii) the $800 amount specified in paragraph (3), and

(iii) the $500,000 amount specified in paragraph (4)(C)(iii),

shall be apportioned among the dealers who are component members of such group in such manner as the Secretary shall by regulations prescribe. For purposes of the preceding sentence, the term "controlled group" has the meaning given to such term by subsection (a) of section 1563 of the Internal Revenue Code of 1954; except that for such purposes the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in such subsection.

(B) NONINCORPORATED DEALERS UNDER COMMON CONTROL.—Under regulations prescribed by the Secretary, principles similar to the principles of subparagraph (A) shall apply to a group of dealers under common control where 1 or more of such dealers is not a corporation.

(6) OTHER LAWS APPLICABLE.—All provisions of law, including penalties, applicable with respect to the taxes imposed by section 5001 of the Internal Revenue Code of 1954 shall, insofar as applicable and not inconsistent with the provisions of this subsection, apply in respect of the taxes imposed by paragraph (1) to the same extent as if such taxes were imposed by such section 5001.

(7) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) DEALER.—The term "dealer" means—

(i) any wholesale dealer in liquors (as defined in section 5112(b) of the Internal Revenue Code of 1954), and

(ii) any retail dealer in liquors (as defined in section 5122(a) of such Code).

(B) DISTILLED SPIRITS.—The term "distilled spirits" has the meaning given such term by section 5002(a)(8) of the Internal Revenue Code of 1954.

(C) PERSON.—The term "person" includes any State or political subdivision thereof, or any agency or instrumentality of a State or political subdivision thereof.

(D) SECRETARY.—The term "Secretary" means the Secretary of the Treasury or his delegate.

(E) TREATMENT OF IMPORTED PERFUMES CONTAINING DISTILLED SPIRITS.—Any article described in section 5001(a)(3) of such Code shall be treated as distilled spirits; except that the tax imposed by paragraph (1) shall be imposed on a wine gallon basis in lieu of a proof gallon basis. To the extent provided in regulations prescribed by the Secretary, the preceding sentence shall not apply to any article held on October 1, 1985, on the premises of a retail establishment.

(c) REQUIREMENT OF ELECTRONIC FUNDS TRANSFER FOR ALCOHOL AND TOBACCO EXCISE TAXES.—

(1) ALCOHOL TAXES.—Section 5061 (relating to method of collecting tax on distilled spirits) is amended by adding at the end thereof the following new subsection:

"(e) PAYMENT BY ELECTRONIC FUND TRANSFER.—

"(1) IN GENERAL.—Any person who in any 12-month period ending December 31, was liable for a gross amount equal to or exceeding $5,000,000 in taxes imposed on distilled spirits, wines, or beer by sections 5001, 5041, and 5051 (or 7652), respectively, shall pay such taxes during the succeeding calendar year by electronic fund transfer to a Federal Reserve Bank.

"(2) ELECTRONIC FUND TRANSFER.—The term 'electronic fund transfer' means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account."

(2) TOBACCO TAXES.—Subsection (b) of section 571 (relating to method of payment of tobacco taxes) is amended by adding at the end thereof the following new paragraph:

"(3) PAYMENT BY ELECTRONIC FUND TRANSFER.—Any person who in any 12-month period ending December 31, was liable for a gross amount equal to or exceeding $5,000,000 in taxes imposed on tobacco products and cigarette papers and tubes by section 5701 (or 7652) shall pay such taxes during the succeeding calendar year by electronic fund transfer (as defined in section 5061(e)(2)) to a Federal Reserve Bank."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall take effect on October 1, 1985.

(2) ELECTRONIC TRANSFER PROVISIONS.—The amendments made by subsection (c) shall apply to taxes required to be paid on or after September 30, 1984.

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Subtitle B—Tax-Exempt Entity Leasing

SEC. 31. DENIAL OF TAX INCENTIVES FOR PROPERTY LEASED TO GOVERNMENTS AND OTHER TAX-EXEMPT ENTITITES.

(a) GENERAL RULE.—Section 168 (relating to accelerated cost recovery system) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) PROPERTY LEASED TO GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.—

"(1) IN GENERAL.—Notwithstanding any other provision of this section, the deduction allowed under subsection (a) (and any other deduction allowable for depreciation or amortization) for any taxable year with respect to tax-exempt use property shall be determined—

"(A) by using the straight-line method (without regard to salvage value), and

"(B) by using a recovery period determined under the following table:

"In the case of:	The recovery period shall be:
(I) Property not described in subclause (II) or subclause (III).	The present class life
(II) Personal property with no present class life.	12 years
(III) 15-year real property.	40 years

"(2) OPERATING RULES.—

"(A) RECOVERY PERIOD MUST AT LEAST EQUAL 125 PERCENT OF LEASE TERM.—In the case of any tax-exempt use property, the recovery period used for purposes of paragraph (1) shall not be less than 125 percent of the lease term.

"(B) CONVENTIONS.—

"(i) PROPERTY OTHER THAN 15-YEAR REAL PROPERTY.—In the case of property other than 15-year real property, the half-year convention shall apply for purposes of paragraph (1).

"(ii) 15-YEAR REAL PROPERTY.—In the case of 15-year real property, the amount determined under paragraph (1) shall be determined on the basis of the number of months in the year in which the property is in service.

"(C) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLIES.—Paragraph (1) shall not apply to any recovery property if the recovery period which applies to such property (without regard to this subsection) exceeds the recovery period for such property determined under this subsection.

"(D) DETERMINATION OF CLASS FOR REAL PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any real property which is not recovery property, for purposes of this subsection, the determination of whether such property is 15-year real property shall be made as if such property were recovery property.

"(E) COORDINATION WITH SUBSECTION (f)(12).—Paragraph (12) of subsection (f) shall not apply to any tax-exempt use property to which this subsection applies.

"(F) 18-YEAR REAL PROPERTY.—For purposes of this section, the term '15-year real property' includes '18-year real property'.

"(3) TAX-EXEMPT USE PROPERTY.—For purposes of this subsection—

"(A) PROPERTY OTHER THAN 15-YEAR REAL PROPERTY.—Except as otherwise provided in this subsection, the term 'tax-exempt use property' means that portion of any tangible property (other than 15-year real property) leased to a tax-exempt entity.

"(B) 15-YEAR REAL PROPERTY.—

"(i) IN GENERAL.—In the case of 15-year real property, the term 'tax-exempt use property' means that portion of the property leased to a tax-exempt entity in a disqualified lease.

"(ii) DISQUALIFIED LEASE.—For purposes of this subparagraph, the term 'disqualified lease' means any lease of the property to a tax-exempt entity, but only if—

"(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103 and such entity (or a related entity) participated in such financing,

"(II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option,

"(III) such lease has a lease term in excess of 20 years, or

"(IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.

"(iii) 35-PERCENT THRESHOLD TEST.—Clause (i) shall apply to any property only if the portion of such property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property.

"(iv) TREATMENT OF IMPROVEMENTS.—For purposes of this subparagraph, improvements to a property (other than land) shall not be treated as a separate property.

"(v) LEASEBACKS DURING 1ST 3 MONTHS OF USE NOT TAKEN INTO ACCOUNT.—Subclause (IV) of clause (ii) shall not apply to any property which is leased within 3 months after the date such property is first used by the tax-exempt entity (or a related entity).

"(C) EXCEPTION FOR SHORT-TERM LEASES.—

"(i) IN GENERAL.—Property shall not be treated as tax-exempt use property merely by reason of a short-term lease.

"(ii) SHORT-TERM LEASE.—For purposes of clause (i), the term 'short-term lease' means any lease the term of which is—

"(I) less than 3 years, and

"(II) less than the greater of 1 year or 30 percent of the property's present class life.

In the case of 15-year real property and property with no present class life, subclause (II) shall not apply.

"(D) EXCEPTION WHERE PROPERTY USED IN UNRELATED TRADE OR BUSINESS.—The term 'tax-exempt use property' shall not include any portion of a property if such portion is predominantly used by the tax-exempt entity (directly or through a partnership of which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under section 511.

"(4) TAX-EXEMPT ENTITY.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'tax-exempt entity' means—

"(i) the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,

"(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, and

"(iii) any foreign person or entity.

"(B) EXCEPTIONS FOR CERTAIN PROPERTY USED BY FOREIGN PERSON OR ENTITY.—

"(i) INCOME FROM PROPERTY SUBJECT TO UNITED STATES TAX.—Clause (iii) of subparagraph (A) shall not apply with respect to any property if more than 50 percent of the gross income for the taxable year derived by the foreign person or entity from the use of such property is—

"(I) subject to tax under this chapter, or

"(II) included under section 951 in the gross income of a United States shareholder for the taxable year with or within which ends the taxable year of the controlled foreign corporation in which such income was derived.

For purposes of the preceding sentence, any exclusion or exemption shall not apply for purposes of determining the amount of the gross income so derived, but shall apply for purposes of determining the portion of such gross income subject to tax under this chapter.

"(ii) MOVIES AND SOUND RECORDINGS.—Clause (iii) of subparagraph (A) shall not apply with respect to any qualified film (as defined in section 48(k)(1)(B)) or any sound recording (as defined in section 48(r)).

"(C) FOREIGN PERSON OR ENTITY.—For purposes of this paragraph, the term 'foreign person or entity' means—

"(i) any foreign government, any international organization, or any agency or instrumentality of any of the foregoing, and

"(ii) any person who is not a United States person.

Such term does not include any foreign partnership or other foreign pass-thru entity.

"(D) TREATMENT OF CERTAIN TAXABLE INSTRUMENTALITIES.—For purposes of this subsection and paragraph (5) of section 48(a), a corporation shall not be treated as an instrumentality of the United States or of any State or political subdivision thereof if—

"(i) all of the activities of such corporation are subject to tax under this chapter, and

"(ii) a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof.

"(E) CERTAIN PREVIOUSLY TAX-EXEMPT ORGANIZATIONS.—

"(i) IN GENERAL.—For purposes of this subsection and paragraph (4) of section 48(a), an organization shall be treated as an organization described in subparagraph (A)(ii) with respect to any property of which such organization is the lessee if such organization was an organization (other than a cooperative described in section 521) exempt from tax imposed by this chapter at any time during the 5-year period ending on the date such property was first leased to such organization. The preceding sentence shall not apply to the Federal Home Loan Mortgage Corporation.

"(ii) ELECTION NOT TO HAVE CLAUSE (i) APPLY.—

"(I) IN GENERAL.—In the case of an organization formerly exempt from tax under section 501(a) as an organization described in section 501(c)(12), clause (i) shall not apply to such organization with respect to any property of which such organization is the lessee if such organization elects not to be exempt from tax under section 501(a) during the tax-exempt use period with respect to such property.

"(II) TAX-EXEMPT USE PERIOD.—For purposes of subclause (I), the term 'tax-exempt use period' means the period beginning with the taxable year in which the property described in subclause (I) is placed in service and ending with the close of the 15th taxable year following the last taxable year of the recovery period of such property.

"(III) ELECTION.—Any election under subclause (I), once made, shall be irrevocable.

"(iii) TREATMENT OF SUCCESSOR ORGANIZATIONS.—Any organization which is engaged in activities substantially similar to those engaged in by a predecessor organization shall succeed to the treatment under this subparagraph of such predecessor organization.

"(5) SPECIAL RULES FOR CERTAIN HIGH TECHNOLOGY EQUIPMENT.—

"(A) EXEMPTION WHERE LEASE TERM IS 5 YEARS OR LESS.—For purposes of this subsection, the term 'tax-exempt use property' shall not include any qualified technological

equipment if the lease to the tax-exempt entity has a lease term of 5 years or less.

"(B) RECOVERY PERIOD WHERE LEASE TERM IS GREATER THAN 5 YEARS.—In the case of any qualified technological equipment not described in subparagraph (A) and which is not property to which subsection (f)(2) applies, the recovery period used for purposes of paragraph (1) shall be 5 years.

"(C) QUALIFIED TECHNOLOGICAL EQUIPMENT.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term 'qualified technological equipment' means—

"(I) any computer or peripheral equipment,

"(II) any high technology telephone station equipment installed on the customer's premises, and

"(III) any high technology medical equipment.

"(ii) EXCEPTION FOR CERTAIN PROPERTY.—The term 'qualified technological equipment' shall not include any property leased to a tax-exempt entity if—

"(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103,

"(II) such lease occurs after a sale (or other transfer) of the property by, or lease of such property from, such entity (or related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease, or

"(III) such tax-exempt entity is the United States or any agency or instrumentality of the United States.

"(iii) LEASEBACKS DURING 1ST 3 MONTHS OF USE NOT TAKEN INTO ACCOUNT.—Subclause (II) of clause (ii) shall not apply to any property which is leased within 3 months after the date such property is first used by the tax-exempt entity (or a related entity).

"(iv) PROPERTY NOT SUBJECT TO RAPID OBSOLESCENCE MAY BE EXCLUDED.—The term 'qualified technological equipment' shall not include any equipment described in subclause (II) or (III) of clause (i)—

"(I) which the Secretary determines by regulations is not subject to rapid obsolescence, and

"(II) which is placed in service after the date on which final regulations implementing such determination are published in the Federal Register.

"(D) COMPUTER OR PERIPHERAL EQUIPMENT DEFINED.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'computer or peripheral equipment' means—

"(I) any computer, and

"(II) any related peripheral equipment.

"(ii) COMPUTER.—The term 'computer' means a programmable electronically activated device which—

"(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

"(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

"(iii) RELATED PERIPHERAL EQUIPMENT.—The term 'related peripheral equipment' means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

"(iv) EXCEPTIONS.—The term 'computer or peripheral equipment' shall not include—

"(I) any equipment which is an integral part of other property which is not a computer,

"(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

"(III) equipment of a kind used primarily for amusement or entertainment of the user.

"(E) HIGH TECHNOLOGY MEDICAL EQUIPMENT.—For purposes of this paragraph, the term 'high technology medical equipment' means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

"(6) OTHER SPECIAL RULES.—For purposes of this subsection—

"(A) LEASE.—The term 'lease' includes any grant of a right to use property.

"(B) LEASE TERM.—In determining a lease term—

"(i) there shall be taken into account options to renew, and

"(ii) 2 or more successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property shall be treated as 1 lease.

"(C) SPECIAL RULE FOR FAIR RENTAL OPTIONS ON 15-YEAR REAL PROPERTY.—For purposes of clause (i) of subparagraph (B), in the case of 15-year real property, there shall not be taken into account any option to renew at fair market value, determined at the time of renewal.

"(7) RELATED ENTITIES.—For purposes of this subsection—

"(A)(i) Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality which directly or indirectly derives its powers, rights, and duties in whole or in part from the same sovereign authority.

"(ii) For purposes of clause (i), the United States, each State, and each possession of the United States shall be treated as a separate sovereign authority.

"(B) Any entity not described in subparagraph (A)(i) is related to any other entity if the 2 entities have—

"(i) significant common purposes and substantial common membership, or

"(ii) directly or indirectly substantial common direction or control.

"(C)(i) An entity is related to another entity if either entity owns (directly or through 1 or more entities) a 50 percent or greater interest in the capital or profits of the other entity.

"(ii) For purposes of clause (i), entities treated as related under subparagraph (A) or (B) shall be treated as 1 entity.

"(D) An entity is related to another entity with respect to a transaction if such transaction is part of an attempt by such entities to avoid the application of this subsection, section 46(e), paragraph (4) or (5) of section 48(a), or clause (vi) of section 48(g)(2)(B).

"(8) TAX-EXEMPT USE OF PROPERTY LEASED TO PARTNERSHIPS, ETC., DETERMINED AT PARTNER LEVEL.—For purposes of this subsection and paragraphs (4) and (5) of section 48(a)—

"(A) IN GENERAL.—In the case of any property which is leased to a partnership, the determination of whether any portion of such property is tax-exempt use property shall be made by treating each tax-exempt entity partner's proportionate share (determined under paragraph (9)(C)) of such property as being leased to such partner.

"(B) OTHER PASS-THRU ENTITIES; TIERED ENTITIES.—Rules similar to the rules of subparagraph (A) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

"(C) PRESUMPTION WITH RESPECT TO FOREIGN ENTITIES.—Unless it is otherwise established to the satisfaction of the Secretary, it shall be presumed that the partners of a foreign partnership (and the beneficiaries of any other foreign pass-thru entity) are persons who are not United States persons.

"(9) TREATMENT OF PROPERTY OWNED BY PARTNERSHIPS, ETC.—

"(A) IN GENERAL.—For purposes of this subsection and paragraphs (4) and (5) of section 48(a), if—

"(i) any property which (but for this subparagraph) is not tax-exempt use property is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and

"(ii) any allocation to the tax-exempt entity of partnership items is not a qualified allocation,

an amount equal to such tax-exempt entity's proportionate share of such property shall (except as provided in paragraph (3)(D)) be treated as tax-exempt use property.

"(B) QUALIFIED ALLOCATION.—For purposes of subparagraph (A), the term 'qualified allocation' means any allocation to a tax-exempt entity which—

"(i) is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and

"(ii) has substantial economic effect within the meaning of section 704(b)(2).

For purposes of this subparagraph, items allocated under section 704(c) shall not be taken into account.

"(C) DETERMINATION OF PROPORTIONATE SHARE.—

"(i) IN GENERAL.—For purposes of subparagraph (A), a tax-exempt entity's proportionate share of any property owned by a partnership shall be determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share.

"(ii) DETERMINATION WHERE ALLOCATIONS VARY.—For purposes of clause (i), if a tax-exempt entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive.

"(D) OTHER PASS-THRU ENTITIES; TIERED ENTITIES.—Rules similar to the rules of subparagraphs (A), (B), and (C) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

"(E) REGULATIONS.—For purposes of determining whether there is a qualified allocation under subparagraph (B), the regulations prescribed under paragraph (10) for purposes of this paragraph—

"(i) shall set forth the proper treatment for partnership guaranteed payments, and

"(ii) may provide for the exclusion or segregation of items.

"(10) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection."

(b) DENIAL OF INVESTMENT TAX CREDIT FOR PROPERTY USED BY FOREIGN GOVERNMENTS AND OTHER FOREIGN PERSONS.—Paragraph (5) of section 48(a) (relating to property used by governmental units) is amended to read as follows:

"(5) PROPERTY USED BY GOVERNMENTAL UNITS OR FOREIGN PERSONS OR ENTITIES.—

"(A) IN GENERAL.—Property used—

"(i) by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, or

"(ii) by any foreign person or entity (as defined in section 168(j)(4)(C)), but only with respect to property to which section 168(j)(4)(A)(iii) applies (determined after the application of section 168(j)(4)(B)).

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shall not be treated as section 38 property.

"(B) EXCEPTION FOR SHORT-TERM LEASES.—

"(i) IN GENERAL.—This paragraph and paragraph (4) shall not apply to any property by reason of use under a lease with a term of less than 6 months (determined under section 168(j)(6)).

"(ii) EXCEPTION FOR CERTAIN OIL DRILLING PROPERTY AND CERTAIN CONTAINERS.—For purposes of this paragraph and paragraph (4), clause (i) shall be applied by substituting the lease term limitation in section 168(j)(3)(C)(ii) for the lease term limitation in clause (i) in the case of property which is leased to a foreign person or entity and—

"(I) which is used in offshore drilling for oil and gas (including drilling vessels, barges, platforms, and drilling equipment) and support vessels with respect to such property, and

"(II) which is a container described in section 48(a)(2)(B)(vi) (without regard to whether such container is used outside the United States) or container chassis or trailer but only if such container, chassis, or trailer has a present class life of not more than 6 years.

"(iii) EXCEPTION FOR CERTAIN AIRCRAFT.—

"(I) IN GENERAL.—In the case of any aircraft to which section 47(a)(7) applies and which is leased to a foreign person or entity before January 1, 1990, clause (i) shall be applied by substituting '3 years' for '6 months'.

"(II) RECAPTURE PERIOD EXTENDED.—For purposes of applying subparagraph (B) of section 47(a)(5) and paragraph (1) of section 47(a), there shall not be taken into account any period of the lease to which subclause (I) applies.

"(C) EXCEPTION FOR QUALIFIED REHABILITATED BUILDINGS LEASED TO GOVERNMENTS, ETC.—If any qualified rehabilitated building is leased to a governmental unit (or a foreign person or entity), this paragraph shall not apply to that portion of the basis of such building which is attributable to qualified rehabilitation expenditures.

"(D) CROSS REFERENCE.—

"For provisions providing special rules for the application of this paragraph and paragraph (4), see section 168(j)."

(c) REHABILITATION CREDIT NOT TO APPLY WHERE PROPERTY USED BY TAX-EXEMPT ENTITY.—

(1) IN GENERAL.—Subparagraph (B) of section 48(g)(2) (relating to certain expenditures not treated as qualified rehabilitation expenditures) is amended by adding at the end thereof the following new clause:

"(vi) TAX-EXEMPT USE PROPERTY.—

"(I) IN GENERAL.—Any expenditure in connection with the rehabilitation of a building which is allocable to that portion of such building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168(j)(3)).

"(II) CLAUSE NOT TO APPLY FOR PURPOSES OF PARAGRAPH (1)(C).—This clause shall not apply for purposes of determining under paragraph (1)(C) whether a building has been substantially rehabilitated."

(2) TECHNICAL AMENDMENT.—Clause (i) of section 48(g)(2)(B) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to any expenditure to the extent subsection (j)(12) or (j) of section 168 applies to such expenditure."

(d) AUTHORITY TO PRESCRIBE PRESENT CLASS LIFE FOR CERTAIN PROPERTY.—Paragraph (2) of section 168(g) (defining present class life) is amended by adding at the end thereof the following new sentence: "If any property (other than section 1250 class property) does not have a present class life within the meaning of the preceding sentence, the Secretary may prescribe a present class life for such property which reasonably reflects the anticipated useful life of such property to the industry or other group."

(e) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES, ETC.—Section 7701 (relating to definitions), as amended by this Act, is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES, ETC.—For purposes of chapter 1—

"(1) IN GENERAL.—A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not—

"(A) the service recipient is in physical possession of the property,

"(B) the service recipient controls the property,

"(C) the service recipient has a significant economic or possessory interest in the property,

"(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

"(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

"(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

"(2) OTHER ARRANGEMENTS.—An arrangement (including a partnership or other passthru entity) which is not described in paragraph (1) shall be treated as a lease if such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in paragraph (1).

"(3) SPECIAL RULES FOR CONTRACTS OR ARRANGEMENTS INVOLVING SOLID WASTE DISPOSAL, ENERGY, AND CLEAN WATER FACILITIES.—

"(A) IN GENERAL.—Notwithstanding paragraphs (1) and (2), and except as provided in paragraph (4), any contract or arrangement between a service provider and a service recipient—

"(i) with respect to—

"(I) the operation of a qualified solid waste disposal facility,

"(II) the sale to the service recipient of electrical or thermal energy produced at a cogeneration or alternative energy facility, or

"(III) the operation of a water treatment works facility, and

"(ii) which purports to be a service contract, shall be treated as a service contract.

"(B) QUALIFIED SOLID WASTE DISPOSAL FACILITY.—For purposes of subparagraph (A), the term 'qualified solid waste disposal facility' means any facility if such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public.

"(C) DEFINITIONS.—For purposes of paragraph (3)—

"(i) QUALIFIED SOLID WASTE DISPOSAL FACILITY.—The term 'qualified solid waste disposal facility' means any facility if such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public.

"(ii) COGENERATION FACILITY.—The term 'cogeneration facility' means a facility which uses the same energy source for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy.

"(iii) ALTERNATIVE ENERGY FACILITY.—The term 'alternative energy facility' means a facility for producing electrical or thermal energy if the primary energy source for the facility is not oil, natural gas, coal, or nuclear power.

"(iv) WATER TREATMENT WORKS FACILITY.—The term 'water treatment works facility' means any treatment works within the meaning of section 212(2) of the Federal Water Pollution Control Act.

"(4) PARAGRAPH (3) NOT TO APPLY IN CERTAIN CASES.—

"(A) IN GENERAL.—Paragraph (3) shall not apply to any qualified solid waste disposal facility used under a contract or arrangement if—

"(i) the service recipient (or a related entity) operates such facility,

"(ii) the service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement (other than for reasons beyond the control of the service provider),

"(iii) the service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement, or

"(iv) the service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or a part of such facility at a fixed and determinable price (other than for fair market value).

"(B) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (A) WITH RESPECT TO CERTAIN RIGHTS AND ALLOCATIONS UNDER THE CONTRACT.—For purposes of subparagraph (A), there shall not be taken into account—

"(i) any right of a service recipient to inspect any facility, to exercise any sovereign power the service recipient may possess, or to act in the event of a breach of contract by the service provider, or

"(ii) any allocation of any financial burden or benefits in the event of any change in any law.

"(C) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (A) IN THE CASE OF CERTAIN EVENTS.—

"(i) TEMPORARY SHUT-DOWNS, ETC.—For purposes of clause (ii) of subparagraph (A), there shall not be taken into account any temporary shut-down of the facility for repairs, maintenance, or capital improvements, or any financial burden caused by the bankruptcy or similar financial difficulty of the service provider.

"(ii) REDUCED COSTS.—For purposes of clause (iii) of subparagraph (A), there shall not be taken into account any significant financial benefit merely because payments by the service recipient under the contract or arrangement are decreased by reason of increased production or efficiency or the recovery of energy or other products.

"(5) EXCEPTION FOR CERTAIN LOW-INCOME HOUSING.—This subsection shall not apply to any low-income housing (within the meaning of section 168) if—

"(A) such property is operated by or for an organization described in paragraph (3) or (4) of section 501(c), and

"(B) at least 80 percent of the units in such property are leased to low-income tenants (within the meaning of section 167(k)(3)(B)).

"(6) REGULATIONS.—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this subsection."

(f) INVESTMENT TAX CREDIT FOR PROPERTY LEASED BY CERTAIN PERSONS NOT TO EXCEED CREDIT ALLOWED IF SUCH PERSONS OWNED PROPERTY.—Section 46(e) (relating to limita-

tions with respect to certain persons) is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULES WHERE SECTION 593 ORGANIZATION IS LESSEE.—

"(A) IN GENERAL.—For purposes of paragraph (1)(A), if an organization described in section 593 is the lessee of any section 38 property, the lessor of such property shall be treated as an organization described in section 593 with respect to such property.

"(B) EXCEPTION FOR SHORT-TERM LEASES.—This paragraph shall not apply to any property by reason of use under a lease with a term of less than 6 months (determined under section 168(j)(6)).

"(C) ELECTION NOT TO HAVE SUBPARAGRAPH (A) APPLY.—Subparagraph (A) shall not apply for any taxable year to an organization described in section 593 if such organization elects to compute for such year and all subsequent taxable years the amount of the deduction for a reasonable addition to a reserve for bad debts on the basis of actual experience. Any such election shall apply to any successor organization engaged in substantially similar activities and, once made, shall be irrevocable."

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply—

(A) to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date, and

(B) to property placed in service by the taxpayer on or before May 23, 1983, if the lease to the tax-exempt entity is entered into after May 23, 1983.

(2) LEASES ENTERED INTO ON OR BEFORE MAY 23, 1983.—The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity if the property is leased pursuant to—

(A) a lease entered into on or before May 23, 1983 (or a sublease under such a lease), or

(B) any renewal or extension of a lease entered into on or before May 23, 1983, if such renewal or extension is pursuant to an option exercisable by the tax-exempt entity which was held by the tax-exempt entity on May 23, 1983.

(3) BINDING CONTRACTS, ETC.—

(A) The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity if such lease is pursuant to 1 or more written binding contracts which, on May 23, 1983, and at all times thereafter, required—

(i) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(ii) the tax-exempt entity (or a tax-exempt predecessor thereof) to be the lessee of such property.

(B) The amendments made by this section shall not apply with respect to any property owned by a partnership if—

(i) such property was acquired by such partnership on or before October 21, 1983, or

(ii) such partnership entered into a written binding contract which, on October 21, 1983, and at all times thereafter, required the partnership to acquire or construct such property.

(C) The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity (other than any foreign person or entity)—

(i) if—

(I) on or before May 23, 1983, the taxpayer (or his predecessor in interest under the contract) or the tax-exempt entity entered into a written binding contract to acquire, construct, reconstruct, or rehabilitate such property and such property had not previously been used by the tax-exempt entity, or

(II) the taxpayer or the tax-exempt entity acquired the property after June 30, 1982 and on or before May 23, 1983, or completed the construction, reconstruction, or rehabilitation of the property after December 31, 1982, and on or before May 23, 1983, and

(ii) if such lease is pursuant to a written binding contract entered into before January 1, 1985, which requires the tax-exempt entity to be the lessee of such property.

(4) OFFICIAL GOVERNMENTAL ACTION ON OR BEFORE NOVEMBER 1, 1983.—

(A) IN GENERAL.—The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity (other than the United States, any agency or instrumentality thereof, or any foreign person or entity) if—

(i) on or before November 1, 1983—

there was significant official governmental action with respect to the project or its design, and

(ii) the lease to the tax-exempt entity is pursuant to a written binding contract entered into before January 1, 1985, which requires the tax-exempt entity to be the lessee of the property.

(B) SIGNIFICANT OFFICIAL GOVERNMENTAL ACTION.—For purposes of subparagraph (A), the term "significant official governmental action" does not include granting of permits, zoning changes, environmental impact statements, or similar governmental actions.

(5) MASS COMMUTING VEHICLES.—The amendments made by this section shall not apply to any qualified mass commuting vehicle (as defined in section 103(b)(9) of the Internal Revenue Code of 1954) which is financed in whole or in part by obligations the interest on which is excludable from gross income under section 103(a) of such Code if—

(A) such vehicle is placed in service before January 1, 1988, or

(B) such vehicle is placed in service on or after such date—

(i) pursuant to a binding contract or commitment entered into before April 1, 1983, and

(ii) solely because of conditions which, as determined by the Secretary of the Treasury or his delegate, are not within the control of the lessor or lessee.

(6) CERTAIN TURBINES AND BOILERS.—The amendments made by this section shall not apply to any property described in section 208(d)(3)(E) of the Tax Equity and Fiscal Responsibility Act of 1982.

(7) CERTAIN FACILITIES FOR WHICH RULING REQUESTS FILED ON OR BEFORE MAY 23, 1983.—The amendments made by this section shall not apply with respect to any facilities described in clause (ii) of section 168(f)(12)(C) of the Internal Revenue Code of 1954 (relating to certain sewage or solid waste disposal facilities), as in effect on the day before the date of the enactment of this Act, if a ruling request with respect to the lease of such facility to the tax-exempt entity was filed with the Internal Revenue Service on or before May 23, 1983.

(8) RECOVERY PERIOD FOR CERTAIN QUALIFIED SEWAGE FACILITIES.—

(A) IN GENERAL.—In the case of any property (other than 15-year real property) which is part of a qualified sewage facility, the recovery period used for purposes of paragraph (1) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section) shall be 12 years.

(B) QUALIFIED SEWAGE FACILITY.—For purposes of subparagraph (A), the term "qualified sewage facility" means any facility which is part of the sewer system of a city, if—

(i) on June 15, 1983, the City Council approved a resolution under which the city authorized the procurement of equity investments for such facility, and

(ii) on July 12, 1983, the Industrial Development Board of the city approved a resolution to issue a $100,000,000 industrial development bond issue to provide funds to purchase such facility.

(9) PROPERTY USED BY THE POSTAL SERVICE.—In the case of property used by the United States Postal Service, paragraphs (1) and (2) shall be applied by substituting "October 31" for "May 23".

(10) EXISTING APPROPRIATIONS.—The amendments made by this section shall not apply to personal property leased to or used by the United States if—

(A) an express appropriation has been made for rentals under such lease for the fiscal year 1983 before May 23, 1983, and

(B) the United States or an agency or instrumentality thereof has not provided an indemnification against the loss of all or a portion of the tax benefits claimed under the lease or service contract.

(11) SPECIAL RULE FOR CERTAIN PARTNERSHIPS.—

(A) PARTNERSHIPS FOR WHICH QUALIFYING ACTION EXISTED BEFORE OCTOBER 21, 1983.—Paragraph (9) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section) shall not apply to any property acquired, directly or indirectly, before January 1, 1985, by any partnership described in subparagraph (B).

(B) APPLICATION FILED BEFORE OCTOBER 21, 1983.—A partnership is described in this subparagraph if—

(i) before October 21, 1983, the partnership was organized, a request for exemption with respect to such partnership was filed with the Department of Labor, and a private placement memorandum stating the maximum of units in the partnership that would be offered had been circulated,

(ii) the interest in the property to be acquired, directly or indirectly (including through acquiring an interest in another partnership) by such partnership was described in such private placement memorandum, and

(iii) the marketing of partnership units in such partnership is completed not later than two years after the later of the date of the enactment of this Act or the date of publication in the Federal Register of such exemption by the Department of Labor and the aggregate number of units in such partnership sold does not exceed the amount described in clause (i).

(C) PARTNERSHIPS FOR WHICH QUALIFYING ACTION EXISTED BEFORE MARCH 6, 1984.—Paragraph (9) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section) shall not apply to any property acquired directly or indirectly, before January 1, 1986, by any partnership described in subparagraph (D). For purposes of this subparagraph, property shall be deemed to have been acquired prior to January 1, 1986, if the partnership had entered into a written binding contract to acquire such property prior to January 1, 1986 and the closing of such contract takes place within 6 months of the date of such contract (24 months in the case of new construction).

(D) PARTNERSHIP ORGANIZED BEFORE MARCH 6, 1984.—A partnership is described in this subparagraph if—

(i) before March 6, 1984, the partnership was organized and publicly announced the maximum amount (as shown in the registration statement, prospectus or partnership agreement, whichever is greater) of interests which would be sold in the partnership, and

(ii) the marketing or partnership interests in such partnership was completed not later than the 90th day after the date of the enact-

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc. (984)

ment of this Act and the aggregate amount of interest in such partnership sold does not exceed the maximum amount described in clause (i).

(12) SPECIAL RULE FOR AMENDMENT MADE BY SUBSECTION (C)(2).—The amendment made by subsection (c)(2) to the extent it relates to subsection (f)(12) of section 168 of the Internal Revenue Code of 1954 shall take effect as if it had been included in the amendments made by section 216(a) of the Tax Equity and Fiscal Responsibility Act of 1982.

(13) SPECIAL RULE FOR SERVICE CONTRACTS NOT INVOLVING TAX-EXEMPT ENTITIES.—In the case of a service contract or other arrangement described in section 7701(e) of the Internal Revenue Code of 1954 (as added by this section) with respect to which no party is a tax-exempt entity, such section 7701(e) shall not apply to—

(A) such contract or other arrangement if such contract or other arrangement was entered into before November 5, 1983, or

(B) any renewal or other extension of such contract or other arrangement pursuant to an option contained in such contract or other arrangement on November 5, 1983.

(14) PROPERTY LEASED TO SECTION 593 ORGANIZATIONS.—For purposes of the amendment made by subsection (f), paragraphs (1), (2), and (4) shall be applied by substituting—

(A) "November 5, 1983" for "May 23, 1983" and "November 1, 1983", as the case may be, and

(B) "organization described in section 593 of the Internal Revenue Code of 1954" for "tax-exempt entity".

(15) SPECIAL RULES RELATING TO FOREIGN PERSONS OR ENTITIES—

(A) IN GENERAL.—In the case of tax-exempt use property which is used by a foreign person or entity, the amendments made by this section shall not apply to any property which—

(i) is placed in service before January 1, 1984, and

(ii) is used by such foreign person or entity pursuant to a lease entered into before January 1, 1984.

(B) SPECIAL RULE FOR SUBLEASES.—If tax-exempt use property is being used by a foreign person or entity pursuant to a sublease under a lease described in subparagraph (A)(ii), subparagraph (A) shall apply to such property only if such property was used before January 1, 1984, by any foreign person or entity pursuant to such lease.

(C) BINDING CONTRACTS, ETC.—The amendments made by this section shall not apply with respect to any property (other than aircraft described in subparagraph (D)) leased to a foreign person or entity—

(i) if—

(I) on or before May 23, 1983, the taxpayer (or a predecessor in interest under the contract) or the foreign person or entity entered into a written binding contract to acquire, construct, or rehabilitate such property and such property had not previously been used by the foreign person or entity, or

(II) the taxpayer or the foreign person or entity acquired the property or completed the construction, reconstruction, or rehabilitation of the property after December 31, 1982 and on or before May 23, 1983, and

(ii) if such lease is pursuant to a written binding contract entered into before January 1, 1984, which requires the foreign person or entity to be the lessee of such property.

(D) CERTAIN AIRCRAFT.—The amendments made by this section shall not apply with respect to any wide-body, four-engine, commercial passenger aircraft used by a foreign person or entity if—

(i) on or before November 1, 1983, the foreign person or entity entered into a written binding contract to acquire such aircraft, and

(ii) such aircraft is placed in service before January 1, 1986.

(E) USE AFTER 1983.—Qualified container equipment placed in service before January 1, 1984, which is used before such date by a foreign person shall not, for purposes of section 47 of the Internal Revenue Code of 1954, be treated as ceasing to be section 38 property by reason of the use of such equipment before January 1, 1985, by a foreign person or entity. For purposes of this subparagraph, the term "qualified container equipment" means any container, container chassis, or container trailer of a United States person with a present class life of not more than 6 years.

(16) ORGANIZATIONS ELECTING EXEMPTION FROM RULES RELATING TO PREVIOUSLY TAX-EXEMPT ORGANIZATIONS MUST ELECT TAXATION OF EXEMPT ARBITRAGE PROFITS.—

(A) IN GENERAL.—An organization may make the election under section 168(j)(4)(E)(ii) of the Internal Revenue Code of 1954 (relating to election not to have rules relating to previously tax-exempt organizations apply) only if such organization elects the tax treatment of exempt arbitrage profits described in subparagraph (B).

(B) TAXATION OF EXEMPT ARBITRAGE PROFITS.—

(i) IN GENERAL.—In the case of an organization which elects the application of this subparagraph, there is hereby imposed a tax on the exempt arbitrage profits of such organization.

(ii) RATE OF TAX, ETC.—The tax imposed by clause (i)—

(I) shall be the amount of tax which would be imposed by section 11 of such Code if the exempt arbitrage profits were taxable income (and there were no other taxable income), and

(II) shall be imposed for the first taxable year of the tax-exempt use period (as defined in section 168(j)(4)(E)(ii) of such Code).

(C) EXEMPT ARBITRAGE PROFITS.—

(i) IN GENERAL.—For purposes of this paragraph, the term exempt arbitrage profits means the aggregate amount described in clauses (i) and (ii) of subparagraph (D) of section 103(c)(6) of such Code for all taxable years for which the organization was exempt from tax under section 501(a) of such Code with respect to obligations—

(I) associated with property described in section 168(j)(4)(E)(i)(I), and

(II) issued before January 1, 1985.

(ii) APPLICATION OF SECTION 103(b)(6).—For purposes of this paragraph, section 103(b)(6) of such Code shall apply to obligations issued before January 1, 1985, but the amount described in clauses (i) and (ii) of subparagraph (D) thereof shall be determined without regard to clauses (i)(II) and (ii) of subparagraph (F) thereof.

(D) OTHER LAWS APPLICABLE.—

(i) IN GENERAL.—Except as provided in clause (ii), all provisions of law, including penalties, applicable with respect to the tax imposed by section 11 of such Code shall apply with respect to the tax imposed by this paragraph.

(ii) NO CREDITS AGAINST TAX, ETC.—The tax imposed by this paragraph shall not be treated as imposed by section 11 of such Code for purposes of—

(I) part VI of subchapter A of chapter 1 of such Code (relating to minimum tax for tax preferences), and

(II) determining the amount of any credit allowable under subpart A of part IV of such subchapter.

(E) ELECTION.—Any election under subparagraph (A)—

(i) shall be made at such time and in such manner as the Secretary may prescribe,

(ii) shall apply to any successor organization which is engaged in substantially similar activities, and

(iii) once made, shall be irrevocable.

(17) CERTAIN TRANSITIONAL LEASED PROPERTY.—The amendments made by this section shall not apply to property described in section 168(c)(1)(D) of the Internal Revenue Code of 1954, as in effect on the day before the date of the enactment of this Act, and which is described in any of the following subparagraphs:

(A) Property is described in this subparagraph if such property is leased to a university, and—

(i) on June 16, 1983, the Board of Administrators of the university adopted a resolution approving the rehabilitation of the property in connection with an overall campus development program; and

(ii) the property houses a basketball arena and university offices.

(B) Property is described in this subparagraph if such property is leased to a charitable organization, and—

(i) on August 21, 1981, the charitable organization acquired the property, with a view towards rehabilitating the property; and

(ii) on June 12, 1982, an arson fire caused substantial damage to the property, delaying the planned rehabilitation.

(C) Property is described in this subparagraph if such property is leased to a corporation that is described in section 501(c)(3) of the Internal Revenue Code of 1954 (relating to organizations exempt from tax) pursuant to a contract—

(i) which was entered into on August 3, 1983; and

(ii) under which the corporation first occupied the property on December 22, 1983.

(D) Property is described in this subparagraph if such property is leased to an educational institution for use as an Arts and Humanities Center and with respect to which—

(i) in November 1982, an architect was engaged to design a planned renovation;

(ii) in January 1983, the architectural plans were completed;

(iii) in December 1983, a demolition contract was entered into; and

(iv) in March 1984, a renovation contract was entered into.

(E) Property is described in this subparagraph if such property is used by a college as a dormitory, and—

(i) in October 1981, the college purchased the property with a view towards renovating the property;

(ii) renovation plans were delayed because of a zoning dispute; and

(iii) in May 1983, the court of highest jurisdiction in the State in which the college is located resolved the zoning dispute in favor of the college.

(F) Property is described in this subparagraph if such property is a fraternity house related to a university with respect to which—

(i) In August 1982, the university retained attorneys to advise the university regarding the rehabilitation of the property;

(ii) on January 21, 1983, the governing body of the university established a committee to develop rehabilitation plans;

(iii) On January 10, 1984, the governor of the state in which the university is located approved historic district designation for an area that includes the property; and

(iv) On February 2, 1984, historic preservation certification applications for the property were filed with a historic landmarks commission.

(G) Property is described in this subparagraph if such property is leased to a retirement community with respect to which—

(i) on January 5, 1977, a certificate of incorporation was filed with the appropriate authority of the State in which the retirement community is located; and

(ii) On November 22, 1983, the Board of Trustees adopted a resolution evidencing the intention to begin immediate construction of the property.

(H) Property is described in this subparagraph if such property is used by a university, and—

(i) in July 1982, the Board of Trustees of the university adopted a master plan for the financing of the property; and

(ii) as of August 1, 1983, at least $60,000 in private expenditures had been expended in connection with the property.

(I) Property is described in this subparagraph if such property is used by a university as a fine arts center and the Board of Trustees of such university authorized the sale-leaseback agreement with respect to such property on March 7, 1984.

(J) Property is described in this subparagraph if such property is used by a tax-exempt entity as an international trade center, and

(i) prior to 1982, an environmental impact study for such property was completed;

(ii) on June 24, 1981, a developer made a commitment to provide one-third of the financing for the development of such property; and

(iii) on October 20, 1983, such developer was approved by the Board of Directors of the tax-exempt entity.

(K) Property is described in this subparagraph if such property is used by university of osteopathic medicine and health sciences, and on or before December 31, 1983, the Board of Trustees of such university approved the construction of such property.

(L) Property is described in this subparagraph if such property is used by a tax-exempt entity, and—

(i) such use is pursuant to a lease with a taxpayer which placed substantial improvements in service;

(ii) on May 23, 1983, there existed architectural plans and specifications (within the meaning of sec. 48(g)(1)(C)(ii) of the Internal Revenue Code) in existence; and

(iii) prior to May 23, 1983, at least 10 percent of the total cost of such improvements was actually paid or incurred.

(M) property is described in this subparagraph if such property is used as a convention center, on June 2, 1983, the City Council of the city in which the center is located provided for over $6 million for the project.

(18) SPECIAL RULE FOR AMENDMENT MADE BY SUBSECTION (C) (1).—

(A) IN GENERAL.—The amendment made by subsection (c)(1) shall not apply to property—

(i) leased by the taxpayer on or before November 1, 1983, or

(ii) leased by the taxpayer after November 1, 1983, if on or before such date the taxpayer entered into a written binding contract requiring the taxpayer to lease such property.

(B) LIMITATION.—Subparagraph (A) shall apply to the amendment made by subsection (c)(1) only to the extent such amendment relates to property described in subclause (II), (III), or (IV) of section 168(j)(3)(B)(ii) of the Internal Revenue Code of 1954 (as added by this section).

(19) SPECIAL RULE FOR CERTAIN ENERGY MANAGEMENT CONTRACTS.—

• (A) IN GENERAL.—The amendments made by subsection (e) shall not apply to property used pursuant to an energy management contract that was entered into prior to May 1, 1984.

(B) Definition of energy management contract.—For purposes of subparagraph (A), the term "energy management contract" means a contract for the providing of energy conservation or energy management services.

(20) DEFINITIONS.—For purposes of this subsection—

(A) TAX-EXEMPT ENTITY.—The term "tax-exempt entity" has the same meaning as when used in section 168(j) of the Internal Revenue Code of 1954 (as added by this section), except that such term shall include any related entity (within the meaning of such section).

(B) TREATMENT OF IMPROVEMENTS.—

(i) IN GENERAL.—For purposes of this subsection, an improvement to property shall not be treated as a separate property unless such improvement is a substantial improvement with respect to such property.

(ii) SUBSTANTIAL IMPROVEMENT.—For purposes of clause (i), the term "substantial improvement" has the meaning given such term by section 168(f)(1)(C) of such Code determined—

(I) by substituting "20 percent" for "25 percent" in clause (ii) thereof, and

(II) without regard to clause (iii) thereof.

(C) FOREIGN PERSON OR ENTITY.—The term "foreign person or entity" has the meaning given to such term by subparagraph (C) of section 168(j)(4) of such Code (as added by this section). For purposes of this subparagraph and subparagraph (A), such subparagraph (C) shall be applied without regard to the last sentence thereof.

(D) LEASES AND SUBLEASES.—The determination of whether there is a lease or sublease shall take into account sections 168(j)(6)(A) and 7701(e) of the Internal Revenue Code of 1954 (as added by this section).

SEC. 22. MOTOR VEHICLES OPERATING LEASES.

(a) IN GENERAL.—Section 168(f) (relating to special rules) is amended by adding at the end thereof the following new paragraph:

"(13) MOTOR VEHICLE OPERATING LEASES.—

"(A) IN GENERAL.—For purposes of this title, in the case of a qualified motor vehicle operating agreement which contains a terminal rental adjustment clause—

"(i) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and

"(ii) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect.

"(B) QUALIFIED MOTOR VEHICLE OPERATING AGREEMENT.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'qualified motor vehicle operating agreement' means any agreeement with respect to a motor vehicle (including a trailer) which meets the requirements of clauses (ii), (iii), and (iv) of this subparagraph.

"(ii) MINIMUM LIABILITY OF LESSOR.—An agreement meets the requirements of this clause if under such agreement the sum of—

"(I) the amount the lessor is personally liable to repay, and

"(II) the net fair market value of the lessor's interest in any property subject to the agreement,

equals or exceeds all amounts borrowed to finance the acquisition of property subject to the agreement. There shall not be taken into account under subclause (II) any property pledged which is property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement.

"(iii) CERTIFICATION BY LESSEE; NOTICE OF TAX OWNERSHIP.—An agreement meets the requirements of this clause if such agreement contains a separate written statement separately signed by the lessee—

"(I) under which the lessee certifies, under penalty of perjury, that it intends that more than 50 percent of the use of the property subject to such agreement is to be in a trade or business of the lessee, and

"(II) which clearly and legibly states that the lessee has been advised that it will not be treated as the owner of the property subject to the agreement for Federal income tax purposes.

"(iv) LESSOR MUST HAVE NO KNOWLEDGE THAT CERTIFICATION FALSE.—An agreement meets the requirements of this clause if the lessor does not know that the certification described in clause (iii)(I) is false.

"(C) TERMINAL RENTAL ADJUSTMENT CLAUSE DEFINED.—

"(i) IN GENERAL.—For purposes of this paragraph, the term 'terminal rental adjustment clause' means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

"(ii) SPECIAL RULE FOR LESSEE DEALERS.—The term 'terminal rental adjustment clause' also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provison achieves substantially the same results as a provision described in clause (i)."

(b) TERMINATION OF SECTION 210.—Section 210(a) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by inserting "entered into on or before the 90th day after the date of the enactment of the Tax Reform Act of 1984" after "agreement" the first place it appears.

(c) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to agreements described in section 168(f)(13) of the Internal Revenue Code of 1954 (as added by subsection (a)) entered into more than 90 days after the date of the enactment of this Act.

Subtitle C—Treatment of Bonds and Other Debt Instruments

SEC. 41. TREATMENT OF BONDS AND OTHER DEBT INSTRUMENTS.

(a) GENERAL RULE.—Subchapter P of chapter 1 (relating to special rules for capital gains and losses) is amended by adding at the end thereof the following new part:

"PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

"Subpart A. Original issue discount.

"Subpart B. Market discount.

"Subpart C. Discount on short-term obligations.

"Subpart D. Miscellaneous provisions.

"Subpart A—Original Issue Discount

"Sec. 1271. Treatment of amounts received on retirement or sale or exchange of debt instruments.

"Sec. 1272. Current inclusion in income of original issue discount.

"Sec. 1273. Determination of amount of original issue discount.

"Sec. 1274. Determination of issue price in the case of certain debt instruments issued for property.

"Sec. 1275. Other definitions and special rules.

"SEC. 1271. TREATMENT OF AMOUNTS RECEIVED ON RETIREMENT OR SALE OR EXCHANGE OF DEBT INSTRUMENTS.

"(a) GENERAL RULE.—For purposes of this title—

"(1) RETIREMENT.—Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor.

"(2) ORDINARY INCOME ON SALE OR EXCHANGE WHERE INTENTION TO CALL BEFORE MATURITY.—

"(A) IN GENERAL.—If at the time of original issue there was an intention to call a debt

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instrument before maturity, any gain realized on the sale or exchange thereof which does not exceed an amount equal to—

"(i) the original issue discount, reduced by

"(ii) the portion of original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(6) or (b)(4) of section 1272 (or the corresponding provisions of prior law)),

shall be treated as ordinary income.

"(B) EXCEPTIONS.—This paragraph (and paragraph (2) of subsection (c)) shall not apply to—

"(i) any tax-exempt obligation, or

"(ii) any holder who has purchased the debt instrument at a premium.

"(3) CERTAIN SHORT-TERM GOVERNMENT OBLIGATIONS.—

"(A) IN GENERAL.—On the sale or exchange of any short-term Government obligation, any gain realized which does not exceed an amount equal to the ratable share of the acquisition discount shall be treated as ordinary income.

"(B) SHORT-TERM GOVERNMENT OBLIGATION.—For purposes of this paragraph, the term 'short-term Government obligation' means any obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia which is—

"(i) issued on a discount basis, and

"(ii) payable without interest at a fixed maturity date not more than 1 year from the date of issue.

Such term does not include any tax-exempt obligation.

"(C) ACQUISITION DISCOUNT.—For purposes of this paragraph, the term 'acquisition discount' means the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation.

"(D) RATABLE SHARE.—For purposes of this paragraph, the ratable share of the acquisition discount is an amount which bears the same ratio to such discount as—

"(i) the number of days which the taxpayer held the obligation, bears to

"(ii) the number of days after the date the taxpayer acquired the obligation and up to (and including) the date of its maturity.

"(b) EXCEPTIONS.—This section shall not apply to—

"(1) NATURAL PERSONS.—Any obligation issued by a natural person.

"(2) OBLIGATIONS ISSUED BEFORE JULY 2, 1982, BY CERTAIN ISSUERS.—Any obligation issued before July 2, 1982, by an issuer which—

"(A) is not a corporation, and

"(B) is not a government or political subdivision thereof.

"(c) TRANSITION RULES.—

"(1) SPECIAL RULE FOR CERTAIN OBLIGATIONS ISSUED BEFORE JANUARY 1, 1955.—Paragraph (1) of subsection (a) shall apply to a debt instrument issued before January 1, 1955, only if such instrument was issued with interest coupons or in registered form, or was in such form on March 1, 1954.

"(2) SPECIAL RULE FOR CERTAIN OBLIGATIONS WITH RESPECT TO WHICH ORIGINAL ISSUE DISCOUNT NOT CURRENTLY INCLUDIBLE.—

"(A) IN GENERAL.—On the sale or exchange of debt instruments issued by a government or political subdivision thereof after December 31, 1954, and before July 2, 1982, or by a corporation after December 31, 1954, and on or before May 27, 1969, any gain realized which does not exceed—

"(i) an amount equal to the original issue discount, or

"(ii) if at the time of original issue there was no intention to call the debt instrument before maturity, an amount which bears the same ratio to the original issue discount as the number of complete months that the debt instrument was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as ordinary income.

"(B) SUBSECTION (a)(2)(A) NOT TO APPLY.—Subsection (a)(2)(A) shall not apply to any debt instrument referred to in subparagraph (A) of this paragraph.

"(C) CROSS REFERENCE.—

"For current inclusion of original issue discount, see section 1272.

"(d) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—This section and sections 1272 and 1286 shall not require the inclusion of any amount previously includible in gross income.

"SEC. 1272. CURRENT INCLUSION IN INCOME OF ORIGINAL ISSUE DISCOUNT.

"(a) ORIGINAL ISSUE DISCOUNT ON DEBT INSTRUMENTS ISSUED AFTER JULY 1, 1982, INCLUDED IN INCOME ON BASIS OF CONSTANT INTEREST RATE.—

"(1) GENERAL RULE.—For purposes of this title, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

"(2) EXCEPTIONS.—Paragraph (1) shall not apply to—

"(A) TAX-EXEMPT OBLIGATIONS.—Any tax-exempt obligation.

"(B) UNITED STATES SAVINGS BONDS.—Any United States savings bond.

"(C) SHORT-TERM OBLIGATIONS.—Any debt instrument which has a fixed maturity date not more than 1 year from the date of issue.

"(D) OBLIGATIONS ISSUED BY NATURAL PERSONS BEFORE MARCH 2, 1984.—Any obligation issued by a natural person before March 2, 1984.

"(E) LOANS BETWEEN NATURAL PERSONS.—

"(i) IN GENERAL.—Any loan made by a natural person to another natural person if—

"(I) such loan is not made in the course of a trade or business of the lender, and

"(II) the amount of such loan (when increased by the outstanding amount of prior loans by such natural person to such other natural person) does not exceed $10,000.

"(ii) CLAUSE (i) NOT TO APPLY WHERE TAX AVOIDANCE A PRINCIPAL PURPOSE.—Clause (i) shall not apply if the loan has as 1 of its principal purposes the avoidance of any Federal tax.

"(iii) TREATMENT OF HUSBAND AND WIFE.—For purposes of this subparagraph, a husband and wife shall be treated as 1 person. The preceding sentence shall not apply where the spouses lived apart at all times during the taxable year in which the loan is made.

"(3) DETERMINATION OF DAILY PORTIONS.—For purposes of paragraph (1), the daily portion of the original issue discount on any debt instrument shall be determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument. For purposes of the preceding sentence, the increase in the adjusted issue price for any accrual period shall be an amount equal to the excess (if any) of—

"(A) the product of—

"(i) the adjusted issue price of the debt instrument at the beginning of such accrual period, and

"(ii) the yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), over

"(B) the sum of the amounts payable as interest on such debt instrument during such accrual period.

"(4) ADJUSTED ISSUE PRICE.—For purposes of this subsection, the adjusted issue price of any debt instrument at the beginning of any accrual period is the sum of—

"(A) the issue price of such debt instrument, plus

"(B) the adjustments under this subsection to such issue price for all periods before the first day of such accrual period.

"(5) ACCRUAL PERIOD.—Except as otherwise provided in regulations prescribed by the Secretary, the term 'accrual period' means a 6-month period (or shorter period from the date of original issue of the debt instrument) which ends on a day in the calendar year corresponding to the maturity date of the debt instrument or the date 6 months before such maturity date.

"(6) REDUCTION WHERE SUBSEQUENT HOLDER PAYS ACQUISITION PREMIUM.—

"(A) REDUCTION.—For purposes of this subsection, in the case of any purchase after its original issue of a debt instrument to which this subsection applies, the daily portion for any day shall be reduced by an amount equal to the amount which would be the daily portion for such day (without regard to this paragraph) multiplied by the fraction determined under subparagraph (B).

"(B) DETERMINATION OF FRACTION.—For purposes of subparagraph (A), the fraction determined under this subparagraph is a fraction—

"(i) the numerator of which is the excess (if any) of—

"(I) the cost of such debt instrument incurred by the purchaser, over

"(II) the issue price of such debt instrument, increased by the portion of original issue discount previously includible in the gross income of any holder (computed without regard to this paragraph), and

"(ii) the denominator of which is the sum of the daily portions for such debt instrument for all days after the date of such purchase and ending on the stated maturity date (computed without regard to this paragraph).

"(b) RATABLE INCLUSION RETAINED FOR CORPORATE DEBT INSTRUMENTS ISSUED BEFORE JULY 2, 1982.—

"(1) GENERAL RULE.—There shall be included in the gross income of the holder of any debt instrument issued by a corporation after May 27, 1969, and before July 2, 1982—

"(A) the ratable monthly portion of original issue discount, multiplied by

"(B) the number of complete months (plus any fractional part of a month determined under paragraph (3)) such holder held such debt instrument during the taxable year.

"(2) DETERMINATION OF RATABLE MONTHLY PORTION.—Except as provided in paragraph (4), the ratable monthly portion of original issue discount shall equal—

"(A) the original issue discount, divided by

"(B) the number of complete months from the date of original issue to the stated maturity date of the debt instrument.

"(3) MONTH DEFINED.—For purposes of this subsection—

"(A) COMPLETE MONTH.—A complete month commences with the date of original issue and the corresponding day of each succeeding calendar month (or the last day of a calendar month in which there is no corresponding day).

"(B) TRANSFERS DURING MONTH.—In any case where a debt instrument is acquired on any day other than a day determined under subparagraph (A), the ratable monthly portion of original issue discount for the complete month (or partial month) in which such acquisition occurs shall be allocated between the transferor and the transferee in accordance with the number of days in such

complete (or partial) month each held the debt instrument.

"(4) REDUCTION WHERE SUBSEQUENT HOLDER PAYS ACQUISITION PREMIUM.—

"(A) REDUCTION.—For purposes of this subsection, the ratable monthly portion of original issue discount shall not include its share of the acquisition premium.

"(B) SHARE OF ACQUISITION PREMIUM.—For purposes of subparagraph (A), any month's share of the acquisition premium is an amount (determined at the time of the purchase) equal to—

"(i) the excess of—

"(I) the cost of such debt instrument incurred by the holder, over

"(II) the issue price of such debt instrument, increased by the portion of original issue discount previously includible in the gross income of any holder (computed without regard to this paragraph),

"(ii) divided by the number of complete months (plus any fractional part of a month) from the date of such purchase to the stated maturity date of such debt instrument.

"(c) EXCEPTIONS.—This section shall not apply to any holder—

"(1) who has purchased the debt instrument at a premium, or

"(2) which is a life insurance company to which section 811(b) applies.

"(d) DEFINITION AND SPECIAL RULE.—

"(1) PURCHASE DEFINED.—For purposes of this section, the term 'purchase' means—

"(A) any acquisition of a debt instrument, where

"(B) the basis of the debt instrument is not determined in whole or in part by reference to the adjusted basis of such debt instrument in the hands of the person from whom acquired.

"(2) BASIS ADJUSTMENT.—The basis of any debt instrument in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to this section.

"SEC. 1273. DETERMINATION OF AMOUNT OF ORIGINAL ISSUE DISCOUNT.

"(a) GENERAL RULE.—For purposes of this subpart—

"(1) IN GENERAL.—The term 'original issue discount' means the excess (if any) of—

"(A) the stated redemption price at maturity, over

"(B) the issue price.

"(2) STATED REDEMPTION PRICE AT MATURITY.—The term 'stated redemption price at maturity' means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

"(3) ¼ OF 1 PERCENT DE MINIMIS RULE.—If the original issue discount determined under paragraph (1) is less than—

"(A) ¼ of 1 percent of the stated redemption price at maturity, multiplied by

"(B) the number of complete years to maturity,

then the original issue discount shall be treated as zero.

"(b) ISSUE PRICE.—For purposes of this subpart—

"(1) PUBLICLY OFFERED DEBT INSTRUMENTS NOT ISSUED FOR PROPERTY.—In the case of any issue of debt instruments—

"(A) publicly offered, and

"(B) not issued for property,

the issue price is the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments was sold.

"(2) OTHER DEBT INSTRUMENTS NOT ISSUED FOR PROPERTY.—In the case of any issue of debt instruments not issued for property and not publicly offered, the issue price of each such instrument is the price paid by the first buyer of such debt instrument.

"(3) DEBT INSTRUMENTS ISSUED FOR PROPERTY WHERE THERE IS PUBLIC TRADING.—In the case of a debt instrument which is issued for property and which—

"(A) is part of an issue a portion of which is traded on an established securities market, or

"(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such debt instrument shall be the fair market value of such property.

"(4) OTHER CASES.—Except in any case—

"(A) to which paragraph (1), (2), or (3) of this subsection applies, or

"(B) to which section 1274 applies,

the issue price of a debt instrument which is issued for property shall be the stated redemption price at maturity.

"(5) PROPERTY.—In applying this subsection, the term 'property' includes services and the right to use property, but such term does not include money.

"(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).—For purposes of subsection (b)—

"(1) INITIAL OFFERING PRICE; PRICE PAID BY THE FIRST BUYER.—The terms 'initial offering price' and 'price paid by the first buyer' include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

"(2) TREATMENT OF INVESTMENT UNITS.—In the case of any debt instrument and an option, security, or other property issued together as an investment unit—

"(A) the issue price for such unit shall be determined in accordance with the rules of this subsection and subsection (b) as if it were a debt instrument,

"(B) the issue price determined for such unit shall be allocated to each element of such unit on the basis of the relationship of the fair market value of such element to the fair market value of all elements in such unit, and

"(C) the issue price of any debt instrument included in such unit shall be the portion of the issue price of the unit allocated to the debt instrument under subparagraph (B).

"SEC. 1274. DETERMINATION OF ISSUE PRICE IN THE CASE OF CERTAIN DEBT INSTRUMENTS ISSUED FOR PROPERTY.

"(a) IN GENERAL.—In the case of any debt instrument to which this section applies, for purposes of this subpart, the issue price shall be—

"(1) where there is adequate stated interest, the stated principal amount, or

"(2) in any other case, the imputed principal amount.

"(b) IMPUTED PRINCIPAL AMOUNT.—For purposes of this section—

"(1) IN GENERAL.—Except as provided in paragraph (3), the imputed principal amount of any debt instrument shall be equal to the sum of the present values of all payments due under such debt instrument.

"(2) DETERMINATION OF PRESENT VALUE.—For purposes of paragraph (1), the present value of a payment shall be determined in the manner provided by regulations prescribed by the Secretary—

"(A) as of the date of the sale or exchange, and

"(B) by using a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually.

"(3) FAIR MARKET VALUE RULE IN POTENTIALLY ABUSIVE SITUATIONS.—

"(A) IN GENERAL.—In the case of any potentially abusive situation, the imputed principal amount of any debt instrument received in exchange for property shall be the fair market value of such property adjusted to take into account other consideration involved in the transaction.

"(B) POTENTIALLY ABUSIVE SITUATION DEFINED.—For purposes of subparagraph (A), the term 'potentially abusive situation' means—

"(i) a tax shelter (as defined in section 6661(b)(2)(C)(ii)), and

"(ii) any other situation which, by reason of—

"(I) recent sales transactions,

"(II) nonrecourse financing,

"(III) financing with a term in excess of the economic life of the property, or

"(IV) other circumstances,

is of a type which the Secretary specifies by regulations as having potential for tax avoidance.

"(c) DEBT INSTRUMENTS TO WHICH SECTION APPLIES.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, this section shall apply to any debt instrument given in consideration for the sale or exchange of property if—

"(A) the stated redemption price at maturity for such debt instrument exceeds—

"(i) where there is adequate stated interest, the stated principal amount, or

"(ii) in any other case, the testing amount, and

"(B) some or all of the payments due under such debt instrument are due more than 6 months after the date of such sale or exchange.

"(2) ADEQUATE STATED INTEREST.—For purposes of this section, there is adequate stated interest with respect to any debt instrument if the stated principal amount for such debt instrument is less than the testing amount.

"(3) TESTING AMOUNT.—For purposes of this section, the term 'testing amount' means, with respect to any debt instrument, the imputed principal amount of such debt instrument which would be determined under subsection (b) (including paragraph (3) thereof) if a discount rate equal to 110 percent of the applicable Federal rate were used.

"(2) EXCEPTIONS.—This section shall not apply to—

"(A) SALES FOR LESS THAN $1,000,000 OF FARMS BY INDIVIDUALS OR SMALL BUSINESSES.—

"(i) IN GENERAL.—Any debt instrument arising from the sale or exchange of a farm (within the meaning of section 6420(c)(2))—

"(I) by an individual, estate, or testamentary trust,

"(II) by a corporation which as of the date of the sale or exchange is a small business corporation (as defined in section 1244(c)(3)), or

"(III) by a partnership which as of the date of the sale or exchange meets requirements similar to those of section 1244(c)(3),

"(ii) $1,000,000 LIMITATION.—Clause (i) shall apply only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $1,000,000. For purposes of the preceding sentence, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

"(B) SALES OF PRINCIPAL RESIDENCES.—Any debt instrument arising from the sale or exchange by an individual of his principal residence (within the meaning of section 1034).

"(C) SALES INVOLVING TOTAL PAYMENTS OF $250,000 OR LESS.—

"(i) IN GENERAL.—Any debt instrument arising from the sale or exchange of property if the sum of the following amounts does not exceed $250,000:

"(I) the aggregate amount of the payments due under such debt instrument and all other debt instruments received as consideration for the sale or exchange, and

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"(II) the aggregate amount of any other consideration to be received for the sale or exchange.

"(ii) CONSIDERATION OTHER THAN DEBT INSTRUMENT TAKEN INTO ACCOUNT AT FAIR MARKET VALUE.—For purposes of clause (i), any consideration (other than a debt instrument) shall be taken into account at its fair market value.

"(iii) AGGREGATION OF TRANSACTIONS.—For purposes of this subparagraph, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

"(D) DEBT INSTRUMENTS WHICH ARE PUBLICLY TRADED OR ISSUED FOR PUBLICLY TRADED PROPERTY.—Any debt instrument to which section 1273(b)(3) applies.

"(E) CERTAIN SALES OF PATENTS.—In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), any amount contingent on the productivity, use, or disposition of the property transferred.

"(F) SALES OR EXCHANGES TO WHICH SECTION 483(e) APPLIES.—Any debt instrument to the extent section 483(e) (relating to certain land transfers between related persons) applies to such instrument.

"(d) DETERMINATION OF APPLICABLE FEDERAL RATE.—For purposes of this section—

"(1) APPLICABLE FEDERAL RATE.—

"(A) IN GENERAL.—

"In the case of a debt instrument with a term of:	The applicable Federal rate is:
Not over 3 years	The Federal short-term rate.
Over 3 years but not over 9 years.	The Federal mid-term rate.
Over 9 years	The Federal long-term rate.

"(B) DETERMINATION OF RATES.—Within 15 days after the close of—

"(i) the 6-month period ending on September 30 of any calendar year, or

"(ii) the 6-month period ending on March 31 of any calendar year,

the Secretary shall determine the Federal short-term rate, mid-term rate, and long-term rate for such 6-month period.

"(C) EFFECTIVE DATE OF DETERMINATION.—Any Federal rate determined under subparagraph (A) shall—

"(i) apply during the 6-month period beginning on January 1 of the succeeding calendar year in the case of a determination made under subparagraph (B)(i), and

"(ii) apply during the 6-month period beginning on July 1 of the calendar year in the case of a determination made under subparagraph (B)(ii).

"(D) FEDERAL RATE FOR ANY 6-MONTH PERIOD.—For purposes of this paragraph—

"(i) FEDERAL SHORT-TERM RATE.—The Federal short-term rate for any 6-month period shall be the rate determined by the Secretary based on the average market yield (during such 6-month period) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less.

"(ii) FEDERAL MID-TERM AND LONG-TERM RATES.—The Federal mid-term rate and long-term rate shall be determined in accordance with the principles of clause (i).

"(2) RATE APPLICABLE TO ANY SALE OR EXCHANGE.—In the case of any sale or exchange, the determination of the applicable Federal rate shall be made as of the first day on which there is a binding contract in writing for the sale or exchange.

"(3) TERM OF DEBT INSTRUMENT.—In determining the term of a debt instrument for purposes of this subsection, under regulations prescribed by the Secretary, there shall be taken into account options to renew or extend.

"SEC. 1275. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) DEFINITIONS.—For purposes of this subpart—

"(1) DEBT INSTRUMENT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'debt instrument' means a bond, debenture, note, or certificate or other evidence of indebtedness.

"(B) EXCEPTION FOR CERTAIN ANNUITY CONTRACTS.—The term 'debt instrument' shall not include any annuity contract to which section 72 applies and which—

"(i) depends (in whole or in substantial part) on the life expectancy of 1 or more individuals, or

"(ii) is issued by an insurance company subject to tax under subchapter L—

"(I) in a transaction in which there is no consideration other than cash or another annuity contract meeting the requirements of this clause,

"(II) pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party under such contract, or

"(III) in a transaction involving a qualified pension or employee benefit plan.

"(2) ISSUE DATE.—

"(A) PUBLICLY OFFERED DEBT INSTRUMENTS.—In the case of any debt instrument which is publicly offered, the term 'date of original issue' means the date on which the issue was first issued to the public.

"(B) ISSUES NOT PUBLICLY OFFERED AND NOT ISSUED FOR PROPERTY.—In the case of any debt instrument to which section 1273(b)(2) applies, the term 'date of original issue' means the date on which the debt instrument was sold by the issuer.

"(C) OTHER DEBT INSTRUMENTS.—In the case of any debt instrument not described in subparagraph (A) or (B), the term 'date of original issue' means the date on which the debt instrument was issued in a sale or exchange.

"(3) TAX-EXEMPT OBLIGATION.—The term 'tax-exempt obligation' means any obligation if—

"(A) the interest on such obligation is not includible in gross income under section 103, or

"(B) the interest on such obligation is exempt from tax (without regard to the identity of the holder) under any other provision of law.

"(4) SPECIAL RULE FOR DETERMINATION OF ISSUE PRICE IN CASE OF EXCHANGE OF DEBT INSTRUMENTS IN REORGANIZATIONS.—

"(A) IN GENERAL.—If—

"(i) any debt instrument is issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) for another debt instrument (hereinafter in this paragraph referred to as the 'old debt instrument'), and

"(ii) the amount which (but for this paragraph) would be the issue price of the debt instrument so issued is less than the adjusted issue price of the old debt instrument,

then the issue price of the debt instrument so issued shall be treated as equal to the adjusted issue price of the old debt instrument.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) DEBT INSTRUMENT.—The term 'debt instrument' includes an investment unit.

"(ii) ADJUSTED ISSUE PRICE.—

"(I) IN GENERAL.—The adjusted issue price of the old debt instrument is its issue price, increased by the portion of any original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(6) or (b)(4) of section 1272 (or the corresponding provisions of prior law)).

"(II) SPECIAL RULE FOR APPLYING SECTION 163(e).—For purposes of section 163(e), the adjusted issue price of the old debt instrument is its issue price, increased by any original issue discount previously allowed as a deduction.

"(b) TREATMENT OF BORROWER IN THE CASE OF CERTAIN LOANS FOR PERSONAL USE.—

"(1) SECTIONS 1274 AND 483 NOT TO APPLY.—In the case of the obligor under any debt instrument given in consideration for the sale or exchange of property, sections 1274 and 483 shall not apply if such property is personal use property.

"(2) ORIGINAL ISSUE DISCOUNT DEDUCTED ON CASH BASIS IN CERTAIN CASES.—In the case of any debt instrument, if—

"(A) such instrument—

"(i) is incurred in connection with the acquisition or carrying of personal use property, and

"(ii) has original issue discount (determined after the application of paragraph (1)), and

"(B) the obligor under such instrument uses the cash receipts and disbursements method of accounting,

notwithstanding section 163(e), the original issue discount on such instrument shall be deductible only when paid.

"(3) PERSONAL USE PROPERTY.—For purposes of this subsection, the term 'personal use property' means any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212. The determination of whether property is described in the preceding sentence shall be made as of the time of issuance of the debt instrument.

"(c) INFORMATION REQUIREMENTS.—

"(1) INFORMATION REQUIRED TO BE SET FORTH ON INSTRUMENT.—

"(A) IN GENERAL.—In the case of any debt instrument having original issue discount, the Secretary may by regulations require that—

"(i) the amount of the original issue discount, and

"(ii) the issue date,

be set forth on such instrument.

"(B) SPECIAL RULE FOR INSTRUMENTS NOT PUBLICLY OFFERED.—In the case of any issue of debt instruments not publicly offered, the regulations prescribed under subparagraph (A) shall not require the information to be set forth on the debt instrument before any disposition of such instrument by the first buyer.

"(2) INFORMATION REQUIRED TO BE SUBMITTED TO SECRETARY.—In the case of any issue of publicly offered debt instruments having original issue discount, the issuer shall (at such time and in such manner as the Secretary shall by regulation prescribe) furnish the Secretary the following information:

"(A) The amount of the original issue discount.

"(B) The issue date.

"(C) Such other information with respect to the issue as the Secretary may by regulations require.

For purposes of the preceding sentence, any person who makes a public offering of stripped bonds (or stripped coupons) shall be treated as the issuer of a publicly offered debt instrument having original issue discount.

"(3) EXCEPTIONS.—This subsection shall not apply to any obligation referred to in section 1272(a)(2) (relating to exceptions from current inclusion of original issue discount).

"(4) CROSS REFERENCE.—

"For civil penalty for failure to meet requirements of this subsection, see section 6706.

"(d) REGULATION AUTHORITY.—The Secretary may prescribe regulations providing that where, by reason of varying rates of in-

terest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e)).

"Subpart B—Market Discount on Bonds

"Sec. 1276. Disposition gain representing accrued market discount treated as ordinary income.

"Sec. 1277. Deferral of interest deduction allocable to accrued market discount.

"Sec. 1278. Definitions and special rules.

"SEC. 1276. DISPOSITION GAIN REPRESENTING ACCRUED MARKET DISCOUNT TREATED AS ORDINARY INCOME.

"(a) ORDINARY INCOME.—

"(1) IN GENERAL.—Except as otherwise provided in this section, gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(2) DISPOSITIONS OTHER THAN SALES, ETC.—For purposes of paragraph (1), a person disposing of any market discount bond in any transaction other than a sale, exchange, or involuntary conversion shall be treated as realizing an amount equal to the fair market value of the bond.

"(3) GAIN TREATED AS INTEREST FOR CERTAIN PURPOSES.—Except for purposes of sections 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount treated as ordinary income under paragraph (1) shall be treated as interest for purposes of this title.

"(b) ACCRUED MARKET DISCOUNT.—For purposes of this section—

"(1) RATABLE ACCRUAL.—Except as otherwise provided in this subsection or subsection (c), the accrued market discount on any bond shall be an amount which bears the same ratio to the market discount on such bond as—

"(A) the number of days which the taxpayer held the bond, bears to

"(B) the number of days after the date the taxpayer acquired the bond and up to (and including) the date of its maturity.

"(2) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE (IN LIEU OF RATABLE ACCRUAL).—

"(A) IN GENERAL.—At the election of the taxpayer with respect to any bond, the accrued market discount on such bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a) with respect to such bond for all periods during which the bond was held by the taxpayer if such bond had been—

"(i) originally issued on the date on which such bond was acquired by the taxpayer,

"(ii) for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition.

"(B) COORDINATION WHERE BOND HAS ORIGINAL ISSUE DISCOUNT.—In the case of any bond having original issue discount, for purposes of applying subparagraph (A)—

"(i) the stated redemption price at maturity of such bond shall be treated as equal to its revised issue price, and

"(ii) the determination of the portion of the original issue discount which would have been includible in the gross income of the taxpayer under section 1272(a) shall be made under regulations prescribed by the Secretary.

"(C) ELECTION IRREVOCABLE.—An election under subparagraph (A), once made with respect to any bond, shall be irrevocable.

"(c) TREATMENT OF NONRECOGNITION TRANSACTIONS.—Under regulations prescribed by the Secretary—

"(1) TRANSFERRED BASIS PROPERTY.—If a market discount bond is transferred in a nonrecognition transaction and such bond is transferred basis property in the hands of the transferee, for purposes of determining the amount of the accrued market discount with respect to the transferee—

"(A) the transferee shall be treated as having acquired the bond on the date on which it was acquired by the transferor for an amount equal to the basis of the transferor, and

"(B) proper adjustments shall be made for gain recognized by the transferor on such transfer (and for any original issue discount or market discount included in the gross income of the transferor).

"(2) EXCHANGED BASIS PROPERTY.—If any market discount bond is disposed of by the taxpayer in a nonrecognition transaction and paragraph (1) does not apply to such transaction, any accrued market discount determined with respect to the property disposed of to the extent not theretofore treated as ordinary income under subsection (a)—

"(A) shall be treated as accrued market discount with respect to the exchanged basis property received by the taxpayer in such transaction if such property is a market discount bond, and

"(B) shall be treated as ordinary income on the disposition of the exchanged basis property received by the taxpayer in such exchange if such property is not a market discount bond.

"(3) PARAGRAPH (1) TO APPLY TO CERTAIN DISTRIBUTIONS BY CORPORATIONS OR PARTNERSHIPS.—For purposes of paragraph (1), if the basis of any market discount bond in the hands of a transferee is determined under section 334(c), 732(a), or 732(b), such property shall be treated as transferred basis property in the hands of such transferee.

"(d) SPECIAL RULES.—Under regulations prescribed by the Secretary—

"(1) rules similar to the rules of subsection (b) of section 1245 shall apply for purposes of this section; except that—

"(A) paragraph (1) of such subsection shall not apply, and

"(B) an exchange qualifying under section 354(a), 355(a), or 356(a) (determined without regard to subsection (a) of this section) shall be treated as an exchange described in paragraph (3) of such subsection, and

"(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

"(e) SECTION NOT TO APPLY TO MARKET DISCOUNT BONDS ISSUED ON OR BEFORE DATE OF ENACTMENT OF SECTION.—This section shall not apply to any market discount bond issued on or before the date of the enactment of this section.

"SEC. 1277. DEFERRAL OF INTEREST DEDUCTION ALLOCABLE TO ACCRUED MARKET DISCOUNT.

"(a) GENERAL RULE.—Except as otherwise provided in this section, the net direct interest expense with respect to any market discount bond shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer (as determined under the rules of section 1276(b)).

"(b) DISALLOWED DEDUCTION ALLOWED FOR LATER YEARS.—

"(1) ELECTION TO TAKE INTO ACCOUNT IN LATER YEAR WHERE NET INTEREST INCOME FROM BOND.—

"(A) IN GENERAL.—If—

"(i) there is net interest income for any taxable year with respect to any market discount bond, and

"(ii) the taxpayer makes an election under this subpqragraph with respect to such bond,

any disallowed interest expense with respect to such bond shall be treated as interest paid or accrued by the taxpayer during such taxable year to the extent such disallowed interest expense does not exceed the net interest income with respect to such bond.

"(B) DETERMINATION OF DISALLOWED INTEREST EXPENSE.—For purposes of subparagraph (A), the amount of the disallowed interest expense—

"(i) shall be determined as of the close of the preceding taxable year, and

"(ii) shall not include any amount previously taken into account under subparagraph (A).

"(C) NET INTEREST INCOME.—For purposes of this paragaph, the term 'net interest income' means the excess of the amount determined under paragraph (2) of subsection (c) over the amount determined under paragraph (1) of subsection (c).

"(2) REMAINDER OF DISALLOWED INTEREST EXPENSE ALLOWED FOR YEAR OF DISPOSITION.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the amount of the disallowed interest expense with respect to any market discount bond shall be treated as interest paid or accrued by the taxpayer in the taxable year in which such bond is disposed of.

"(B) NONRECOGNITION TRANSACTIONS.—If any market discount bond is disposed of in a nonrecognition transaction—

"(i) the disallowed interest expense with respect to such bond shall be treated as interest paid or accrued in the year of disposition only to the extent of the amount of gain recognized on such disposition, and

"(ii) the disallowed interest expense with respect to such property (to the extent not so treated) shall be treated as disallowed interest expense—

"(I) in the case of a transaction described in section 1276(c)(1), of the transferee with respect to the transferred basis property, or

"(II) in the case of a transaction described in section 1276(c)(2), with respect to the exchanged basis property.

"(C) DISALLOWED INTEREST EXPENSE REDUCED FOR AMOUNTS PREVIOUSLY TAKEN INTO ACCOUNT UNDER PARAGRAPH 1.—For purposes of this paragraph, the amount of the disallowed interest expense shall not include any amount previously taken into account under paragraph (1).

"(3) DISALLOWED INTEREST EXPENSE.—For purposes of this subsection, the term 'disallowed interest expense' means the aggregate amount disallowed under subsection (a) with respect to the market discount bond.

"(c) NET DIRECT INTEREST EXPENSE.—For purposes of this section, the term 'net direct interest expense' means, with respect to any market discount bond, the excess (if any) of—

"(1) the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, over

"(2) the aggregate amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such bond.

In the case of any financial institution to which section 585 or 593 applies, the determination of whether interest is described in paragraph (1) shall be made under principles similar to the principles of section 291(e)(1)(B)(ii). Under rules similar to the rules of section 265(5), short sales expenses

shall be treated as interest for purposes of determining net direct interest expense.

"(d) SPECIAL RULE FOR GAIN RECOGNIZED ON DISPOSITION OF MARKET DISCOUNT BONDS ISSUED ON OR BEFORE DATE OF ENACTMENT OF SECTION.—In the case of a market discount bond issued on or before the date of the enactment of this section, any gain recognized by the taxpayer on any disposition of such bond shall be treated as ordinary income to the extent the amount of such gain does not exceed the amount allowable with respect to such bond under subsection (b)(2) for the taxable year in which such bond is disposed of.

"SEC. 1278. DEFINITIONS AND SPECIAL RULES.

"(a) IN GENERAL.—For purposes of this part—

"(1) MARKET DISCOUNT BOND.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'market discount bond' means any bond having market discount.

"(B) EXCEPTIONS.—The term 'market discount bond' shall not include—

"(i) SHORT-TERM OBLIGATIONS.—Any obligation with a fixed maturity date not exceeding 1 year from the date of issue.

"(ii) TAX-EXEMPT OBLIGATIONS.—Any tax-exempt obligation (as defined in section 1275(a)(3)).

"(iii) UNITED STATES SAVINGS BONDS.—Any United States savings bond.

"(iv) INSTALLMENT OBLIGATIONS.—Any installment obligation to which section 453B applies.

"(2) MARKET DISCOUNT.—

"(A) IN GENERAL.—The term 'market discount' means the excess (if any) of—

"(i) the stated redemption price of the bond at maturity, over

"(ii) the basis of such bond immediately after its acquisition by the taxpayer.

"(B) COORDINATION WHERE BOND HAS ORIGINAL ISSUE DISCOUNT.—In the case of any bond having original issue discount, for purposes of subparagraph (A), the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price.

"(C) DE MINIMIS RULE.—If the market discount is less than ¼ of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), then the market discount shall be considered to be zero.

"(3) BOND.—The term 'bond' means any bond, debenture, note, certificate, or other evidence of indebtedness.

"(4) REVISED ISSUE PRICE.—The term 'revised issue price' means of the sum of—

"(A) the issue price of the bond, and

"(B) the aggregate amount of the original issue discount includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer (determined without regard to section 1272 (a)(6) or (b)(4)).

"(5) ORIGINAL ISSUE DISCOUNT, ETC.—The terms 'original issue discount', 'stated redemption price at maturity', and 'issue price' have the respective meanings given such terms by subpart A of this part.

"(b) ELECTION TO INCLUDE MARKET DISCOUNT CURRENTLY.—

"(1) IN GENERAL.—If the taxpayer makes an election under this subsection—

"(A) sections 1276 and 1277 shall not apply, and

"(B) market discount on any market discount bond shall be included in the gross income of the taxpayer for the taxable years to which it is attributable (as determined under the rules of subsection (b) of section 1276).

Except for purposes of sections 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount included in gross income under subparagraph (B) shall be treated as interest for purposes of this title.

"(2) SCOPE OF ELECTION.—An election under this subsection shall apply to all market discount bonds acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

"(3) PERIOD TO WHICH ELECTION APPLIES.—An election under this subsection shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(c) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subpart.

"Subpart C—Discount on Short-Term Obligations

"Sec. 1281. Current inclusion in income of discount on certain short-term obligations.
"Sec. 1282. Deferral of interest deduction allocable to accrued discount.
"Sec. 1283. Definitions and special rules.

"SEC. 1281. CURRENT INCLUSION IN INCOME OF DISCOUNT ON CERTAIN SHORT-TERM OBLIGATIONS.

"(a) IN GENERAL.—In the case of any short-term obligation to which this section applies, for purposes of this title, there shall be included in the gross income of the holder an amount equal to the sum of the daily portions of the acquisition discount for each day during the taxable year on which such holder held such obligation.

"(b) SHORT-TERM OBLIGATIONS TO WHICH SECTION APPLIES.—

"(1) IN GENERAL.—This section shall apply to any short-term obligation which—

"(A) is held by a taxpayer using an accrual method of accounting,

"(B) is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business,

"(C) is held by a bank (as defined in section 581),

"(D) is held by a regulated investment company or a common trust fund, or

"(E) is identified by the taxpayer under section 1256(e)(2) as being part of a hedging transaction.

"(2) TREATMENT OF OBLIGATIONS HELD BY PASS-THRU ENTITIES.—

"(A) IN GENERAL.—This section shall apply also to—

"(i) any short-term obligation which is held by a pass-thru entity which is formed or availed of for purposes of avoiding the provisions of this section, and

"(ii) any short-term obligation which is acquired by a pass-thru entity (not described in clause (i)) during the required accrual period.

"(B) REQUIRED ACCRUAL PERIOD.—For purposes of subparagraph (A), the term 'required accrual period' means the period—

"(i) which begins with the first taxable year for which the ownership test of subparagraph (C) is met with respect to the pass-thru entity (or a predecessor), and

"(ii) which ends with the first taxable year after the taxable year referred to in clause (i) for which the ownership test of subparagraph (C) is not met and with respect to which the Secretary consents to the termination of the required accrual period.

"(C) OWNERSHIP TEST.—The ownership test of this subparagraph is met for any taxable year if, on at least 90 days during the taxable year, 20 percent or more of the value of the interests in the pass-thru entity are held by persons described in paragraph (1) or by other pass-thru entities to which subparagraph (A) applies.

"(D) PASS-THRU ENTITY.—The term 'pass-thru entity' means any partnership, S corporation, trust, or other pass-thru entity.

"(c) CROSS REFERENCE.—

"For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

"SEC. 1282. DEFERRAL OF INTEREST DEDUCTION ALLOCABLE TO ACCRUED DISCOUNT.

"(a) GENERAL RULE.—Except as otherwise provided in this section, the net direct interest expense with respect to any short-term obligation shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the sum of the daily portions of the acquisition discount for each day during the taxable year on which the taxpayer held such obligation.

"(b) SECTION NOT TO APPLY TO OBLIGATIONS TO WHICH SECTION 1281 APPLIES.—

"(1) IN GENERAL.—This section shall not apply to any short-term obligation to which section 1281 applies.

"(2) ELECTION TO HAVE SECTION 1281 APPLY TO ALL OBLIGATIONS.—

"(A) IN GENERAL.—A taxpayer may make an election under this paragraph to have section 1281 apply to all short-term obligations acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

"(B) PERIOD TO WHICH ELECTION APPLIES.—An election under this paragraph shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(c) CERTAIN RULES MADE APPLICABLE.—Rules similar to the rules of subsections (b) and (c) of section 1277 shall apply for purposes of this section.

"(d) CROSS REFERENCE.—

"For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

"SEC. 1283. DEFINITIONS AND SPECIAL RULES.

"(a) DEFINITIONS.—For purposes of this subpart—

"(1) SHORT-TERM OBLIGATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'short-term obligation' means any bond, debenture, note, certificate, or other evidence of indebtedness which has a fixed maturity date not more than 1 year from the date of issue.

"(B) EXCEPTIONS FOR TAX-EXEMPT OBLIGATIONS.—The term 'short-term obligation' shall not include any tax-exempt obligation (as defined in section 1275(a)(3)).

"(2) ACQUISITION DISCOUNT.—The term 'acquisition discount' means the excess of—

"(A) the stated redemption price at maturity (as defined in section 1273), over

"(B) the taxpayer's basis for the obligation.

"(b) DAILY PORTION.—For purposes of this subpart—

"(1) RATABLE ACCRUAL.—Except as otherwise provided in this subsection, the daily portion of the acquisition discount is an amount equal to—

"(A) the amount of such discount, divided by

"(B) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity.

"(2) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE (IN LIEU OF RATABLE ACCRUAL).—

"(A) IN GENERAL.—At the election of the taxpayer with respect to any obligation, the daily portion of the acquisition discount for any day is the portion of the acquisition discount accruing on such day determined

(under regulations prescribed by the Secretary) on the basis of—

"(i) the taxpayer's yield to maturity based on the taxpayer's cost of acquiring the obligation, and

"(ii) compounding daily.

"(B) ELECTION IRREVOCABLE.—An election under subparagraph (A), once made with respect to any obligation, shall be irrevocable.

"(c) SPECIAL RULES FOR NONGOVERNMENTAL OBLIGATIONS.—

"(1) IN GENERAL.—In the case of any short-term obligation which is not a short-term Government obligation (as defined in section 1271(a)(3)(B))—

"(A) sections 1281 and 1282 shall be applied by taking into account original issue discount in lieu of acquisition discount, and

"(B) appropriate adjustments shall be made in the application of subsection (b) of this section.

"(2) ELECTION TO HAVE PARAGRAPH (1) NOT APPLY.—

"(A) IN GENERAL.—A taxpayer may make an election under this paragraph to have paragraph (1) not apply to all obligations acquired by the taxpayer on or after the first day of the first taxable year to which such election applies.

"(B) PERIOD TO WHICH ELECTION APPLIES.—An election under this paragraph shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(d) OTHER SPECIAL RULES.—

"(1) BASIS ADJUSTMENTS.—The basis of any short-term obligation in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to section 1281.

"(2) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—Section 1281 shall not require the inclusion of any amount previously includible in gross income.

"(3) COORDINATION WITH OTHER PROVISIONS.—Section 454(b) and section 1271(a)(3) shall not apply to any short-term obligation to which section 1281 applies.

"Subpart D—Miscellaneous Provisions

"Sec. 1286. Tax treatment of stripped bonds.
"Sec. 1287. Denial of capital gain treatment for gains on certain obligations not in registered form.
"Sec. 1288. Treatment of original issue discount on tax-exempt obligations.

"SEC. 1286. TAX TREATMENT OF STRIPPED BONDS.

"(a) INCLUSION IN INCOME AS IF BOND AND COUPONS WERE ORIGINAL ISSUE DISCOUNT BONDS.—If any person purchases after July 1, 1982, a stripped bond or a stripped coupon, then such bond or coupon while held by such purchaser (or by any other person whose basis is determined by reference to the basis in the hands of such purchaser) shall be treated for purposes of this part as a bond originally issued on the purchase date and having an original issue discount equal to the excess (if any) of—

"(1) the stated redemption price at maturity (or, in the case of coupon, the amount payable on the due date of such coupon), over

"(2) such bond's or coupon's ratable share of the purchase price.

For purposes of paragraph (2), ratable shares shall be determined on the basis of their respective fair market values on the date of purchase.

"(b) TAX TREATMENT OF PERSON STRIPPING BOND.—For purposes of this subtitle, if any person strips 1 or more coupons from a bond and after July 1, 1982, disposes of the bond or such coupon—

"(1) such person shall include in gross income an amount equal to the interest accrued on such bond while held by such person and before the time that such coupon or bond was disposed of (to the extent such interest has not theretofore been included in such person's gross income),

"(2) the basis of the bond and coupons shall be increased by the amount of the accrued interest described in paragraph (1),

"(3) the basis of the bond and coupons immediately before the disposition (as adjusted pursuant to paragraph (2)) shall be allocated among the items retained by such person and the items disposed of by such person on the basis of their respective fair market values, and

"(4) for purposes of subsection (a), such person shall be treated as having purchased on the date of such disposition each such item which he retains for an amount equal to the basis allocated to such item under paragraph (3).

A rule similar to the rule of paragraph (4) shall apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis of the person described in the preceding sentence.

"(c) RETENTION OF EXISTING LAW FOR STRIPPED BONDS PURCHASED BEFORE JULY 2, 1982.—If a bond issued at any time with interest coupons—

"(1) is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

"(2) is purchased after December 31, 1957, and before July 2, 1982, and the purchaser does not receive all the coupons which first become payable after the date of the purchase,

then the gain on the sale or other disposition of such bond by such purchaser (or by a person whose basis is determined by reference to the basis in the hands of such purchaser) shall be considered as ordinary income to the extent that the fair market value (determined as of the time of the purchase) of the bond with coupons attached exceeds the purchase price. If this subsection and section 1271(a)(2)(A) apply with respect to gain realized on the sale or exchange of any evidence of indebtedness, then section 1271(a)(2)(A) shall apply with respect to that part of the gain to which this subsection does not apply.

"(d) SPECIAL RULES FOR TAX-EXEMPT OBLIGATIONS.—In the case of any tax-exempt obligation (as defined in section 1275(a)(3))—

"(1) subsections (a) and (b)(1) shall not apply,

"(2) the rules of subsection (b)(4) shall apply for purposes of subsection (c), and

"(3) subsection (c) shall be applied without regard to the requirement that the bond be purchased before July 2, 1982.

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) BOND.—The term 'bond' means a bond, debenture, note, or certificate or other evidence of indebtedness.

"(2) STRIPPED BOND.—The term 'stripped bond' means a bond issued at any time with interest coupons where there is a separation in ownership between the bond and any coupon which has not yet become payable.

"(3) STRIPPED COUPON.—The term 'stripped coupon' means any coupon relating to a stripped bond.

"(4) STATED REDEMPTION PRICE AT MATURITY.—The term 'stated redemption price at maturity' has the meaning given such term by section 1273(a)(2).

"(5) COUPON.—The term 'coupon' includes any right to receive interest on a bond (whether or not evidenced by a coupon). This paragraph shall apply for purposes of subsection (c) only in the case of purchases after July 1, 1982.

"(6) PURCHASE.—The term 'purchase' has the meaning given such term by section 1272(d)(1).

"(f) REGULATION AUTHORITY.—The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, or other circumstances, the tax treatment under this section does not accurately reflect the income of the holder of a stripped coupon or stripped bond, or of the person disposing of such bond or coupon, as the case may be, for any period, such treatment shall be modified to require that the proper amount of income be included for such period.

"SEC. 1287. DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.

"(a) IN GENERAL.—If any registration-required obligation is not in registered form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income (unless the issuance of such obligation was subject to tax under section 4701).

"(b) DEFINITIONS.—For purposes of subsection (a)—

"(1) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(2) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f).

"SEC. 1288. TREATMENT OF ORIGINAL ISSUE DISCOUNT ON TAX-EXEMPT OBLIGATIONS.

"(a) GENERAL RULE.—Original issue discount on any tax-exempt obligation shall be treated as accruing—

"(1) for purposes of section 163, in the manner provided by section 1272(a) (determined without regard to paragraph (6) thereof), and

"(2) for purposes of determining the adjusted basis of the holder, in the manner provided by section 1272(a) (determined with regard to paragraph (6) thereof).

"(b) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) ORIGINAL ISSUE DISCOUNT.—The term 'original issue discount' has the meaning given to such term by section 1273(a) without regard to paragraph (3) thereof. In applying section 483 or 1274, under regulations prescribed by the Secretary, appropriate adjustments shall be made to the applicable Federal rate to take into account the tax exemption for interest on the obligation.

"(2) TAX-EXEMPT OBLIGATION.—The term 'tax-exempt obligation' has the meaning given to such term by section 1275(a)(3).

"(3) SHORT-TERM OBLIGATIONS.—In applying this section to obligations with maturity of 1 year or less, rules similar to the rules of section 1283(b) shall apply."

(b) AMENDMENT OF SECTION 483.—Section 483 (relating to interest on certain deferred payments) is amended to read as follows:

"SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

"(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any payment—

"(1) under any contract for the sale or exchange of any property, and

"(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

"(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term 'total unstated

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc. (984)

interest' means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

"(1) the sum of the payments to which this section applies which are due under the contract, over

"(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to 120 percent of the applicable Federal rate determined under section 1274(d).

"(c) PAYMENTS TO WHICH SUBSECTION (a) APPLIES.—

"(1) IN GENERAL.—Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

"(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

"(B) under which, using a discount rate equal to 110 percent of the applicable Federal rate determined under section 1274(d), there is total unstated interest.

"(2) TREATMENT OF OTHER DEBT INSTRUMENTS.—For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

"(3) DEBT INSTRUMENT DEFINED.—For purposes of this subsection, the term 'debt instrument' has the meaning given such term by section 1275(a)(1).

"(d) EXCEPTIONS AND LIMITATIONS.—

"(1) COORDINATION WITH ORIGINAL ISSUE DISCOUNT RULES.—This section shall not apply to any debt instrument to which section 1272 applies.

"(2) SALES PRICES OF $3,000 OR LESS.—This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

"(3) CARRYING CHARGES.—In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

"(4) CERTAIN SALES OF PATENTS.—In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), this section shall not apply to any amount contingent on the productivity, use, or disposition of the property transferred.

"(e) MAXIMUM RATE OF INTEREST ON CERTAIN TRANSFERS OF LAND BETWEEN RELATED PARTIES.—

"(1) IN GENERAL.—In the case of any qualified sale, the discount rate used in determining the total unstated interest rate under subsection (b) shall not exceed 7 percent, compounded semiannually.

"(2) QUALIFIED SALE.—For purposes of this subsection, the term 'qualified sale' means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).

"(3) $500,000 LIMITATION.—Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.

"(4) NONRESIDENT ALIEN INDIVIDUALS.—Paragraph (1) shall not apply to any sale or exchange if any party to such sale or exchange is a nonresident alien individual.

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section including regulations providing for the application of this section in the case of—

"(1) any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment cannot be determined at the time of the sale or exchange, or

"(2) any change in the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property.

"(g) CROSS REFERENCE.—

"For special rules in the case of the borrower under certain loans for personal use, see section 1275(b)."

(c) PENALTY FOR FAILURE TO MEET INFORMATION REQUIREMENTS.—

(1) IN GENERAL.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6706. ORIGINAL ISSUE DISCOUNT INFORMATION REQUIREMENTS.

"(a) FAILURE TO SHOW INFORMATION ON DEBT INSTRUMENT.—In the case of a failure to set forth on a debt instrument the information required to be set forth on such instrument under section 1275(c)(1), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the issuer shall pay a penalty of $50 for each instrument with respect to which such a failure exists.

"(b) FAILURE TO FURNISH INFORMATION TO SECRETARY.—Any issuer who fails to furnish information required under section 1275(c)(2) with respect to any issue of debt instruments on the date prescribed therefor (determined with regard to any extension of time for filing) shall pay a penalty equal to 1 percent of the aggregate issue price of such issue, unless it is shown that such failure is due to reasonable cause and not willful neglect. The amount of the penalty imposed under the preceding sentence with respect to any issue of debt instruments shall not exceed $50,000 for such issue.

"(c) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assessment or collection of any penalty imposed by this section."

(2) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6706. Original issue discount information requirements."

SEC. 42. TECHNICAL AND CONFORMING AMENDMENTS RELATED TO ORIGINAL ISSUE DISCOUNT CHANGES.

(a) IN GENERAL.—

(1) Sections 1232, 1232A, and 1232B are hereby repealed.

(2) Clause (i) of section 103A(i)(2)(C) (defining yield on the issue) is amended by striking out "section 1232(b)(2)" and inserting in lieu thereof "sections 1273(b) and 1274".

(3) Subsection (e) of section 163 (relating to original issue discount) is amended to read as follows:

"(e) ORIGINAL ISSUE DISCOUNT.—

"(1) IN GENERAL.—In the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

"(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) DEBT INSTRUMENT.—The term 'debt instrument' has the meaning given such term by section 1275(a)(1).

"(B) DAILY PORTIONS.—The daily portion of the original issue discount for any day shall be determined under section 1272(a) (without regard to paragraph (6) thereof and without regard to section 1273(a)(3)).

"(C) SHORT-TERM OBLIGATIONS.—In the case of an obligor of a short-term obligation (as defined in section 1283(a)(1)(A)) who uses the cash receipts and disbursements method of accounting, the original issue discount on such obligation shall be deductible only when paid.

"(3) EXCEPTIONS.—This subsection shall not apply to any debt instrument described in—

"(A) subparagraph (D) of section 1272(a)(2) (relating to obligations issued by natural persons before March 2, 1984), and

"(B) subparagraph (E) of section 1272(a)(2) (relating to loans between natural persons).

"(4) CROSS REFERENCES.—

"For provision relating to deduction of original issue discount on tax-exempt obligation, see section 1288.

"For special rules in the case of the borrower under certain loans for personal use, see section 1275(b)."

(4) Paragraph (3) of section 165(j) (relating to denial of deductions for losses on certain obligations not in registered form) is amended by striking out "subsection (d) of section 1232" and inserting in lieu thereof "section 1287".

(5) Paragraph (1) of section 249(b) (relating to limitation on deduction of bond premium on repurchase) is amended by striking out "section 1232(b)" and inserting in lieu thereof "sections 1273(b) and 1274".

(6) Paragraph (1) of section 405(d) (relating to taxability of beneficiary of qualified bond purchase plan) is amended by striking out "section 1232 (relating to bonds and other evidences of indebtedness)" and inserting in lieu thereof "section 1271 (relating to treatment of amounts received on retirement or sale or exchange of debt instruments)".

(7) Paragraph (1) of section 469(b) (relating to income tax treatment of bonds) is amended by striking out "section 1232 (relating to bonds and other evidences of indebtedness)" and inserting in lieu thereof "section 1271 (relating to treatment of amounts received on retirement or sale or exchange of debt instruments)".

(8) Paragraph (3) of section 811(b) (relating to amortization of premium and accrual of discount), as amended by this Act, is amended by striking out "section 1232(b)" and inserting in lieu thereof "section 1273".

(9) Subparagraph (A) of section 871(a)(1) (relating to income other than capital gains) is amended by striking out "section 1232(b)" and inserting in lieu thereof "section 1273".

(10) Paragraph (1) of section 881(a) (relating to imposition of tax) is amended by striking out "section 1232(b)" and inserting in lieu thereof "section 1273".

(11) Subsection (b) of section 1037 (relating to application of section 1232) is amended—

(A) by striking out "section 1232(a)(2)(B)" in paragraph (1) and inserting in lieu thereof "section 1271(c)(2)".

(B) by striking out "section 1232" in paragraphs (1) and (2) and inserting in lieu thereof "subpart A of part V of subchapter P", and

(C) by striking out "SECTION 1232" in the subsection heading and inserting in lieu thereof "ORIGINAL ISSUE DISCOUNT RULES".

(12) Subsection (h) of section 1351 (relating to special rule for evidences of indebtedness) is amended by striking out "section 1232(a)(2)" and inserting in lieu thereof "section 1273(a)".

(13) Subsection (b) of section 1441 (relating to withholding of tax on nonresident alien) is amended by striking out "section 1232(b)" and inserting in lieu thereof "section 1273".

(14) Paragraph (6) of section 6049(d) (relating to treatment of original issue discount) is amended—

(A) by striking out "section 1232A" each place it appears in subparagraph (A) and inserting in lieu thereof "section 1272", and

(B) by striking out "section 1232(b)(1)" and inserting in lieu thereof "section 1273(a)".

(b) CLERICAL AMENDMENTS.—

(1) The table of parts for subchapter P of chapter 1 is amended by adding at the end thereof the following new item:

"PART V. Special rules for bonds and other debt instruments."

(2) The table of sections for part IV of subchapter P of chapter 1 is amended by striking out the items relating to sections 1232, 1232A, and 1232B.

SEC. 43. TECHNICAL AND CONFORMING AMENDMENTS RELATED TO TREATMENT OF MARKET DISCOUNT AND ACQUISITION DISCOUNT.

(a) DEFINITION OF SUBSTITUTED BASIS PROPERTY; ETC.—

(1) IN GENERAL.—Section 7701(a) (relating to definitions) is amended by adding at the end thereof the following new paragraphs:

"(42) SUBSTITUTED BASIS PROPERTY.—The term 'substituted basis property' means property which is—

"(A) transferred basis property, or

"(B) exchanged basis property.

"(43) TRANSFERRED BASIS PROPERTY.—The term 'transferred basis property' means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

"(44) EXCHANGED BASIS PROPERTY.—The term 'exchanged basis property' means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

"(45) NONRECOGNITION TRANSACTION.—The term 'nonrecognition transaction' means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A."

(2) TECHNICAL AMENDMENT.—Subsection (b) of section 1016 is amended by striking out the last sentence.

(b) ELECTIONS MADE IN MANNER PRESCRIBED BY SECRETARY.—Section 7805 (relating to rules and regulations) is amended by adding at the end thereof the following new subsection:

"(d) MANNER OF MAKING ELECTIONS PRESCRIBED BY SECRETARY.—Except to the extent otherwise provided by this title, any election under this title shall be made at such time and in such manner as the Secretary shall by regulations or forms prescribe."

(c) OTHER TECHNICAL AMENDMENTS.—

(1) Paragraph (12) of section 341(e) (related to nonapplication of section 1254(a)) is amended by striking out "and 1254(a)" and inserting in lieu thereof "1254(a), and 1276(a)".

(2) Paragraph (2) of section 453B(d) (relating to liquidations to which section 337 applies) is amended by striking out "or 1254(a)" and inserting in lieu thereof "1254(a), or 1276(a)".

(3) Subsection (c) of section 751 (defining unrealized receivables) is amended by adding at the end thereof the following new sentence: "For purposes of this section and sections 731, 736, and 741, such term also includes any market discount bond (as defined in section 1278) and any short-term obligation (as defined in section 1283) but only to the extent of the amount which would be treated as ordinary income if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership."

SEC. 44. EFFECTIVE DATES.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amendments made by this subtitle shall apply to taxable years ending after the date of the enactment of this Act.

(b) TREATMENT OF DEBT INSTRUMENTS RECEIVED IN EXCHANGE FOR PROPERTY.—

(1) IN GENERAL.—

(A) Except as otherwise provided in this subsection, section 1274 of the Internal Revenue Code of 1954 (as added by section 41) and the amendment made by section 41(b) (relating to amendment of section 483) shall apply to sales or exchanges after December 31, 1984.

(B) Section 1274 of such Code and the amendment made by section 41(b) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.

(2) REVISION OF SECTION 482 REGULATIONS.—Not later than 180 days after the date of the enactment of this Act, the Secretary of the Treasury or his delegate shall modify the safe harbor interest rates applicable under the regulations prescribed under section 482 of the Internal Revenue Code of 1954 so that such rates are consistent with the rates applicable under section 483 of such Code by reason of the amendments made by section 41.

(3) CLARIFICATION OF INTEREST ACCRUAL; FAIR MARKET VALUE RULE IN CASE OF POTENTIALLY ABUSIVE SITUATIONS.—

(A) IN GENERAL.—

(i) CLARIFICATION OF INTEREST ACCRUAL.—In the case of any sale or exchange—

(I) after March 1, 1984, and before January 1, 1985, nothing in section 483 of the Internal Revenue Code of 1954 shall permit any interest to be deductible before the period to which such interest is properly allocable, or

(II) after June 8, 1984, and before January 1, 1985, notwithstanding section 483 of the Internal Revenue Code of 1954 or any other provision of law, no interest shall be deductible before the period to which such interest is properly allocable.

(ii) FAIR MARKET RULE.—In the case of any sale or exchange after March 1, 1984, and before January 1, 1985, such section 483 shall be treated as including provisions similar to the provisions of section 1274(b)(3) of such Code (as added by section 41).

(B) EXCEPTION FOR BINDING CONTRACTS.—Subparagraph (A) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.

(C) INTEREST ACCRUAL RULE NOT TO APPLY WHERE SUBSTANTIALLY EQUAL ANNUAL PAYMENTS.—Clause (i) of subparagraph (A) shall not apply to any debt instrument with substantially equal annual payments.

(c) MARKET DISCOUNT RULES.—

(1) ORDINARY INCOME TREATMENT.—Section 1276 of the Internal Revenue Code of 1954 (as added by section 41) shall apply to obligations issued after the date of the enactment of this Act in taxable years ending after such date.

(2) INTEREST DEFERRAL RULES.—Section 1277 of such Code (as added by section 41) shall apply to obligations acquired after the date of the enactment of this Act in taxable years ending after such date.

(d) RULES RELATING TO DISCOUNT ON SHORT-TERM OBLIGATIONS.—Subpart C of part V of subchapter P of chapter 1 of such Code (as added by section 41) shall apply to obligations acquired after the date of the enactment of this Act.

(e) 5-YEAR SPREAD OF ADJUSTMENTS REQUIRED BY REASON OF ACCRUAL OF DISCOUNT ON CERTAIN SHORT-TERM OBLIGATIONS.—

(1) ELECTION TO HAVE SECTION 1281 APPLY TO ALL OBLIGATIONS HELD DURING TAXABLE YEAR.—A taxpayer may elect for his first taxable year ending after the date of the enactment of this Act to have section 1281 of the Internal Revenue Code of 1954 apply to all short-term obligations described in subsection (b) of such section which were held by the taxpayer at any time during such first taxable year.

(2) 5-YEAR SPREAD.—

(A) IN GENERAL.—In the case of any taxpayer who makes an election under paragraph (1)—

(i) the provisions of section 1281 of the Internal Revenue Code of 1954 (as added by section 41) shall be treated as a change in the method of accounting of the taxpayer,

(ii) such change shall be treated as having been made with the consent of the Secretary, and

(iii) the net amount of the adjustments required by section 481(a) of such Code to be taken into account by the taxpayer in computing taxable income (hereinafter in this paragraph referred to as the "net adjustments") shall be taken into account during the spread period with the amount taken into account in each taxable year in such period determined under subparagraph (B).

(B) AMOUNT TAKEN INTO ACCOUNT DURING EACH YEAR OF SPREAD PERIOD.—

(i) FIRST YEAR.—The amount taken into account for the first taxable year in the spread period shall be the sum of—

(I) one-fifth of the net adjustments, and

(II) the excess (if any) of—

(a) the cash basis income over the accrual basis income, over

(b) one-fifth of the net adjustments.

(ii) FOR SUBSEQUENT YEARS IN SPREAD PERIOD.—The amount taken into account in the second or any succeeding taxable year in the spread period shall be the sum of—

(I) the portion of the net adjustments not taken into account in the preceding taxable year of the spread period divided by the number of remaining taxable years in the spread period (including the year for which the determination is being made), and

(II) the excess (if any) of—

(a) the excess of the cash basis income over the accrual basis income, over

(b) One-fifth of the net adjustments, multiplied by 5 minus the number of years remaining in the spread period (not including the current year).

The excess described in subparagraph (B)(ii)(II)(a) shall be reduced by any

amount taken into account under this subclause or clause (I)(II) in any prior year.

(C) SPREAD PERIOD.—For purposes of this paragraph, the term "spread period" means the period consisting of the 5 taxable years beginning with the year for which the election is made under paragraph (1).

(D) CASH BASIS INCOME.—For purposes of this paragraph, the term "cash basis income" means for any taxable year the aggregate amount which would be includible in the gross income of the taxpayer with respect to short-term obligations described in subsection (b) of section 1281 of such Code if the provisions of section 1281 of such Code did not apply to such taxable year and all prior taxable years within the spread period.

(E) ACCRUAL BASIS INCOME.—For purposes of this paragraph, the term "accrual basis income" means for any taxable year the aggregate amount includible in gross income under section 1281(a) of such Code for such a taxable year and all prior taxable years within the spread period.

(f) TREATMENT OF ORIGINAL ISSUE DISCOUNT ON TAX-EXEMPT OBLIGATIONS.—Section 1288 of such Code (as added by section 41) shall apply to obligations issued after September 3, 1982, and acquired after March 1, 1984.

(g) REPEAL OF CAPITAL ASSET REQUIREMENT.—Section 1272 of such Code (as added by section 41) shall not apply to any obligation issued before December 31, 1984, which is not a capital asset in the hands of the taxpayer.

(h) REPORTING REQUIREMENTS.—Section 1275(c) of such Code (as added by section 41) and the amendments made by section 41(c) shall take effect on the day 30 days after the date of the enactment of this Act.

(i) OTHER MISCELLANEOUS CHANGES.—

(1) ACCRUAL PERIOD.—In the case of any obligation issued after July 1, 1982, and before January 1, 1985, the accrual period, for purposes of section 1272(a) of the Internal Revenue Code of 1954 (as amended by section 41(a)), shall be a 1-year period (or shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue of the obligation.

(2) CHANGE IN REDUCTION FOR PURCHASE AFTER ORIGINAL ISSUE.—Section 1272(a)(6) of such Code (as so amended) shall not apply to any purchase on or before the date of the enactment of this Act, and the rules of section 1232A(a)(6) of such Code (as in effect on the day before the date of the enactment of this Act) shall continue to apply to such purchase.

(j) CLARIFICATION THAT PRIOR EFFECTIVE DATE RULES NOT AFFECTED.—Nothing in the amendment made by section 41(a) shall affect the application of any effective date provision (including any transitional rule) for any provision which was a predecessor to any provision contained in part V of subchapter P of chapter 1 of the Internal Revenue Code of 1954 (as added by section 41).

Subtitle D—Corporate Provisions

PART I—LIMITATIONS ON DIVIDENDS RECEIVED DEDUCTION

SEC. 51. DIVIDENDS RECEIVED DEDUCTION REDUCED WHERE PORTFOLIO STOCK IS DEBT FINANCED.

(a) GENERAL RULE.—Part VIII of subchapter B of chapter 1 (relating to special deductions for corporations) is amended by inserting after section 246 the following new section:

"SEC. 246A. DIVIDENDS RECEIVED DEDUCTION REDUCED WHERE PORTFOLIO STOCK IS DEBT FINANCED.

"(a) GENERAL RULE.—In the case of any dividend on debt-financed portfolio stock, there shall be substituted for the percentage which (but for this subsection) would be used in determining the amount of the deduction allowable under section 243, 244, or 245 a percentage equal to the product of—

"(1) 85 percent, and

"(2) 100 percent minus the average indebtedness percentage.

"(b) SECTION NOT TO APPLY TO DIVIDENDS FOR WHICH 100 PERCENT DIVIDENDS RECEIVED DEDUCTION ALLOWABLE.—Subsection (a) shall not apply to—

"(1) qualifying dividends (as defined in section 243(b) without regard to section 243(c)(4)), and

"(2) dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

"(c) DEBT FINANCED PORTFOLIO STOCK.—For purposes of this section—

"(1) IN GENERAL.—The term 'debt financed portfolio stock' means any portfolio stock if at some time during the base period there is portfolio indebtedness with respect to such stock.

"(2) PORTFOLIO STOCK.—The term 'portfolio stock' means any stock of a corporation unless—

"(A) as of the beginning of the ex-dividend date, the taxpayer owns stock of such corporation—

"(i) possessing at least 50 percent of the total voting power of the stock of such corporation, and

"(ii) having a value equal to at least 50 percent of the total value of the stock of such corporation, or

"(B) as of the beginning of the ex-dividend date—

"(i) the taxpayer owns stock of such corporation which would meet the requirements of subparagraph (A) if '20 percent' were substituted for '50 percent' each place it appears in such subparagraph, and

"(ii) stock meeting the requirements of subparagraph (A) is owned by 5 or fewer corporate shareholders.

"(3) SPECIAL RULE FOR STOCK IN A BANK OR BANK HOLDING COMPANY.—

"(A) IN GENERAL.—If, as of the beginning of the ex-dividend date, the taxpayer owns stock of any bank or bank holding company having a value equal to at least 80 percent of the total value of the stock of such bank or bank holding company, for purposes of paragraph (2)(A)(i), the taxpayer shall be treated as owning any stock of such bank or bank holding company which the taxpayer has an option to acquire.

"(B) DEFINITIONS.—For purposes of subparagraph (A)—

"(i) BANK.—The term 'bank' has the meaning given such term by section 581.

"(ii) BANK HOLDING COMPANY.—The term 'bank holding company' means a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956).

"(4) TREATMENT OF CERTAIN PREFERRED STOCK.—For purposes of determining whether the requirements of subparagraph (A) or (B) of paragraph (2) or of subparagraph (A) of paragraph (3) are met, stock described in section 1504(a)(4) shall not be taken into account.

"(d) AVERAGE INDEBTEDNESS PERCENTAGE.—For purposes of this section—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'average indebtedness percentage' means the percentage obtained by dividing—

"(A) the average amount (determined under regulations prescribed by the Secretary) of the portfolio indebtedness with respect to the stock during the base period, by

"(B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of the stock during the base period.

"(2) SPECIAL RULE WHERE STOCK NOT HELD THROUGHOUT BASE PERIOD.—In the case of any stock which was not held by the taxpayer throughout the base period, paragraph (1) shall be applied as if the base period consisted only of that portion of the base period during which the stock was held by the taxpayer.

"(3) PORTFOLIO INDEBTEDNESS.—

"(A) IN GENERAL.—The term 'portfolio indebtedness' means any indebtedness directly attributable to investment in the portfolio stock.

"(B) CERTAIN AMOUNTS RECEIVED FROM SHORT SALE TREATED AS INDEBTEDNESS.—For purposes of subparagraph (A), any amount received from a short sale shall be treated as indebtedness for the period beginning on the day on which such amount is received and ending on the day the short sale is closed.

"(4) BASE PERIOD.—The term 'base period' means, with respect to any dividend, the shorter of—

"(A) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or

"(B) the 1-year period ending on the day before the ex-dividend date for the dividend involved.

"(e) REDUCTION IN DIVIDENDS RECEIVED DEDUCTION NOT TO EXCEED ALLOCABLE INTEREST.—Under regulations prescribed by the Secretary, any reduction under this section in the amount allowable as a deduction under section 243, 244, or 245 with respect to any dividend shall not exceed the amount of any interest deduction (including any deductible short sale expense) allocable to such dividend.

"(f) REGULATIONS.—The regulations prescribed for purposes of this section under section 7701(f) shall include regulations providing for the disallowance of interest deductions or other appropriate treatment (in lieu of reducing the dividend received deduction) where the obligor of the indebtedness is a person other than the person receiving the dividend."

(b) CLERICAL AMENDMENT.—The table of sections for part VIII of subchapter B of chapter 1 is amended by inserting after the item relating to section 246 the following new item:

"Sec. 246A. Dividends received deduction reduced where portfolio stock is debt financed."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to stock the holding period for which begins after the date of the enactment of this Act in taxable years ending after such date.

SEC. 52. TREATMENT OF DIVIDENDS FROM REGULATED INVESTMENT COMPANIES.

(a) INCREASE IN REQUIRED AMOUNT OF DIVIDENDS.—Paragraph (1) of section 854(b) (relating to other dividends) is amended to read as follows:

"(1) AMOUNT TREATED AS DIVIDEND.—

"(A) DEDUCTION UNDER SECTION 243.—In any case in which—

"(i) a dividend is received from a regulated investment company (other than a dividend to which subsection (a) applies), and

"(ii) such investment company meets the requirements of section 852(a) for the taxable year during which it paid such dividend,

then, in computing any deduction under section 243, there shall be taken into account only that portion of such dividend designated under this subparagraph by the regulated investment company.

"(B) EXCLUSION UNDER SECTION 116.—If the aggregate dividends received by a regulated investment company during any taxable

year are less than 95 percent of its gross income, then, in computing the exclusion under section 116, rules similar to the rules of subparagraph (A) shall apply.

"(C) LIMITATION.—The aggregate amount which may be designated as dividends under subparagraph (A) or (B) shall not exceed the aggregate dividends received by the company for the taxable year."

(b) CERTAIN DIVIDENDS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF COMPUTING DEDUCTION UNDER SECTION 243.—Subsection (b) of section 854 is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE FOR COMPUTING DEDUCTION UNDER SECTION 243.—For purposes of subparagraph (A) of paragraph (1), an amount shall be treated as a dividend for the purpose of paragraph (1) only if a deduction would have been allowable under section 243 to the regulated investment company determined—

"(A) as if section 243 applied to dividends received by a regulated investment company,

"(B) after the application of section 246 (but without regard to subsection (b) thereof), and

"(C) after the application of section 246A."

(c) GROSS INCOME INCLUDES NET SHORT-TERM CAPITAL GAIN.—Paragraph (3)(A) of section 854(b) is amended to read as follows:

"(A) In the case of 1 or more sales or other dispositions of stock and securities, the term 'gross income' includes only the excess of—

"(i) the net short-term capital gain from such sales or dispositions, over

"(ii) the net long-term capital loss from such sales or dispositions."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of regulated investment companies beginning after the date of the enactment of this Act.

PART II—TREATMENT OF CERTAIN DISTRIBUTIONS

SEC. 52. CORPORATE SHAREHOLDER'S BASIS IN STOCK REDUCED BY NONTAXED PORTION OF EXTRAORDINARY DIVIDENDS.

(a) GENERAL RULE.—Part IV of subchapter O of chapter 1 (relating to special rules for gain or loss on disposition of property) is amended by redesignating section 1059 as section 1060 and by inserting after section 1058 the following new section:

"SEC. 1059. CORPORATE SHAREHOLDER'S BASIS IN STOCK REDUCED BY NONTAXED PORTION OF EXTRAORDINARY DIVIDENDS.

"(a) GENERAL RULE.—If any corporation—

"(1) receives an extraordinary dividend with respect to any share of stock, and

"(2) sells or otherwise disposes of such stock before such stock has been held for more than 1 year,

the basis of such corporation in such stock shall be reduced by the nontaxed portion of such dividend. If the nontaxed portion of such dividend exceeds such basis, such excess shall be treated as gain from the sale or exchange of such stock.

"(b) NONTAXED PORTION.—For purposes of this section—

"(1) IN GENERAL.—The nontaxed portion of any dividend is the excess (if any) of—

"(A) the amount of such dividend, over

"(B) the taxable portion of such dividend.

"(2) TAXABLE PORTION.—The taxable portion of any dividend is—

"(A) the portion of such dividend includible in gross income, reduced by

"(B) the amount of any deduction allowable with respect to such dividend under section 243, 244, or 245.

"(c) EXTRAORDINARY DIVIDEND DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'extraordinary dividend' means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such share of stock (determined without regard to this section).

"(2) THRESHOLD PERCENTAGE.—The term 'threshold percentage' means—

"(A) 5 percent in the case of stock which is preferred as to dividends, and

"(B) 10 percent in the case of any other stock.

"(3) AGGREGATION OF DIVIDENDS.—

"(A) AGGREGATION WITHIN 85-DAY PERIOD.—All dividends—

"(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and

"(ii) which have ex-dividend dates within the same period of 85 consecutive days,

shall be treated as 1 dividend.

"(B) AGGREGATION WITHIN 1 YEAR WHERE DIVIDENDS EXCEED 20 PERCENT OF ADJUSTED BASIS.—All dividends—

"(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and

"(ii) which have ex-dividend dates during the same period of 365 consecutive days,

shall be treated as extraordinary dividends if the aggregate of such dividends exceeds 20 percent of the taxpayer's adjusted basis in such stock (determined without regard to this section).

"(C) SUBSTITUTED BASIS TRANSACTIONS.—In the case of any stock, a person is described in this subparagraph if—

"(i) the basis of such stock in the hands of such person is determined in whole or in part by reference to the basis of such stock in the hands of the taxpayer, or —

"(ii) the basis of such stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of such stock in the hands of such person.

"(d) SPECIAL RULES.—For purposes of this section—

"(1) TIME FOR REDUCTION.—Any reduction in basis under subsection (a) by reason of any distribution which is an extraordinary dividend shall occur at the beginning of the ex-dividend date for such distribution.

"(2) DISTRIBUTIONS IN KIND.—To the extent any dividend consists of property other than cash, the amount of such dividend shall be treated as the fair market value of such property (as of the date of the distribution) reduced as provided in section 301(b)(2).

"(3) DETERMINATION OF HOLDING PERIOD.—For purposes of determining the holding period of stock under subsection (a)(2), rules similar to the rules of paragraphs (3) and (4) of section 246(c) shall apply; except that '1 year' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

"(4) EX-DIVIDEND DATE.—The term 'ex-dividend date' means the date on which the share of stock becomes ex-dividend.

"(5) EXTENSION TO CERTAIN PROPERTY DISTRIBUTIONS.—In the case of any distribution of property (other than cash) to which section 301 applies—

"(A) such distribution shall be treated as a dividend without regard to whether the corporation has earnings and profits, and

"(B) the amount so treated shall be reduced by the amount of any reduction in basis under section 301(c)(2) by reason of such distribution.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations providing for the application of this section in the case of stock dividends, stock splits, reorganizations, and other similar transactions."

(b) HOLDING PERIODS.—

(1) 46-day holding period.—Subsection (c) of section 246(c) (relating to the exclusion of certain dividends) is amended by striking out "15" each place it appears and inserting in lieu thereof "45".

(2) Rules for computing holding periods.—Subsection (c) of section 246 (relating to the exclusion of certain dividends) is amended by adding at the end thereof the following new paragraphs:

"(4) HOLDING PERIOD REDUCED FOR PERIODS WHERE RISK OF LOSS DIMINISHED.—The holding periods determined under paragraph (3) shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary) for any period (during such periods) in which—

"(A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities,

"(B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or

"(C) under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.

The preceding sentence shall not apply in the case of any qualified covered call (as defined in section 1092(c)(4) but without regard to the requirement that gain or loss with respect to the option not be ordinary income or loss)."

(3) Subparagraph (B) of section 246(c)(1) is amended to read as follows:

"(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property."

(4) Paragraph (3) of section 246(c) is amended by striking out the last sentence.

(c) APPLICATION OF RELATED PERSON RULES TO SECTION 246(c) AND CERTAIN OTHER PROVISIONS.—Section 7701, is amended by redesignating subsection (f) as (g) and by inserting after subsection (e) the following new subsection:

"(f) USE OF RELATED PERSONS OR PASS-THRU ENTITIES.—(The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with—

"(1) the linking of borrowing to investment, or

"(2) diminishing risks,

through the use of related persons, pass-thru entities, or other intermediaries."

(d) CONFORMING AMENDMENTS.—

(1) The table of sections for part IV of subchapter O of chapter 1 is amended by striking out the item relating to section 1059 and inserting in lieu thereof the following new items:

"Sec. 1059. Corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends.

"Sec. 1060. Cross references."

(2) Paragraph (1) of section 246(b) (relating to limitation on aggregate amount of deduction) is amended by striking out "and without regard" and inserting in lieu thereof "without regard to any adjustment under section 1059, and without regard".

(3) Section 1016(a) (relating to adjustments to basis) is amended by striking out "and" at the end of paragraph (24), by striking out the period at the end of paragraph (25) and inserting in lieu thereof ", and" and by adding at the end thereof the following new paragraph:

"(26) to the extent provided in section 1059 (relating to reduction in basis for extraordinary dividends)."

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(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to distributions after March 1, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to stock acquired after the date of the enactment of this Act in taxable years ending after such date.

(3) RELATED PERSON PROVISIONS.—The amendment made by subsection (c) shall take effect on the date of the enactment of this Act.

SEC. 54. DISTRIBUTIONS OF APPRECIATED PROPERTY BY CORPORATIONS.

(a) GAIN RECOGNIZED ON DISTRIBUTIONS OF APPRECIATED PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 311(d) (relating to appreciated property used to redeem stock) is amended to read as follows:

"(1) IN GENERAL.—If—

"(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

"(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. This subsection shall be applied after the application of subsections (b) and (c)."

(2) EXCEPTIONS.—

(A) Paragraph (2) of section 311(d) is amended by striking out subparagraphs (A) and (B) and inserting in lieu thereof the following:

"(A) a distribution which is made with respect to qualified stock if—

"(i) section 302(b)(4) applies to such distribution, or

"(ii) such distribution is a qualified dividend;".

(B) Paragraph (2) of section 311(d) is amended by redesignating subparagraphs (C), (D), (E), and (F) as subparagraphs (B), (C), (D), and (E), respectively.

(C) Subsection (e) of section 311 is amended by adding at the end thereof the following new paragraph:

"(3) QUALIFIED DIVIDEND.—The term 'qualified dividend' means any distribution of property to a shareholder other than a corporation if—

"(A) such distribution is a dividend,

"(B) such property was used by the distributing corporation in the active conduct of a qualified business (as defined in paragraph (2)), and

"(C) such property is not property described in paragraph (1) or (4) of section 1221."

(3) CLERICAL AMENDMENT.—The subsection heading of subsection (d) of section 311 is amended to read as follows:

"(d) DISTRIBUTIONS OF APPRECIATED PROPERTY.—".

(b) HOLDING PERIOD OF CORPORATE DISTRIBUTEE OF APPRECIATED PROPERTY.—Section 301 (relating to distributions of property) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULE FOR HOLDING PERIOD OF APPRECIATED PROPERTY DISTRIBUTED TO CORPORATION.—For purposes of this subtitle—

"(1) WHERE GAIN RECOGNIZED UNDER SECTION 311(d).—If—

"(A) property is distributed to a corporation, and

"(B) gain is recognized on such distribution under paragraph (1) of section 311(d), then such corporation's holding period in the distributed property shall begin on the date of such distribution.

"(2) WHERE GAIN NOT RECOGNIZED UNDER SECTION 311(d).—If—

"(A) property is distributed to a corporation,

"(B) gain is not recognized on such distribution under paragraph (1) of section 311(d), and

"(C) the basis of such property in the hands of such corporation is determined under subsection (d)(2)(B),

then (except for purposes of section 1248(f)(2)) such corporation shall not be treated as holding the distributed property during any period before the date on which such corporation's holding period in the stock began."

(c) CROSS REFERENCE.—Paragraph (13) of section 1223 (relating to holding period of property) is amended to read as follows:

"(13) CROSS REFERENCES.—

"(A) For special holding period provision relating to certain partnership distributions, see section 735(b).

"(B) For special holding period provision relating to distributions of appreciated property to corporations, see section 301(e)."

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—Except as otherwise provided in this subsection, the amendments made by subsection (a) shall apply to distributions declared on or after June 14, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to distributions after the date of the enactment of this Act in taxable years ending after such date.

(3) EXCEPTION FOR DISTRIBUTIONS BEFORE JANUARY 1, 1985, TO 80-PERCENT CORPORATE SHAREHOLDERS.—

(A) IN GENERAL.—The amendments made by subsection (a) shall not apply to any distribution before January 1, 1985, to an 80-percent corporate shareholder if the basis of the property distributed is determined under section 301(d)(2) of the Internal Revenue Code of 1954.

(B) 80-PERCENT CORPORATE SHAREHOLDER.—The term "80-percent corporate shareholder" means, with respect to any distribution, any corporation which owns—

(i) stock in the corporation making the distribution possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and

(ii) at least 80 percent of the total number of shares of all other classes of stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends).

(C) SPECIAL RULE FOR AFFILIATED GROUP FILING CONSOLIDATED RETURN.—For purposes of this paragraph and paragraph (4), all members of the same affiliated group (as defined in section 1504 of the Internal Revenue Code of 1954) which file a consolidated return for the taxable year which includes the date of the distribution shall be treated as 1 corporation.

(4) EXCEPTION FOR CERTAIN DISTRIBUTIONS WHERE TENDER OFFER COMMENCED ON MAY 23, 1984.—

(A) IN GENERAL.—The amendments made by subsection (a) shall not apply to any distribution made before September 1, 1986, if—

(i) such distribution consists of qualified stock held (directly or indirectly) on June 15, 1984, by the distributing corporation,

(ii) control of the distributing corporation (as defined in section 368(c) of the Internal Revenue Code of 1954) is acquired other than in a tax-free transaction after January 1, 1984, but before January 1, 1985,

(iii) a tender offer for the shares of the distributing corporation was commenced on May 23, 1984, and was amended on May 24, 1984, and

(iv) the distributing corporation and the distributee corporation are members of the same affiliated group (as defined in section 1504 of such Code) which filed a consolidated return for the taxable year which includes the date of the distribution.

If the common parent of any affiliated group filing a consolidated return meets the requirements of clauses (ii) and (iii), each other member of such group shall be treated as meeting such requirements.

(B) QUALIFIED STOCK.—For purposes of subparagraph (A), the term "qualified stock" means any stock in a corporation which on June 15, 1984, was a member of the same affiliated group as the distributing corporation and which filed a consolidated return with the distributing corporation for the taxable year which included June 15, 1984.

(5) EXCEPTION FOR CERTAIN DISTRIBUTIONS.—

(A) IN GENERAL.—The amendments made by this section shall not apply to distributions before February 1, 1986, if—

(i) the distribution consists of property held on March 7, 1984 (or property acquired thereafter in the ordinary course of a trade or business) by—

(I) the controlled corporation, or

(II) any subsidiary controlled corporation,

(ii) a group of 1 or more shareholders (acting in concert)—

(I) acquired, during the 1-year period ending on February 1, 1984, at least 10 percent of the outstanding stock of the controlled corporation,

(II) held at least 10 percent of the outstanding stock of the common parent on February 1, 1984, and

(III) submitted a proposal for distributions of interests in a royalty trust from the common parent or the controlled corporation, and

(iii) the common parent acquired control of the controlled corporation during the 1-year period ending on February 1, 1984.

(B) DEFINITIONS.—For purposes of this paragraph—

(i) The term "common parent" has the meaning given such term by section 1504(a) of the Internal Revenue Code of 1954.

(ii) The term "controlled corporation" means a corporation with respect to which 50 percent or more of the outstanding stock of its common parent is tendered for pursuant to a tender offer outstanding on March 7, 1984.

(iii) The term "subsidiary controlled corporation" means any corporation with respect to which the controlled corporation has control (within the meaning of section 368(c) of such Code) on March 7, 1984.

(6) EXCEPTION FOR CERTAIN DISTRIBUTION OF PARTNERSHIP INTERESTS.—The amendments made by this section shall not apply to any distribution before February 1, 1986, of an interest in a partnership the interests of which were being traded on a national securities exchange on March 7, 1984, if—

(A) such interest was owned by the distributing corporation (or any member of an affiliated group within the meaning of section 1504(a) of such Code of which the distributing corporation was a member) on March 7, 1984,

(B) the distributing corporation (or any such affiliated member) owned more than 80 percent of the interests in such partnership on March 7, 1984, and

(C) more than 10 percent of the interests in such partnership was offered for sale to the public during the 1-year period ending on March 7, 1984.

SEC. 55. EXTENSION OF HOLDING PERIOD FOR LOSSES ATTRIBUTABLE TO CAPITAL GAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES OR REAL ESTATE INVESTMENT TRUSTS.

(a) REGULATED INVESTMENT COMPANIES.—

(1) IN GENERAL.—Subparagraph (A) of section 852(b)(4) (relating to loss attributable to capital gain dividend) is amended to read as follows:

"(A) LOSS ATTRIBUTABLE TO CAPITAL GAIN DIVIDEND.—If—

"(i) subparagraph (B) or (D) of paragraph (3) provides that any amount with respect to any share is to be treated as long-term capital gain, and

"(ii) such share is held by the taxpayer for 6 months or less,

then any loss (to the extent not disallowed under subparagraph (B)) on the sale or exchange of such share shall, to the extent of the amount described in clause (i), be treated as a long-term capital loss."

(2) DETERMINATION OF HOLDING PERIODS.—Subparagraph (C) of section 852(b)(4) is amended to read as follows:

"(C) DETERMINATION OF HOLDING PERIODS.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of section 246(c) shall apply in determining the period for which the taxpayer held any share of stock; except that for the number of days specified in subparagraph (B) of section 246(c)(3) there shall be substituted—

"(i) '6 months' for purposes of subparagraph (A), and

"(ii) '30 days' for purposes of subparagraph (B)."

(3) EXCEPTION FOR LOSSES INCURRED UNDER PERIODIC LIQUIDATION PLANS.—Paragraph (4) of section 852(b) is amended by adding at the end thereof the following new subparagraph:

"(D) LOSSES INCURRED UNDER A PERIODIC LIQUIDATION PLAN.—To the extent provided in regulations, subparagraph (A) shall not apply to losses incurred on the sale or exchange of shares of stock in a regulated investment company pursuant to a plan which provides for the periodic liquidation of such shares."

(b) REAL ESTATE INVESTMENT TRUST.—Paragraph (7) of section 857(b) (relating to loss on sale or exchange of stock in real estate investment trust) is amended to read as follows:

"(7) LOSS ON SALE OR EXCHANGE OF STOCK HELD 6 MONTHS OR LESS.—

"(A) IN GENERAL.—If—

"(i) subparagraph (B) of paragraph (3) provides that any amount with respect to any share or beneficial interest is to be treated as a long-term capital gain, and

"(ii) the taxpayer has held such share or interest for 6 months or less,

then any loss on the sale or exchange of such share or interest shall, to the extent of the amount described in clause (i), be treated as a long-term capital loss.

"(B) DETERMINATION OF HOLDING PERIOD.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of section 246(c) shall apply in determining the period for which the taxpayer has held any share of stock or beneficial interest; except that '6 months' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

"(C) EXCEPTION FOR LOSSES INCURRED UNDER PERIODIC LIQUIDATION PLANS.—To the extent provided in regulations, subparagraph (A) shall not apply to any loss incurred on the sale or exchange of shares of stock of, or beneficial interest in, a real estate investment trust pursuant to a plan which provides for the periodic liquidation of such shares or interests."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to losses incurred with respect to shares of stock and beneficial interests with respect to which the taxpayer's holding period begins after the date of the enactment of this Act.

PART III—MISCELLANEOUS PROVISIONS

SEC. 56. DENIAL OF DEDUCTIONS FOR CERTAIN EXPENSES INCURRED IN CONNECTION WITH SHORT SALES.

(a) SHORT SALE PAYMENTS ATTRIBUTABLE TO DIVIDENDS.—Section 263 (relating to capital expenditures) is amended by adding at the end thereof the following new subsection:

"(h) PAYMENTS IN LIEU OF DIVIDENDS IN CONNECTION WITH SHORT SALES.—

"(1) IN GENERAL.—If—

"(A) a taxpayer makes any payment with respect to any stock used by such taxpayer in a short sale and such payment is in lieu of a dividend payment on such stock, and

"(B) the closing of such short sale occurs on or before the 45th day after the date of such short sale,

then no deduction shall be allowed for such payment. The basis of the stock used to close the short sale shall be increased by the amount not allowed as a deduction by reason of the preceding sentence.

"(2) LONGER PERIOD IN CASE OF EXTRAORDINARY DIVIDENDS.—If the payment described in paragraph (1)(A) is in respect of an extraordinary dividend, paragraph (1)(B) shall be applied by substituting 'the day 1 year after the date of such short sale' for 'the 45th day after the date of such short sale'.

"(3) EXTRAORDINARY DIVIDEND.—For purposes of this subsection, the term 'extraordinary dividend' has the meaning given to such term by section 1059(c); except that such section shall be applied by treating the amount realized by the taxpayer in the short sale as his adjusted basis in the stock.

"(4) SPECIAL RULE WHERE RISK OF LOSS DIMINISHED.—The running of any period of time applicable under paragraph (1)(B) (as modified by paragraph (2)) shall be suspended during any period in which—

"(A) the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities, or

"(B) under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.

"(5) DEDUCTION ALLOWABLE TO EXTENT OF ORDINARY INCOME FROM AMOUNTS PAID BY LENDING BROKER FOR USE OF COLLATERAL.—

"(A) IN GENERAL.—Paragraph (1) shall apply only to the extent that the payments or distributions with respect to any short sale exceed the amount which—

"(i) is treated as ordinary income by the taxpayer, and

"(ii) is received by the taxpayer as compensation for the use of any collateral with respect to any stock used in such short sale.

"(B) EXCEPTION NOT TO APPLY TO EXTRAORDINARY DIVIDENDS.—Subparagraph (A) shall not apply if one or more payments or distributions is in respect of an extraordinary dividend.

"(6) APPLICATION OF THIS SUBSECTION WITH SUBSECTION (g).—In the case of any short sale, this subsection shall be applied before subsection (g)."

(b) INVESTMENT INTEREST TO INCLUDE CERTAIN EXPENSES INVOLVING SHORT SALES.—Subparagraph (D) of section 163(d)(3) (defining investment interest) is amended to read as follows:

"(D) INVESTMENT INTEREST.—

"(i) IN GENERAL.—The term 'investment interest' means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

"(ii) CERTAIN EXPENSES INCURRED IN CONNECTION WITH SHORT SALES.—For purposes of clause (i), the term 'interest' includes any amount allowable as a deduction in connection with personal property used in a short sale."

(c) APPLICATION OF SECTION 265(2) TO SHORT SALES.—Section 265 (relating to denial of deduction of interest relating to tax-exempt income) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (2) IN THE CASE OF SHORT SALES.—For purposes of paragraph (2)—

"(A) IN GENERAL.—The term 'interest' includes any amount paid or incurred—

"(i) by any person making a short sale in connection with personal property used in such short sale, or

"(ii) by any other person for the use of any collateral with respect to such short sale.

"(B) EXCEPTION WHERE NO RETURN ON CASH COLLATERAL.—If—

"(i) the taxpayer provides cash as collateral for any short sale, and

"(ii) the taxpayer receives no material earnings on such cash during the period of the sale,

subparagraph (A)(i) shall not apply to such short sale."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to short sales after the date of the enactment of this Act in taxable years ending after such date.

SEC. 57. NONRECOGNITION OF GAIN OR LOSS BY CORPORATION ON OPTIONS WITH RESPECT TO ITS STOCK.

(a) GENERAL RULE.—Subsection (a) of section 1032 (relating to exchange of stock of property) is amended by adding at the end thereof the following new sentence: "No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to options acquired or lapsed after the date of the enactment of this Act in taxable years ending after such date.

SEC. 58. AMENDMENTS TO ACCUMULATED EARNINGS TAX.

(a) CLARIFICATION THAT TAX APPLIES TO CORPORATIONS WHICH ARE NOT CLOSELY HELD.—Section 532 (relating to corporations subject to accumulated earnings tax) is amended by adding at the end thereof the following new subsection:

"(c) APPLICATION DETERMINED WITHOUT REGARD TO NUMBER OF SHAREHOLDERS.—The application of this part to a corporation shall be determined without regard to the number of shareholders of such corporation."

(b) TREATMENT OF CAPITAL GAINS AND LOSSES.—Subsection (b) of section 535 (defining accumulated taxable income) is amended by striking out paragraphs (5), (6), and (7) and inserting in lieu thereof the following:

"(5) CAPITAL LOSSES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), there shall be allowed as a deduction an amount equal to the net capital loss for the taxable year (determined without regard to paragraph (7)(A)).

"(B) RECAPTURE OF PREVIOUS DEDUCTIONS FOR CAPITAL GAINS.—The aggregate amount allowable as a deduction under subparagraph (A) for any taxable year shall be reduced by the lesser of—

"(i) the nonrecaptured capital gains deductions, or

"(ii) the amount of the accumulated earnings and profits of the corporation as of the close of the preceding taxable year.

"(C) NONRECAPTURED CAPITAL GAINS DEDUCTIONS.—For purposes of subparagraph (B),

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the term 'nonrecaptured capital gains deductions' means the excess of—

"(i) the aggregate amount allowable as a deduction under paragraph (6) for preceding taxable years beginning after the date of the enactment of the Tax Reform Act of 1984, over

"(ii) the aggregate of the reductions under subparagraph (B) for preceding taxable years.

"(6) NET CAPITAL GAINS.—

"(A) IN GENERAL.—There shall be allowed as a deduction—

"(i) the net capital gain for the taxable year (determined with the application of paragraph (7)), reduced by

"(ii) the taxes attributable to such net capital gain.

"(B) ATTRIBUTABLE TAXES.—For purposes of subparagraph (A), the taxes attributable to the net capital gain shall be an amount equal to the difference between—

"(i) the taxes imposed by this subtitle (except the tax imposed by this part) for the taxable year, and

"(ii) such taxes computed for such year without including in taxable income the net capital gain for the taxable year (determined without the application of paragraph (7)).

"(7) CAPITAL LOSS CARRYOVERS.—

"(A) UNLIMITED CARRYFORWARD.—The net capital loss for any taxable year shall be treated as a short-term capital loss in the next taxable year.

"(B) SECTION 1212 INAPPLICABLE.—No allowance shall be made for the capital loss carryback or carryforward provided in section 1212.

"(8) SPECIAL RULES FOR MERE HOLDING OR INVESTMENT COMPANIES.—In the case of a mere holding or investment company—

"(A) CAPITAL LOSS DEDUCTION, ETC., NOT ALLOWED.—Paragraphs (5) and (7)(A) shall not apply.

"(B) DEDUCTION FOR CERTAIN OFFSETS.—There shall be allowed as a deduction the net short-term capital gain for the taxable year to the extent such gain does not exceed the amount of any capital loss carryover to such taxable year under section 1212 (determined without regard to paragraph (7)(B)).

"(C) EARNINGS AND PROFITS.—For purposes of subchapter C, the accumulated earnings and profits at any time shall not be less than they would be if this subsection had applied to the computation of earnings and profits for all taxable years beginning after the date of the enactment of the Tax Reform Act of 1984."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 58. REPEAL OF STOCK FOR DEBT EXCEPTIONS FOR PURPOSES OF DETERMINING INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) GENERAL RULE.—Subsection (e) of section 108 (relating to income from discharge of indebtedness) is amended by adding at the end thereof the following new paragraph:

"(10) INDEBTEDNESS SATISFIED BY CORPORATION'S STOCK.—

"(A) IN GENERAL.—For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

"(B) EXCEPTION FOR TITLE 11 CASES AND INSOLVENT DEBTORS.—Subparagraph (A) shall not apply in the case of a debtor in a title 11 case or to the extent the debtor is insolvent."

(b) EXCEPTION FOR CERTAIN WORKOUTS.—

(1) IN GENERAL.—Paragraph (10) of section 108(e) (as added by subsection (a)) is amended by adding at the end thereof the following new subparagraph:

"(C) EXCEPTION FOR TRANSFERS IN CERTAIN WORKOUTS.—

"(i) IN GENERAL.—Subparagraph (A) shall not apply to any transfer of stock in a qualified workout.

"(ii) QUALIFIED WORKOUT.—For purposes of clause (i), the term 'qualified workout' means any plan under which stock is transferred to creditors in satisfaction of indebtedness if—

"(I) because of cash flow and credit problems, the corporation making such transfer will have trouble in meeting liabilities coming due during the next 12 months to such an extent that there is a substantial threat of involuntary proceedings relating to insolvency or bankruptcy,

"(II) such corporation in any report to its shareholders for the period during which such transfer occurs includes a statement that such corporation believes it meets the requirement of subclause (I) and that it is availing itself of the workout provisions of this subparagraph,

"(III) the holders of more than 50 percent of the total indebtedness of the corporation approve such plan, and

"(IV) at least 25 percent of the total indebtedness of the corporation is extinguished by transfers pursuant to such plan."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall take effect as if it had been included in the amendments made by subsections (e) and (f) of section 806 of the Tax Reform Act of 1976.

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

(2) TRANSITIONAL RULE.—The amendment made by subsection (a) shall not apply to the transfer by a corporation of its stock in exchange for debt of the corporation after the date of the enactment of this Act if such transfer is—

(A) pursuant to a written contract requiring such transfer which was binding on the corporation at all times on June 7, 1984, and at all times after such date but only if the transfer takes place before January 1, 1985, and only if the transferee held the debt at all times on June 7, 1984, or

(B) pursuant to the exercise of an option to exchange debt for stock but only if such option was in effect at all times on June 7, 1984, and at all times after such date and only if at all times on June 7, 1984, the option and the debt were held by the same person.

(3) CERTAIN TRANSFERS TO CONTROLLING SHAREHOLDER.—The amendment made by subsection (a) shall not apply to any transfer before January 1, 1985, by a corporation of its stock in exchange for debt of such corporation if—

(A) such transfer is to another corporation which at all times on June 7, 1984, owned 75 percent or more of the total value of the stock of the corporation making such transfer, and

(B) immediately after such transfer, the transferee corporation owns 80 percent or more of the total value of the stock of the transferor corporation.

(4) CERTAIN TRANSFERS PURSUANT TO DEBT RESTRUCTURE AGREEMENT.—The amendment made by subsection (a) shall not apply to the transfer by a corporation of its stock in exchange for debt of the corporation after the date of the enactment of this Act and before January 1, 1985, if—

(A) such transfer is covered by a debt restructure agreement entered into by the corporation during November 1983, and

(B) such agreement was specified in a registration statement filed with the Securities and Exchange Commission by the corporation on March 7, 1984.

SEC. 60. AFFILIATED GROUP DEFINED.

(a) IN GENERAL.—Subsection (a) of section 1504 (defining affiliated group) is amended to read as follows:

"(a) AFFILIATED GROUP DEFINED.—For purposes of this subtitle—

"(1) IN GENERAL.—The term 'affiliated group' means—

"(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—

"(B)(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and

"(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

"(2) 80-PERCENT VOTING AND VALUE TEST.—The ownership of stock of any corporation meets the requirements of this paragraph if it—

"(A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

"(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

"(3) 5 YEARS MUST ELAPSE BEFORE RECONSOLIDATION.—

"(A) IN GENERAL.—If—

"(i) a corporation is included (or required to be included) in a consolidated return filed by an affiliated group for a taxable year which includes any period after December 31, 1984, and

"(ii) such corporation ceases to be a member of such group in a taxable year beginning after December 31, 1984,

with respect to periods after such cessation, such corporation (and any successor of such corporation) may not be included in any consolidated return filed by the affiliated group (or by another affiliated group with the same common parent or a successor of such common parent) before the 61st month beginning after its first taxable year in which it ceased to be a member of such affiliated group.

"(B) SECRETARY MAY WAIVE APPLICATION OF SUBPARAGRAPH (A).—The Secretary may waive the application of subparagraph (A) to any corporation for any period subject to such conditions as the Secretary may prescribe.

"(4) STOCK NOT TO INCLUDE CERTAIN PREFERRED STOCK.—For purposes of this subsection, the term 'stock' does not include any stock which—

"(A) is not entitled to vote,

"(B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,

"(C) has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and

"(D) is not convertible into another class of stock.

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including (but not limited to) regulations—

"(A) which treat warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock,

"(B) which treat options to acquire or sell stock as having been exercised,

"(C) which provide that the requirements of paragraph (2)(B) shall be treated as met if the affiliated group, in reliance on a good faith determination of value, treated such requirements as met,

"(D) which disregard an inadvertent ceasing to meet the requirements of paragraph (2)(B) by reason of changes in relative values of different classes of stock,

"(E) which provide that transfers of stock within the group shall not be taken into account in determining whether a corporation ceases to be a member of an affiliated group, and

"(F) which disregard changes in voting power to the extent such changes are disproportionate to related changes in value."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

(2) SPECIAL RULE FOR CORPORATIONS AFFILIATED ON JUNE 22, 1984.—IN THE CASE OF A CORPORATION WHICH ON JUNE 22, 1984, is a member of an affiliated group which files a consolidated return for such corporation's taxable year which includes June 22, 1984, for purposes of determining whether such corporation continues to be a member of such group for taxable years beginning before January 1, 1988, the amendment made by subsection (a) shall not apply.

(3) Special rule not to apply to sell-downs after June 22, 1984. If—

(A) the requirements of subsection (b)(2) are satisfied with respect to a corporation,

(B) more than a de minimis amount of the stock of such corporation is sold or exchanged (including in a redemption), or issued (other than in the ordinary course of business) after June 22, 1984, and

(C) the requirements of the amendment made by subsection (a) are not satisfied after such sale, exchange, or issuance, then the amendments made by subsection (a) shall apply for purposes of determining whether such corporation continues to be a member of such group.

(4) EXCEPTION FOR CERTAIN SELL-DOWNS.—Subsection (b)(2) (and not subsection (b)(3)) will apply to a corporation if such corporation issues or sells stock after June 22, 1984, pursuant to a registration statement filed with the Securities and Exchange Commission on or before June 22, 1984, but only if the requirements of the amendment made by subsection (a) (substituting "more than 50 percent" for "at least 80 percent" in paragraph (2)(B) of section 1504(a) of the Internal Revenue Code of 1954) are satisfied immediately after such issuance or sale and at all times thereafter until the first day of the first taxable year beginning after December 31, 1987.

(5) NATIVE CORPORATIONS.—The amendments made by subsection (a) shall not apply to any Native Corporation established under the Alaska Native Claims Settlement Act (43 U.S.C. 1601 et seq.) during any taxable year beginning before 1992 or any part thereof in which such Corporation is subject to the provisions of section 7 (h)(1) of such Act (43 U.S.C. 1606 (h)(1)).

SEC. 61. PROVISIONS RELATING TO EARNINGS AND PROFITS.

(a) ADJUSTMENTS TO EARNINGS AND PROFITS.—

(1) IN GENERAL.—Section 312 (relating to effect on earnings and profits) is amended by adding at the end thereof the following new subsection:

"(n) ADJUSTMENTS TO EARNINGS AND PROFITS TO MORE ACCURATELY REFLECT ECONOMIC GAIN AND LOSS.—For purposes of computing the earnings and profits of a corporation, the following adjustments shall be made:

"(1) CONSTRUCTION PERIOD CARRYING CHARGES.—

"(A) IN GENERAL.—In the case of any amount paid or incurred for construction period carrying charges—

"(i) no deduction shall be allowed with respect to such amount, and

"(ii) the basis of the property with respect to which such charges are allocable shall be increased by such amount.

"(B) CONSTRUCTION PERIOD CARRYING CHARGES DEFINED.—For purposes of this paragraph, the term 'construction period carrying charges' means all—

"(i) interest paid or accrued on indebtedness incurred or continued to acquire, construct, or carry property,

"(ii) property taxes, and

"(iii) similar carrying charges,

to the extent such interest, taxes, or charges are attributable to the construction period for such property and would be allowable as a deduction in determining taxable income under this chapter for the taxable year in which paid or incurred (determined without regard to section 189).

"(C) CONSTRUCTION PERIOD.—The term 'construction period' has the meaning given such term by section 189(e)(2) (determined without regard to any real property limitation).

"(2) INTANGIBLE DRILLING COSTS AND MINERAL EXPLORATION AND DEVELOPMENT COSTS.—

"(A) INTANGIBLE DRILLING COSTS.—Any amount allowable as a deduction under section 263(c) in determining taxable income (other than costs incurred in connection with a nonproductive well)—

"(i) shall be capitalized, and

"(ii) shall be allowed as a deduction ratably over the 60-month period beginning with the month in which the production from the well begins.

"(B) MINERAL EXPLORATION AND DEVELOPMENT COSTS.—Any amount allowable as a deduction under section 616(a) or 617 in determining taxable income—

"(i) shall be capitalized, and

"(ii) shall be allowed as a deduction ratably over the 120-month period beginning with the later of—

"(I) the month in which production from the deposit begins, or

"(II) the month in which such amount was paid or incurred.

"(3) CERTAIN AMORTIZATION PROVISIONS NOT TO APPLY.—Sections 173, 177, and 248 shall not apply.

"(4) CERTAIN UNTAXED APPRECIATION OF DISTRIBUTED PROPERTY.—In the case of any distribution of property by a corporation described in section 311(d), earnings and profits shall be increased by the amount of any gain which would be includible in gross income for any taxable year if section 311(d)(2) did not apply.

"(5) LIFO INVENTORY ADJUSTMENTS.—Earnings and profits shall be increased or decreased by the amount of any increase or decrease in the LIFO recapture amount (determined under section 336(b)(3)) as of the close of each taxable year; except that any decrease below the LIFO recapture amount as of the close of the taxable year preceding the first taxable year to which this paragraph applies to the taxpayer shall be taken into account only to the extent provided in regulations prescribed by the Secretary.

"(6) INSTALLMENT SALES.—In the case of any installment sale, earnings and profits shall be computed as if the corporation did not use the installment method.

"(7) COMPLETED CONTRACT METHOD OF ACCOUNTING.—In the case of a taxpayer who uses the completed contract method of accounting, earnings and profits shall be computed as if such taxpayer used the percentage of completion method of accounting.

"(8) REDEMPTIONS.—If a corporation distributes amounts in a redemption to which section 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of such corporation accumulated after February 28, 1913, attributable to the stock so redeemed.

"(9) SPECIAL RULE FOR CERTAIN FOREIGN CORPORATIONS.—In the case of a foreign corporation described in subsection (k)(4), paragraphs (5), (6), and (7) shall apply only in the case of taxable years beginning after December 31, 1985."

(2) CONFORMING AMENDMENTS.—

(A) Section 312(j) (relating to earnings and profits of foreign investment companies) is amended by striking out paragraph (3).

(B) Subsection (e) of section 312 is hereby repealed.

(b) ADJUSTMENT TO EFFECT OF DEPRECIATION ON EARNINGS AND PROFITS.—The table contained in section 312(k)(3)(A) (relating to recovery property), as amended by this Act, is amended by striking out "35 years" in the item relating to 15-year real property and 20-year real property and inserting in lieu thereof "40 years".

(c) DISTRIBUTIONS OF OBLIGATIONS HAVING ORIGINAL ISSUE DISCOUNT.—

(1) EFFECT ON EARNINGS AND PROFITS.—

(A) Paragraph (2) of section 312(a) (relating to effect of earnings and profits) is amended to read as follows:

"(2) the principal amount of the obligations of such corporation (or, in the case of obligations having original issue discount, the aggregate issue price of such obligations), and".

(B) Section 312, as amended by subsection (a), is amended by adding at the end thereof the following new subsection:

"(o) DEFINITION OF ORIGINAL ISSUE DISCOUNT AND ISSUE PRICE FOR PURPOSES OF SUBSECTION (a)(2).—For purposes of subsection (a)(2), the terms 'original issue discount' and 'issue price' have the same respective meanings as when used in subpart A of part V of subchapter P of this chapter."

(2) TREATMENT UNDER ORIGINAL ISSUE DISCOUNT RULES.—Subsection (a) of section 1275 (relating to other definitions and special rules), as added by this Act, is amended by adding at the end thereof the following new paragraph:

"(4) TREATMENT OF OBLIGATIONS DISTRIBUTED TO CORPORATIONS.—Any debt obligation of a corporation distributed by such corporation with respect to its stock shall be treated as if it had been issued by such corporation for property."

(d) SPECIAL RULE IN CASE OF DISTRIBUTIONS RECEIVED BY 20 PERCENT CORPORATE SHAREHOLDER.—Section 301 (relating to distributions of property) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) SPECIAL RULE FOR CERTAIN DISTRIBUTIONS RECEIVED BY 20 PERCENT CORPORATE SHAREHOLDER.—

"(1) IN GENERAL.—Except to the extent otherwise provided in regulations, solely for purposes of determining the taxable income of any 20 percent corporate shareholder (and its adjusted basis in the stock of the distributing corporation), section 312 shall be applied with respect to the distributing corporation as if it did not contain subsection (n) thereof.

"(2) 20 PERCENT CORPORATE SHAREHOLDER.—For purposes of this subsection, the term '20 percent corporate shareholder' means, with respect to any distribution, any corporation

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which owns (directly or through the application of section 318)—

"(A) stock in the corporation making the distribution possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote, or

"(B) at least 20 percent of the total value of all stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends),

but only if, but for this subsection, the distributee corporation would be entitled to a deduction under section 243, 244, or 245 with respect to such distribution.

"(3) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(e) EFFECTIVE DATES.—

(1) ADJUSTMENTS TO EARNINGS AND PROFITS.—

(A) PARAGRAPHS (1), (2), AND (3) OF SECTION 312(n).—The provisions of paragraphs (1), (2), and (3) of section 312(n) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall apply to amounts paid or incurred in taxable years beginning after September 30, 1984.

(B) PARAGRAPH (4) OF SECTION 312(n).—The provisions of paragraph (4) of section 312(n) of such Code (as so added) shall apply to distributions after September 30, 1984; except that such provisions shall not apply to any distribution to which the amendments made by section 54(a) of this Act do not apply.

(C) LIFO INVENTORY.—The provisions of paragraph (5) of section 312(n) of such Code (as so added) shall apply to taxable years beginning after September 30, 1984.

(D) INSTALLMENT SALES.—The provisions of paragraph (6) of section 312(n) of such Code (as so added) shall apply to sales after September 30, 1984, in taxable years ending after such date.

(E) COMPLETED CONTRACT METHOD.—The provisions of paragraph (7) of section 312(n) of such Code (as so added) shall apply to contracts entered into after September 30, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to property placed in service in taxable years beginning after September 30, 1984.

(3) SUBSECTION (c).—The amendments made by subsection (c) shall apply with respect to distributions declared after March 15, 1984, in taxable years ending after such date.

(4) SUBSECTION (d).—The amendment made by subsection (d) shall apply to distributions after the date of the enactment of this Act in taxable years ending after such date.

SEC. 62. 2-YEAR DELAY IN APPLICATION OF THE NET OPERATING LOSS RULES ADDED BY THE TAX REFORM ACT OF 1976.

(a) IN GENERAL.—Subsection (g) of section 806 of the Tax Reform Act of 1976 (26 U.S.C. 382 note) (relating to effective dates for the amendments to sections 382 and 383 of the Internal Revenue Code of 1954) is amended—

(1) by striking out "June 30, 1984" in paragraph (2) and inserting in lieu thereof "December 31, 1985";

(2) by striking out "January 1, 1984" in paragraph (2)(B) and inserting in lieu thereof "January 1, 1986"; and

(3) by striking out "January 1, 1984" in paragraph (3) and inserting in lieu thereof "January 1, 1986".

(b) TECHNICAL AMENDMENT.—

(1) Paragraph (1) of section 382(b) (as amended by the Tax Reform Act of 1976) is amended by striking out "section 368(a)(1)(A), (B), (C), (D) (but only if the requirements of section 354(b)(1) are met), or (F)" and inserting in lieu thereof "subparagraph (A), (B), (C), or (F) of section 368(a)(1) or subparagraph (D) or (G) of section 368(a)(1) (but only if the requirements of section 354(b)(1) are met)".

(2) The amendment made by paragraph (1) shall take effect as if included in the amendments made by section 4 of the Bankruptcy Tax Act of 1980.

SEC. 63. TARGET CORPORATION MUST DISTRIBUTE ASSETS AFTER REORGANIZATION DESCRIBED IN SECTION 368(a)(1)(C).

(a) IN GENERAL.—Paragraph (2) of section 368(a) (relating to special rules for paragraph (1)) is amended by adding at the end thereof the following new subparagraph:

"(G) DISTRIBUTION REQUIREMENT FOR PARAGRAPH (1)(C).—

"(i) IN GENERAL.—A transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization.

"(ii) EXCEPTION.—The Secretary may waive the application of clause (i) to any transaction subject to any conditions the Secretary may prescribe."

(b) ALLOCATION IN CERTAIN CORPORATE SEPARATIONS AND REORGANIZATIONS.—Subsection (h) of section 312 (relating to allocation in certain corporate separations) is amended to read as follows:

"(h) ALLOCATION IN CERTAIN CORPORATE SEPARATIONS AND REORGANIZATIONS.—

"(1) SECTION 355.—In the case of a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary.

"(2) SECTION 368 (a)(1)(C) OR (D).—In the case of a reorganization described in subparagraph (C) or (D) of section 368(a)(1), proper allocation with respect to the earnings and profits of the acquired corporation shall, under regulations prescribed by the Secretary, be made between the acquiring corporation and the acquired corporation (or any corporation which had control of the acquired corporation before the reorganization)."

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to transactions pursuant to plans adopted after the date of the enactment of this Act.

SEC. 64. DEFINITION OF CONTROL FOR PURPOSES OF NONDIVISIVE REORGANIZATIONS UNDER SECTION 368(a)(1)(D).

(a) IN GENERAL.—Subsection (c) of section 368 (defining control) is amended to read as follows:

"(c) CONTROL DEFINED.—

"(1) IN GENERAL.—For purposes of part I (other than section 304), part II, this part, and part V, the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

"(2) SPECIAL RULE FOR DETERMINING WHETHER CERTAIN TRANSACTIONS ARE DESCRIBED IN SUBSECTION (a)(1)(D).—In the case of any transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, for purposes of determining whether such transaction is described in subparagraph (D) of subsection (a)(1), the term 'control' has the meaning given to such term by section 304(c)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to transactions pursuant to plans adopted after the date of the enactment of this Act.

SEC. 65. COLLAPSIBLE CORPORATIONS.

(a) DEFINITION.—Subparagraph (A) of section 341(b)(1) (relating to collapsible corporations) is amended by striking out "a substantial part" and inserting in lieu thereof "⅔".

(b) LIMITATIONS.—Subsection (d) of section 341 (relating to limitations on application of section) is amended by adding at the end thereof the following sentence: "In determining whether property is described in subsection (b)(1) for purposes of applying paragraph (2), all property described in section 1221(1) shall, to the extent provided in regulations prescribed by the Secretary, be treated as one item of property."

(c) CONFORMING AMENDMENT.—Paragraph (2) of section 341(d) is amended by striking out "so manufactured, constructed, produced, or purchased" and inserting in lieu thereof "described in subsection (b)(1)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to sales, exchanges, and distributions made after the date of the enactment of this Act.

SEC. 66. PHASE-OUT OF GRADUATED RATES FOR LARGE CORPORATIONS.

(a) IN GENERAL.—Subsection (b) of section 11 (relating to amount of tax imposed on corporations) is amended by adding at the end thereof the following new flush sentence: "In the case of a corporation with taxable income in excess of $1,000,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (A) 5 percent of such excess, or (B) $20,250."

(b) CONFORMING AMENDMENT.—Section 1561(a) (relating to limitations on certain multiple tax benefits in the case of certain control corporations) is amended by adding at the end thereof the following new sentence: "Notwithstanding paragraph (1), in applying the last sentence of section 11(b) to such component members, the taxable income of all such component members shall be taken into account and any increase in tax under such last sentence shall be divided among such component members in the same manner as amounts under paragraph (1)."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

(2) AMENDMENTS NOT TREATED AS CHANGED IN RATE OF TAX.—The amendments made by this subsection shall not be treated as a change in a rate of tax for purposes of section 21 of the Internal Revenue Code of 1954.

SEC. 67. RESTRICTIONS ON GOLDEN PARACHUTE PAYMENTS.

(a) DENIAL OF DEDUCTION.—Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding after section 280F the following new section:

"SEC. 280G. GOLDEN PARACHUTE PAYMENTS.

"(a) GENERAL RULE.—No deduction shall be allowed under this chapter for any excess parachute payment.

"(b) EXCESS PARACHUTE PAYMENT.—For purposes of this section—

"(1) IN GENERAL.—The term 'excess parachute payment' means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

"(2) PARACHUTE PAYMENT DEFINED.—

"(A) IN GENERAL.—The term 'parachute payment' means any payment in the nature of compensation to (or for the benefit of) a disqualified individual if—

"(i) such payment is contingent on a change—

"(I) in the ownership or effective control of the corporation, or

"(II) in the ownership of a substantial portion of the assets of the corporation, and

"(ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to 3 times the base amount.

"(B) AGREEMENTS.—The term 'parachute payment' shall also include any payment in the nature of compensation to (or for the benefit of) a disqualified individual if such payment is pursuant to an agreement which violates any securities laws or regulations.

"(C) TREATMENT OF CERTAIN AGREEMENTS ENTERED INTO WITHIN 1 YEAR BEFORE CHANGE OF OWNERSHIP.—For purposes of subparagraph (A)(i), any payment pursuant to—

"(i) an agreement entered into within 1 year before the change described in subparagraph (A)(i), or

"(ii) an amendment made within such 1-year period of a previous agreement,

shall be presumed to be contingent on such change unless the contrary is established by clear and convincing evidence.

"(3) BASE AMOUNT.—

"(A) IN GENERAL.—The term 'base amount' means the individual's annualized includible compensation for the base period.

"(B) ALLOCATION.—The portion of the base amount allocated to any parachute payment shall be an amount which bears the same ratio to the base amount as—

"(i) the present value of such payment, bears to

"(ii) the aggregate present value of all such payments.

"(4) EXCESS PARACHUTE PAYMENTS REDUCED TO EXTENT TAXPAYER ESTABLISHES REASONABLE COMPENSATION.—In the case of any parachute payment described in paragraph (2)(A), the amount of any excess parachute payment shall be reduced by the portion of such payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered. For purposes of the preceding sentence, reasonable compensation shall be first offset against the base amount.

"(c) DISQUALIFIED INDIVIDUALS.—For purposes of this section, the term 'disqualified individual' means any individual who is—

"(1) an employee, independent contractor, or other person specified in regulations by the Secretary who performs personal services for any corportion, and

"(2) is an officer, shareholder, or highly-compensated individual.

For purposes of this section, a personal service corporation (or similar entity) shall be treated as an individual.

"(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) ANNUALIZED INCLUDIBLE COMPENSATION FOR BASE PERIOD.—The term 'annualized includible compensation for the base period' means the average annual compensation which—

"(A) was payable by the corporation with respect to which the change in ownership or control described in paragraph (2)(A) of subsection (b) occurs, and

"(B) was includible in the gross income of the disqualified individual for taxable years in the base period.

"(2) BASE PERIOD.—The term 'base period' means the period consisting of the most recent 5 taxable years ending before the date on which the change in ownership or control described in paragraph (2)(A) of subsection (b) occurs (or such portion of such period during which the disqualified individual was an employee of the corporation).

"(3) PROPERTY TRANSFERS.—Any transfer of property—

"(A) shall be treated as a payment, and

"(B) shall be taken into account as its fair market value.

"(4) PRESENT VALUE.—Present value shall be determined in accordance with section 1274(b)(2).

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section (including regulations for the application of this section in the case of related corporations and in the case of personal service corporations)."

(b) EXCISE TAX ON AMOUNTS RECEIVED.—

(1) IN GENERAL.—Subtitle D (relating to miscellaneous excise taxes) is amended by adding at the end thereof the following new chapter:

"CHAPTER 46—GOLDEN PARACHUTE PAYMENTS

"Sec. 4999. Golden parachute payments.

"SEC. 4999. GOLDEN PARACHUTE PAYMENTS.

"(a) IMPOSITION OF TAX.—There is hereby imposed on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of such payment.

"(b) EXCESS PARACHUTE PAYMENT DEFINED.—For purposes of this section, the term 'excess parachute payment' has the meaning given to such term by section 280G(b).

"(c) ADMINISTRATIVE PROVISIONS.—

"(1) WITHHOLDING.—In the case of any excess parachute payment which is wages (within the meaning of section 3401) the amount deducted and withheld under section 3402 shall be increased by the amount of the tax imposed by this section on such payment.

"(2) OTHER ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, any tax imposed by this section shall be treated as a tax imposed by subtitle A."

(2) DENIAL OF DEDUCTION.—Paragraph (6) of section 275(a) (relating to denial of deduction for certain taxes) is amended by striking out "and 44" and inserting in lieu thereof "44, and 46".

(c) FICA TAXES.—Subparagraph (A) of section 3121(v)(2) (relating to treatment of certain nonqualified deferred compensation plans) is amended by adding at the end thereof the following new sentence:

"The preceding sentence shall not apply to any excess parachute payment (as defined in section 280G(b))."

(d) CLERICAL AMENDMENTS.—

(1) The table of sections for part IX of subchapter B of chapter 1 is amended by adding after the item relating to section 280F the following new item:

"Sec. 280G. Golden parachute payments."

(2) The table of chapters for subtitle D is amended by adding at the end thereof the following new item:

"CHAPTER 46. Golden parachute payments."

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to payments under agreements entered into or renewed after June 14, 1984, in taxable years ending after such date.

(2) SPECIAL RULE FOR CONTRACT AMENDMENTS.—In the case of any contract entered into before June 15, 1984, any amendment to such contract after June 14, 1984, which amends such contract in any significant relevant aspect shall be treated as a new contract.

SEC. 68. INCREASE IN REDUCTION IN CERTAIN CORPORATE PREFERENCE ITEMS FROM 15 PERCENT TO 20 PERCENT.

(a) IN GENERAL.—Each subsection (other than subsection (a)(2)) of section 291 (relating to special rules for corporate preference items) is amended by striking out "15 percent" each place it appears and inserting in lieu thereof "20 percent".

(b) DEFERRED FSC INCOME.—Paragraph (4) of section 291(a) (relating to certain deferred DISC income) is amended to read as follows:

"(4) CERTAIN DEFERRED FSC INCOME.—If a corporation is a shareholder of the FSC, in the case of taxable years beginning after December 31, 1984, section 923(a) shall be applied with respect to such corporation by substituting—

"(A) '32 percent' for '34 percent' in paragraph (2), and

"(B) '16/23' for '17/23' in paragraph (3).".

(c) MINIMUM TAX.—

(1) IN GENERAL.—Paragraph (1) of section 57(b) is amended to read as follows:

"(1) IN GENERAL.—

"(A) POLLUTION CONTROL FACILITIES; BAD DEBT RESERVES.—In the case of any item of tax preference of a corporation described in paragraph (4) or (7) of section (a), only 59½ percent of the amount of such item of tax preference (determined without regard to this subsection) shall be taken into account as an item of tax preference.

"(B) IRON ORE AND COAL.—In the case of any item of tax preference of a corporation described in paragraph (8) of subsection (a) (but only to the extent such item is allocable to a deduction for depletion for iron ore and coal (including lignite)),

only 71.6 percent of the amount of such item of tax preference (determined without regard to this subsection) shall be taken into account as an item of tax preference.".

(2) CERTAIN CAPITAL GAINS.—Paragraph (2) of section 57(h) (relating to capital gains) is amended by striking out "71.6 percent" and inserting in lieu thereof "59½ percent".

(d) DEFERRED DISC INCOME.—Section 995(b)(1)(F)(i) (relating to deemed distributions) is amended by striking out "one/half" and inserting in lieu thereof "one-seventeenth".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to taxable years beginning after December 31, 1984.

(2) 1250 GAIN.—The amendments made by this section to section 291(a)(1) of the Internal Revenue Code of 1954 shall apply to sales or other dispositions after December 31, 1984, in taxable years ending after such date.

(3) POLLUTION CONTROL FACILITIES.—The amendments made by this section to section 291(a)(5) of such Code shall apply to property placed in service after December 31, 1984, in taxable years ending after such date.

(4) DRILLING AND MINING COSTS.—The amendments made by this section to section 291(b) of such Code shall apply to expenditures after December 31, 1984, in taxable years ending after such date.

Subtitle E—Partnership Provisions

SEC. 71. PARTNERSHIP ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY.

(a) GENERAL RULE.—Subsection (c) of section 704 (relating to contributed property) is amended to read as follows:

"(c) CONTRIBUTED PROPERTY.—Under regulations prescribed by the Secretary, income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. Under regulations prescribed by the Secretary, rules similar to the rules of the preceding sentence shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting) of accounts payable and other accrued but unpaid items."

(b) CONFORMING AMENDMENTS.—The fourth sentence of section 613A(c)(7)(D) and the

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third sentence of section 743(b) are each amended by striking out "an agreement described in section 704(c)(2) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account" and inserting in lieu thereof "property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to property contributed to the partnership after March 31, 1984, in taxable years ending after such date.

SEC. 72. DETERMINATION OF DISTRIBUTIVE SHARES WHEN PARTNER'S INTEREST CHANGES.

(a) GENERAL RULE.—Section 706 (relating to taxable years of partner and partnership) is amended by adding at the end thereof the following new subsection:

"(d) DETERMINATION OF DISTRIBUTIVE SHARE WHEN PARTNER'S INTEREST CHANGES.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

"(2) CERTAIN CASH BASIS ITEMS PRORATED OVER PERIOD TO WHICH ATTRIBUTABLE.—

"(A) IN GENERAL.—If during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item shall be determined—

"(i) by assigning the appropriate portion of each such item to each day in the period to which it is attributable, and

"(ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.

"(B) ALLOCABLE CASH BASIS ITEM.—For purposes of this paragraph, the term 'allocable cash basis item' means any of the following items which are described in paragraph (1) and with respect to which the partnership uses the cash receipts and disbursements method of accounting:

"(i) Interest.

"(ii) Taxes.

"(iii) Payments for services or for the use of property.

"(iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

"(C) ITEMS ATTRIBUTABLE TO PERIODS NOT WITHIN TAXABLE YEAR.—If any portion of any allocable cash basis item is attributable to—

"(i) any period before the beginning of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the first day of such taxable year and allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, or

"(ii) periods after the close of the taxable year, such item shall be assigned under subparagraph (A)(i) to the last day of the taxable year.

"(D) TREATMENT OF ITEMS ALLOCATED TO PERSONS WHO ARE NO LONGER PARTNERS.—Any deduction allocated to a person under clause (i) of subparagraph (C) who is not a partner in the partnership on the first day referred to in such clause shall be capitalized by the partnership and treated in the manner provided for in section 755.

"(3) ITEMS ATTRIBUTABLE TO INTEREST IN LOWER TIER PARTNERSHIP PRORATED OVER ENTIRE TAXABLE YEAR.—If—

"(A) during any taxable year of the partnership there is a change in any partner's interest in the partnership (hereinafter in this paragraph referred to as the 'upper tier partnership'), and

"(B) such partnership is a partner in another partnership (hereinafter in this paragraph referred to as the 'lower tier partnership'),

then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles of subparagraphs (C) and (D) of paragraph (2)) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.

"(4) TAXABLE YEAR DETERMINED WITHOUT REGARD TO SUBSECTION (C)(2)(A).—For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A)."

(b) CONFORMING AMENDMENTS.—Paragraph (2) of section 706(c) is amended—

(1) by striking out the last sentence of subparagraph (A), and

(2) by striking out ", but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year" in subparagraph (B).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) in the case of items described in section 706(d)(2) of the Internal Revenue Code of 1954 (as added by subsection (a)), to amounts attributable to periods after March 31, 1984, and

(2) in the case of items described in section 706(d)(3) of such Code (as added by subsection (a)), to amounts paid or accrued by the other partnership after March 31, 1984.

SEC. 73. PAYMENTS TO PARTNERS FOR PROPERTY OR CERTAIN SERVICES.

(a) GENERAL RULE.—Subsection (a) of section 707 (relating to transactions between partner and partnership) is amended to read as follows:

"(a) PARTNER NOT ACTING IN CAPACITY AS PARTNER.—

"(1) IN GENERAL.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

"(2) TREATMENT OF PAYMENTS TO PARTNERS FOR PROPERTY OR SERVICES.—Under regulations prescribed by the Secretary—

"(A) TREATMENT OF CERTAIN SERVICES AND TRANSFERS OF PROPERTY.—If—

"(i) a partner performs services for a partnership or transfers property to a partnership,

"(ii) there is a related direct or indirect allocation and distribution to such partner, and

"(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

such allocation and distribution shall be treated as a transaction described in paragraph (1).

"(B) TREATMENT OF CERTAIN PROPERTY TRANSFERS.—If—

"(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

"(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

"(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply—

(A) in the case of arrangements described in section 707(a)(2)(A) of the Internal Revenue Code of 1954 (as amended by subsection (a)), to services performed or property transferred after February 29, 1984, and

(B) in the case of transfers described in section 707(a)(2)(B) of such Code (as so amended), to property transferred after March 31, 1984.

(2) BINDING CONTRACT EXCEPTION.—The amendment made by subsection (a) shall not apply to a transfer of property described in section 707(a)(2)(B)(i) if such transfer is pursuant to a binding contract in effect on March 31, 1984, and at all times thereafter before the transfer.

(3) EXCEPTION FOR CERTAIN TRANSFERS.—The amendment made by subsection (a) shall not apply to a transfer of property described in section 707(a)(2)(B)(i) that is made before December 31, 1984, if—

(A) such transfer was proposed in a written private offering memorandum circulated before February 28, 1984;

(B) the out-of-pocket costs incurred with respect to such offering exceeded $250,000 as of February 28, 1984;

(C) the encumbrances placed on such property in anticipation of such transfer all constitute obligations for which neither the partnership nor any partner is liable; and

(D) the transferor of such property is the sole general partner of the partnership.

SEC. 74. CONTRIBUTIONS TO A PARTNERSHIP OF UNREALIZED RECEIVABLES, INVENTORY ITEMS, OR CAPITAL LOSS PROPERTY.

(a) GENERAL RULE.—Subpart A of part II of subchapter K of chapter 1 (relating to contributions to a partnership) is amended by adding at the end thereof the following new section:

"SEC. 724. CHARACTER OF GAIN OR LOSS ON CONTRIBUTED UNREALIZED RECEIVABLES, INVENTORY ITEMS, AND CAPITAL LOSS PROPERTY.

"(a) CONTRIBUTIONS OF UNREALIZED RECEIVABLES.—In the case of any property which—

"(1) was contributed to the partnership by a partner, and

"(2) was an unrealized receivable in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be.

"(b) CONTRIBUTIONS OF INVENTORY ITEMS.—In the case of any property which—

"(1) was contributed to the partnership by a partner, and

"(2) was an inventory item in the hands of such partner immediately before such contribution,
any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

"(c) CONTRIBUTIONS OF CAPITAL LOSS PROPERTY.—In the case of any property which—

"(1) was contributed by a partner to the partnership, and

"(2) was a capital asset in the hands of such partner immediately before such contribution,
any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

"(d) DEFINITIONS.—For purposes of this section—

"(1) UNREALIZED RECEIVABLE.—The term 'unrealized receivable' has the meaning given such term by section 751(c) (determined by treating any reference to the partnership as referring to the partner).

"(2) INVENTORY ITEM.—The term 'inventory item' has the meaning given such term by section 751(d)(2) (determined by treating any reference to the partnership as referring to the partner and by applying section 1231 without regard to any holding period therein provided).

"(3) SUBSTITUTED BASIS PROPERTY.—

"(A) IN GENERAL.—If any property described in subsection (a), (b), or (c) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of non-recognition transactions.

"(B) EXCEPTION FOR STOCK IN C CORPORATION.—Subparagaph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351."

(b) AMENDMENT OF SECTION 735.—Section 735 (relating to character of gain or loss on disposition of distributed property) is amended by adding at the end thereof the following new subsection:

"(c) SPECIAL RULES.—

"(1) WAIVER OF HOLDING PERIODS CONTAINED IN SECTION 1231.—For purposes of this section, section 751(d)(2) (defining inventory item) shall be applied without regard to any holding period in section 1231(b).

"(2) SUBSTITUTED BASIS PROPERTY.—

"(A) IN GENERAL.—If any property described in subsection (a) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of nonrecognition transactions.

"(B) EXCEPTION FOR STOCK IN C CORPORATION.—Subparagraph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351."

(c) CLERICAL AMENDMENT.—The table of sections for subpart A of part II of subchapter K of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 724. Character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property."

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to property contributed to a partnership after March 31, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to property distributed after March 31, 1984, in taxable years ending after such date.

SEC. 75. TRANSFERS OF PARTNERSHIP AND TRUST INTERESTS BY CORPORATIONS.

(a) GENERAL RULE.—Subchapter C of chapter 1 (relating to corporate distributions and adjustments) is amended by adding at the end thereof the following new part:

"PART VII—MISCELLANEOUS CORPORATE PROVISIONS

"Sec. 386. Transfers of partnership and trust interests by corporations.

"SEC. 386. TRANSFERS OF PARTNERSHIP AND TRUST INTERESTS BY CORPORATIONS.

"(a) CORPORATE DISTRIBUTIONS.—For purposes of determining the amount (and character) of gain recognized by a corporation on any distribution of an interest in a partnership, the distribution shall be treated in the same manner as if it included a property distribution consisting of the corporation's proportionate share of the recognition property of such partnership.

"(b) SALES OR EXCHANGE TO WHICH SECTION 337 APPLIES.—For purposes of determining the amount (and character) of gain recognized on a sale or exchange described in section 337, any sale or exchange by a corporation of an interest in a partnership shall be treated as a sale or exchange of the corporation's proportionate share of the recognition property of such partnership.

"(c) RECOGNITION PROPERTY.—For purposes of this section, the term 'recognition property' means any property with respect to which gain would be recognized to the corporation if such property—

"(1) were distributed by the corporation in a distribution described in section 311 or 336, or

"(2) were sold in a sale described in section 337,
whichever is appropriate. In determining whether property of a partnership is recognition property, such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner.

"(d) EXTENSION TO TRUSTS.—Under regulations, rules similar to the rules of this section shall also apply in the case of the distribution or sale or exchange by a corporation of an interest in a trust."

(b) DISTRIBUTIONS TREATED AS EXCHANGES FOR PURPOSES OF SUBCHAPTER K.—Section 761 (relating to definitions) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) DISTRIBUTIONS TREATED AS EXCHANGES.—For purposes of—

"(1) section 708 (relating to continuation of partnership),

"(2) section 743 (relating to optional adjustment to basis of partnership property), and

"(3) any other provision of this subchapter specified in regulations prescribed by the Secretary,
any distribution (not otherwise treated as an exchange) shall be treated as an exchange."

(c) CLARIFICATION OF FAIR MARKET VALUE IN THE CASE OF NONRECOURSE INDEBTEDNESS.—Section 7701 (relating to definitions), as amended by this Act, is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) CLARIFICATION OF FAIR MARKET VALUE IN THE CASE OF NONRECOURSE INDEBTEDNESS.—For purposes of subtitle A, in determining the amount of gain or loss or deemed gain or loss with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject."

(d) CLERICAL AMENDMENT.—The table of parts for subchapter C of chapter 1 is amended by adding at the end thereof the following new item:

"Part VII. Miscellaneous corporate provisions."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after such date.

SEC. 76. APPLICATION OF SECTION 751 IN THE CASE OF TIERED PARTNERSHIPS.

(a) GENERAL RULE.—Section 751 (relating to unrealized receivables and inventory items) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULES IN THE CASE OF TIERED PARTNERSHIPS, ETC.—In determining whether property of a partnership is—

"(1) an unrealized receivable, or

"(2) an inventory item,
such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Under regulations, rules similar to the rules of the preceding sentence shall also apply in the case of interests in trusts."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after such date.

SEC. 77. SECTION 1031 NOT APPLICABLE TO PARTNERSHIP INTERESTS; LIMITATION ON THE PERIOD DURING WHICH LIKE KIND EXCHANGES MAY BE MADE.

(a) IN GENERAL.—Subsection (a) of section 1031 (relating to nonrecognition of gain or loss from exchanges solely in kind) is amended to read as follows:

"(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—

"(1) IN GENERAL.—No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

"(2) EXCEPTION.—This subsection shall not apply to any exchange of—

"(A) stock in trade or other property held primarily for sale,

"(B) stocks, bonds, or notes,

"(C) other securities or evidences of indebtedness or interest,

"(D) interests in a partnership,

"(E) certificates of trust or beneficial interests, or

"(F) choses in action.

"(3) REQUIREMENT THAT PROPERTY BE IDENTIFIED AND THAT EXCHANGE BE COMPLETED NOT MORE THAN 180 DAYS AFTER TRANSFER OF EXCHANGED PROPERTY.—For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

"(A) such property is not identified as property to be received in the exchange before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

"(B) such property is received after the earlier of—

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"(I) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

"(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply to transfers made after the date of the enactment of this Act in taxable years ending after such date.

(2) BINDING CONTRACT EXCEPTION FOR TRANSFER OF PARTNERSHIP INTERESTS.—Paragraph (2)(D) of section 1031(a) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall not apply in the case of any exchange pursuant to a binding contract in effect on March 1, 1984, and at all times thereafter before the exchange.

(3) REQUIREMENT THAT PROPERTY BE IDENTIFIED WITHIN 45 DAYS AND THAT EXCHANGE BE COMPLETED WITHIN 180 DAYS.—Paragraph (3) of section 1031(a) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall apply—

(A) to transfers after the date of the enactment of this Act, and

(B) to transfers on or before such date of enactment if the property to be received in the exchange is not received before January 1, 1987.

In the case of any transfer on or before the date of the enactment of this Act which the taxpayer treated as part of a like-kind exchange, the period for assessing any deficiency of tax attributable to the amendment made by subsection (a) shall not expire before January 1, 1988.

(4) SPECIAL RULE WHERE PROPERTY IDENTIFIED IN BINDING CONTRACT.—If the property to be received in the exchange is identified in a binding contract in effect on June 13, 1984, and at all times thereafter before the transfer, paragraph (3) shall be applied—

(A) by substituting "January 1, 1988" for "January 1, 1987", and

(B) by substituting "January 1, 1990" for "January 1, 1988".

(5) SPECIAL RULE FOR LIKE KIND EXCHANGE OF PARTNERSHIP INTERESTS.—Paragraph (2)(D) of section 1031(a) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall not apply to any exchange of an interest as general partner pursuant to a plan of reorganization of ownership interest under a contract which took effect on March 29, 1984, but only if all the exchanges contemplated by the reorganization plan are completed on, or before December 31, 1984.

SEC. 78. ELIMINATION OF BASIS STRIPS UNDER SECTION 734(b).

(a) GENERAL RULE.—Subsection (b) of section 734 is amended by adding at the end thereof the following new sentence: "Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions after March 1, 1984, in taxable years ending after such date.

SEC. 79. OVERRULING OF RAPHAN CASE.

(a) GENERAL RULE.—Section 752 of the Internal Revenue Code of 1954 (and the regulations prescribed thereunder) shall be applied without regard to the result reached in the case of Raphan vs the United States, 3 Cl. Ct. 457 (1983).

(b) REGULATIONS.—In amending the regulations prescribed under section 752 of such Code to reflect subsection (a), the Secretary of the Treasury or his delegate shall prescribe regulations relating to liabilities including the treatment of guarantees, assumptions, indemnity agreements, and similar arrangements.

Subtitle F—Trust Provisions

SEC. 81. TREATMENT OF PROPERTY DISTRIBUTED IN KIND.

(a) GENERAL RULE.—Section 643 (relating to definitions applicable to subchapters A, B, C, and D) is amended by adding at the end thereof the following new subsection:

"(d) TREATMENT OF PROPERTY DISTRIBUTED IN KIND.—

"(1) BASIS OF BENEFICIARY.—The basis of any property received by a beneficiary in a distribution from an estate or trust shall be—

"(A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for

"(B) any gain or loss recognized to the estate or trust on the distribution.

"(2) AMOUNT OF DISTRIBUTION.—In the case of any distribution of property (other than cash), the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the lesser of—

"(A) the basis of such property in the hands of the beneficiary (as determined under paragraph (1)), or

"(B) the fair market value of such property.

"(3) ELECTION TO RECOGNIZE GAIN.—

"(A) IN GENERAL.—In the case of any distribution of property (other than cash) to which an election under this paragraph applies—

"(i) paragraph (2) shall not apply,

"(ii) gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and

"(iii) the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the fair market value of such property.

"(B) ELECTION.—Any election under this paragraph shall be made by the estate or trust on its return for the taxable year for which the distribution was made.

Any such election, once made, may be revoked only with the consent of the Secretary.

"(4) EXCEPTION FOR DISTRIBUTIONS DESCRIBED IN SECTION 663 (a).—This subsection shall not apply to any distribution described in section 663(a)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to distributions after June 1, 1984, in taxable years ending after such date.

(2) TIME FOR MAKING ELECTION.—In the case of any distribution before the date of the enactment of this Act—

(A) the time for making an election under section 643(d)(3) of the Internal Revenue Code of 1954 (as added by this section) shall not expire before January 1, 1985, and

(B) the requirement that such election be made on the return of the estate or trust shall not apply.

SEC. 82. TREATMENT OF MULTIPLE TRUSTS.

(a) GENERAL RULE.—Section 643 (relating to definitions applicable to subparts A, B, C, and D) is amended by adding at the end thereof the following new subsection:

"(e) TREATMENT OF MULTIPLE TRUSTS.—For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

"(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

"(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after March 1, 1984.

Subtitle G—Accounting Changes

SEC. 91. CERTAIN AMOUNTS NOT TREATED AS INCURRED BEFORE ECONOMIC PERFORMANCE.

(a) IN GENERAL.—Section 461 (relating to general rule for taxable year of deduction) is amended by adding at the end thereof the following new subsections:

"(h) CERTAIN LIABILITIES NOT INCURRED BEFORE ECONOMIC PERFORMANCE.—

"(1) IN GENERAL.—For purposes of this title, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

"(2) TIME WHEN ECONOMIC PERFORMANCE OCCURS.—Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

"(A) SERVICES AND PROPERTY PROVIDED TO THE TAXPAYER.—If the liability of the taxpayer arises out of—

"(i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,

"(ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or

"(iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

"(B) SERVICES AND PROPERTY PROVIDED BY THE TAXPAYER.—If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

"(C) WORKERS COMPENSATION AND TORT LIABILITIES OF THE TAXPAYER.—If the liability of the taxpayer requires a payment to another person and—

"(i) arises under any workers compensation act, or

"(ii) arises out of any tort,

economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

"(D) OTHER ITEMS.—In the case of any other liability of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

"(3) EXCEPTION FOR CERTAIN RECURRING ITEMS.—

"(A) IN GENERAL.—Notwithstanding paragraph (1) an item shall be treated as incurred during any taxable year if—

"(i) the all events test with respect to such item is met during such taxable year (determined without regard to paragraph (1)),

"(ii) economic performance with respect to such item occurs within the shorter of—

"(I) a reasonable period after the close of such taxable year, or

"(II) 8½ months after the close of such taxable year,

"(iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and

"(iv) either—

"(I) such item is not a material item, or

"(II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

"(B) FINANCIAL STATEMENTS CONSIDERED UNDER SUBPARAGRAPH (A)(iv).—In making a determination under subparagraph (A)(iv), the treatment of such item on financial statements shall be taken into account.

"(C) PARAGRAPH NOT TO APPLY TO WORKERS COMPENSATION AND TORT LIABILITIES.—This paragraph shall not apply to any item described in subparagraph (C) of paragraph (2).

"(4) ALL EVENTS TEST.—For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

"(5) SUBSECTION NOT TO APPLY TO CERTAIN CASES TO WHICH OTHER PROVISIONS OF THIS TITLE SPECIFICALLY APPLY.—This subsection shall not apply to any item to which any of the following provisions apply:

"(A) Subsection (c) or (f) of section 166 (relating to reserves for bad debts).

"(B) Section 463 (relating to vacation pay).

"(C) Section 466 (relating to discount coupons).

"(D) Any other provisions of this title which specifically provides for a deduction for a reserve for estimated expenses.

"(i) TAX SHELTERS MAY NOT DEDUCT ITEMS EARLIER THAN WHEN ECONOMIC PERFORMANCE OCCURS.—

"(1) IN GENERAL.—In the case of a tax shelter computing taxable income under the cash receipts and disbursements method of accounting, such tax shelter shall not be allowed a deduction under this chapter with respect to any item any earlier than the time when such item would be treated as incurred under subsection (h) (determined without regard to paragraph (3) thereof).

"(2) EXCEPTION (TO EXTENT OF CASH BASIS) WHEN ECONOMIC PERFORMANCE OCCURS WITHIN 90 DAYS AFTER THE CLOSE OF THE TAXABLE YEAR.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to any item if economic performance with respect to such item occurs within 90 days after the close of the taxable year.

"(B) DEDUCTION LIMITED TO CASH BASIS.—

"(i) TAX SHELTER PARTNERSHIPS.—In the case of a tax shelter which is a partnership, in applying section 704(d) to a deduction or loss for any taxable year attributable to an item which is deductible by reason of subparagraph (A), the term 'cash basis' shall be substituted for the term 'adjusted basis'.

"(ii) OTHER TAX SHELTERS.—Under regulations prescribed by the Secretary, in the case of a tax shelter other than a partnership, the aggregate amount of the deductions allowable by reason of subparagraph (A) for any taxable year shall be limited in a manner similar to the limitation under clause (i).

"(C) CASH BASIS DEFINED.—For purposes of subparagraph (B), a partner's cash basis in a partnership shall be equal to the adjusted basis of such partner's interest in the partnership, determined without regard to—

"(i) any liability of the partnership, and

"(ii) any amount borrowed by the partner with respect to such partnership which—

"(I) was arranged by the partnership or by any person who participated in the organization, sale, or management of the partnership (or any person related to such person within the meaning of section 168(e)(4)), or

"(II) was secured by any assets of the partnership.

"(D) SPECIAL CASH BASIS RULE FOR SPUDDING OF OIL OR GAS WELLS.—Solely for purposes of applying subparagraph (A), economic performance with respect to the act of drilling of an oil or gas well shall be treated as occurring when the drilling of the well is commenced.

"(3) TAX SHELTER DEFINED.—For purposes of this subsection, the term 'tax shelter' means—

"(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,

"(B) any syndicate (within the meaning of section 1256(e)(3)(B)), and

"(C) any tax shelter (within the meaning of section 6661(b)(2)(C)(ii)).

"(4) SPECIAL RULES FOR FARMING.—In the case of the trade or business of farming (as defined in section 464(e))—

"(A) section 464 shall be applied to any tax shelter described in paragraph (3)(C),

"(B) section 464 shall be applied before this subsection, and

"(C) in determining whether an entity is a tax shelter, the definition of farming syndicate in section 464(c) shall be substituted for subparagraphs (A) and (B) of paragraph (3).

"(5) ECONOMIC PERFORMANCE.—For purposes of this subsection, the term 'economic performance' has the meaning given such term by subsection (h)."

(b) SPECIAL RULES FOR MINING AND SOLID WASTE RECLAMATION AND CLOSING COSTS.—

(1) IN GENERAL.—Subpart C of part II of subchapter E of chapter 1 (relating to taxable year for which deduction taken), as amended by section 92, is amended by adding at the end thereof the following new section:

"SEC. 468. SPECIAL RULES FOR MINING AND SOLID WASTE RECLAMATION AND CLOSING COSTS.

"(a) ESTABLISHMENT OF RESERVES FOR RECLAMATION AND CLOSING COSTS.—

"(1) ALLOWANCE OF DEDUCTION.—If a taxpayer elects the application of this subsection with respect to any mining or solid waste disposal property, the amount of any deduction for qualified reclamation or closing costs for any taxable year to which such election applies shall be equal to the current reclamation or closing costs allocable to—

"(A) in the case of qualified reclamation costs, the portion of the reserve property which was disturbed during such taxable year, and

"(B) in the case of qualified closing costs, the production from the reserve property during such taxable year.

"(2) OPENING BALANCE AND ADJUSTMENTS TO RESERVE.—

"(A) OPENING BALANCE.—The opening balance of any reserve for its first taxable year shall be zero.

"(B) INCREASE FOR INTEREST.—

"(i) IN GENERAL.—A reserve shall be increased each taxable year by an amount equal to the amount of interest which would be earned during such taxable year on the opening balance of such reserve for such taxable year if such interest were computed—

"(I) at the Federal short-term rate or rates (determined under section 1274) in effect, and

"(II) by compounding semiannually.

"(ii) PHASE-IN OF INTEREST RATE.—In the case of taxable years ending before 1987, the rate determined under clause (i)(I) shall be equal to the following percentage of such rate (determined without regard to this clause):

"In the case of taxable years ending in:	*The percentage is:*
1984 or 1985	*70*
1986	*85.*

"(C) RESERVE TO BE CHARGED FOR AMOUNTS PAID.— Any amount paid by the taxpayer during any taxable year for qualified reclamation or closing costs allocable to portions of the reserve property for which the election under paragraph (1) was in effect shall be charged to the appropriate reserve as of the close of the taxable year.

"(3) ALLOWANCE OF DEDUCTION FOR EXCESS AMOUNTS PAID.—There shall be allowed as a deduction for any taxable year the excess of—

"(A) the amounts described in paragraph (2)(C) paid during such taxable year, over

"(B) the closing balance of the reserve for such taxable year (determined without regard to paragraph (2)(C)).

"(4) LIMITATION ON BALANCE AS OF THE CLOSE OF ANY TAXABLE YEAR.—

"(A) RECLAMATION RESERVES.—In the case of any reserve for qualified reclamation costs, there shall be included in gross income for any taxable year an amount equal to the excess of—

"(i) the closing balance of the reserve for such taxable year, over

"(ii) the current reclamation costs of the taxpayer for all portions of the reserve property disturbed during any taxable year to which the election under paragraph (1) applies.

"(B) CLOSING COSTS RESERVES.—In the case of any reserve for qualified closing costs, there shall be included in gross income for any taxable year an amount equal to the excess of—

"(i) the closing balance of the reserve for such taxable year, over

"(ii) the current closing cost of the taxpayer with respect to the reserve property, determined as if all production with respect to the reserve property for any taxable year to which the election under paragraph (1) applies had occurred in such taxable year.

(c) ORDER OF APPLICATION.—This paragraph shall be applied after all adjustments to the reserve have been made for the taxable year.

"(5) INCOME INCLUSIONS ON COMPLETION OR DISPOSITION.—Proper inclusion in income shall be made upon—

"(A) the revocation of an election under paragraph (1), or

"(B) completion of the closing, or disposition of any portion, of a reserve property.

"(b) ALLOCATION FOR PROPERTY WHERE ELECTION NOT IN EFFECT FOR ALL TAXABLE YEARS.—If the election under subsection (a)(1) is not in effect for 1 or more taxable years in which the reserved property is disturbed (or production occurs), items with respect to the reserve property shall be allocated to the reserve in such manner as the Secretary may prescribe by regulations.

"(c) REVOCATION OF ELECTION; SEPARATE RESERVES.—

"(1) REVOCATION OF ELECTION.—

"(A) IN GENERAL.—The taxpayer may revoke an election under subsection (a)(1) with respect to any property. Such revocation, once made, shall be irrevocable.

"(B) TIME AND MANNER OF REVOCATION.—Any revocation under subparagraph (A) shall be made at such time and in such manner as the Secretary may prescribe.

"(2) SEPARATE RESERVES REQUIRED.—If a taxpayer makes an election under subsection (a)(1), the taxpayer shall establish with respect to the property for which the election was made—

"(A) a separate reserve for qualified reclamation costs, and

"(B) a separate reserve for qualified closing costs.

"(d) DEFINITIONS AND SPECIAL RULES RELATING TO RECLAMATION AND CLOSING COSTS.— For purposes of this section—

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"(1) CURRENT RECLAMATION AND CLOSING COSTS.—

"(A) CURRENT RECLAMATION COSTS.—The term 'current reclamation costs' means the amount which the taxpayer would be required to pay for qualified reclamation costs if the reclamation activities were performed currently.

"(B) CURRENT CLOSING COSTS.—

"(i) IN GENERAL.—The term 'current closing costs' means the amount which the taxpayer would be required to pay for qualified closing costs if the closing activities were performed currently.

"(ii) COSTS COMPUTED ON UNIT-OF-PRODUCTION OR CAPACITY METHOD.—Estimated closing costs shall—

"(I) in the case of the closing of any mine site, be computed on the unit-of-production method of accounting, and

"(II) in the case of the closing of any solid waste disposal site, be computed on the unit-of-capacity method.

"(2) QUALIFIED RECLAMATION OR CLOSING COSTS.—The term 'qualified reclamation or closing costs' means any of the following expenses:

"(A) MINING RECLAMATION AND CLOSING COSTS.—Any expenses incurred for any land reclamation or closing activity which is conducted in accordance with a reclamation plan (including an amendment or modification thereof)—

"(i) which—

"(I) is submitted pursuant to the provisions of section 511 or 528 of the Surface Mining Control and Reclamation Act of 1977 (as in effect on January 1, 1984), and

"(II) is part of a surface mining and reclamation permit granted under the provisions of title V of such Act (as so in effect), or

"(ii) which is submitted pursuant to any other Federal or State law which imposes surface mining reclamation and permit requirements substantially similar to the requirements imposed by title V of such Act (as so in effect).

"(B) SOLID WASTE DISPOSAL AND CLOSING COSTS.—

"(i) IN GENERAL.—Any expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site which is conducted in accordance with any permit issued pursuant to—

"(I) any provision of the Solid Waste Disposal Act (as in effect on January 1, 1984) requiring such activity, or

"(II) any other Federal, State, or local law which imposes requirements substantially similar to the requirements imposed by the Solid Waste Disposal Act (as so in effect).

"(ii) EXCEPTION FOR CERTAIN HAZARDOUS WASTE SITES.—Clause (i) shall not apply to that portion of any property which is disturbed after the property is listed in the national contingency plan established under section 105 of the Comprehensive Environmental, Compensation, and Liability Act of 1980.

"(3) PROPERTY.—The term 'property' has the meaning given such term by section 614.

"(4) RESERVE PROPERTY.—The term 'reserve property' means any property with respect to which a reserve is established under subsection (a)(1)."

(2) CONFORMING AMENDMENT.—The table of sections for subpart C of part II of subchapter E of Chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 468. Special rules for mining and solid waste reclamation and closing costs."

(c) SPECIAL RULE FOR LIABILITIES IN CONNECTION WITH THE DECOMMISSIONING OF A NUCLEAR POWERPLANT.—

(1) IN GENERAL.—Subpart C of part II of subchapter E of chapter 1 (relating to taxable year for which deduction taken), as amended by subsection (b), is amended by adding at the end thereof the following new section:

"SEC. 468A. SPECIAL RULES FOR NUCLEAR DECOMMISSIONING COSTS.

"(a) IN GENERAL.—If the taxpayer elects the application of this subsection, there shall be allowed as a deduction for any taxable year the amount of payments made by the taxpayer to a Nuclear Decommissioning Reserve Fund (hereinafter referred to as the 'Fund') during such taxable year.

"(b) LIMITATION ON AMOUNTS PAID INTO FUND.—The amount which a taxpayer may pay into the Fund for any taxable year shall not exceed the lesser of—

"(1) the amount of nuclear decommissioning costs allocable to the Fund which is included in the taxpayer's cost of service for ratemaking purposes for such taxable year, or

"(2) the ruling amount applicable to such taxable year.

"(c) INCOME AND DEDUCTIONS OF THE TAXPAYER.—

"(1) INCLUSION OF AMOUNTS DISTRIBUTED.—There shall be includible in the gross income of the taxpayer for any taxable year—

"(A) any amount distributed from the Fund during such taxable year, other than any amount distributed to pay costs described in subsection (e)(2)(B), and

"(B) except to the extent provided in regulations, amounts properly includible in gross income in the case of any deemed distribution under subsection (e)(6), any termination under subsection (e)(7), or the disposition of any interest in the nuclear powerplant.

"(2) DEDUCTION WHEN ECONOMIC PERFORMANCE OCCURS.—In addition to any deduction under subsection (a), there shall be allowable as a deduction for any taxable year the amount of the nuclear decommissioning costs with respect to which economic performance (within the meaning of section 461(h)(2)) occurs during such taxable year.

"(d) RULING AMOUNT.—For purposes of this subsection—

"(1) REQUEST REQUIRED.—No deduction shall be allowed for any payment to the Fund unless the taxpayer requests, and receives, from the Secretary a schedule of ruling amounts.

"(2) RULING AMOUNT.—The term 'ruling amount' means, with respect to any taxable year, the amount which the Secretary determines under paragraph (1) to be necessary to—

"(A) fund that portion of the nuclear decommissioning costs of the taxpayer with respect to the nuclear powerplant which bears the same ratio to the total nuclear decommissioning costs with respect to such nuclear powerplant as the period for which the Fund is in effect bears to the estimated life of such nuclear powerplant, and useful

"(B) prevent any excessive funding of such costs or the funding of such costs at a rate more rapid than level funding, taking into account such discount rates as the Secretary deems appropriate.

"(3) REVIEW OF AMOUNT.—The Secretary shall at least once during the useful life of the nuclear powerplant (or, more frequently, upon the request of the taxpayer) review, and revise if necessary, the schedule of ruling amounts determined under paragraph (1).

"(e) NUCLEAR DECOMMISSIONING TRUST FUND.—

"(1) IN GENERAL.—Each taxpayer who elects the application of this subsection shall establish a Nuclear Decommissioning Trust Fund with respect to each nuclear powerplant to which such election applies.

"(2) TAXATION OF FUND.—There is imposed on the gross income of the Fund for any taxable year a tax at a rate equal to the maximum rate in effect under section 11(b), except that—

"(A) there shall not be included in the gross income of the Fund any payment to the Fund with respect to which a deduction is allowable under subsection (a), and

"(B) there shall be allowed as a deduction any amount paid by the Fund described in paragraph (4)(B) (other than to the taxpayer).

"(3) CONTRIBUTIONS TO FUND.—The Fund shall not accept any payments (or other amounts) other than payments with respect to which a deduction is allowable under subsection (a).

"(4) USE OF FUND.—The Fund shall be used exclusively for—

"(A) satisfying, in whole or in part, any liability of any person contributing to the Fund for the decommissioning of a nuclear powerplant (or unit thereof), and

"(B) to pay administrative costs (including taxes) and other incidental expenses of the Fund (including legal, accounting, actuarial, and trustee expenses) in connection with the operation of the Fund.

"(5) PROHIBITIONS AGAINST SELF-DEALING.—Under regulations prescribed by the Secretary, for purposes of section 4951 (and so much of this title as relates to such section), the Fund shall be treated in the same manner as a trust described in section 501(c)(21).

"(6) DISQUALIFICATION OF FUND.—In any case in which the Fund violates any provision of this subsection or section 4951, the Secretary may disqualify such Fund from the application of this subsection. In any case to which this subparagraph applies, the Fund shall be treated as having distributed all of its funds on the date such determination takes effect.

"(7) TERMINATION UPON COMPLETION.—Upon substantial completion of the nuclear decommissioning of the nuclear powerplant with respect to which a Fund relates, the taxpayer shall terminate such Fund.

"(f) NUCLEAR POWERPLANT.—The term 'nuclear powerplant' includes any unit thereof."

(2) CONFORMING AMENDMENT.—The table of sections for subpart C of part II of subchapter E of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 468A. Special rules for nuclear decommissioning costs."

(d) 10-YEAR NET OPERATING LOSS CARRYBACK PERIOD FOR DEFERRED STATUTORY OR TORT LIABILITY DEDUCTIONS.—

(1) IN GENERAL.—Paragraph (1) of section 172(b) (relating to years to which loss may be carried) is amended by adding at the end thereof the following new subparagraph:

"(K) SPECIAL RULE FOR DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—In the case of a taxpayer which has a deferred statutory or tort liability loss (as defined in subsection (k)) for any taxable year beginning after December 31, 1983, the deferred statutory or tort liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss."

(2) DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—Section 172 is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) DEFINITIONS AND SPECIAL RULES RELATING TO DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—For purposes of this section—

"(1) DEFERRED STATUTORY OR TORT LIABILITY LOSS.—The term 'deferred statutory or tort li-

ability loss' means, for any taxable year, the lesser of—

"(A) the net operating loss for such taxable year, reduced by any portion thereof attributable to—

"(i) a foreign expropriation loss, or

"(ii) a product liability loss, or

"(B) the sum of the amounts allowable as a deduction under this chapter (other than any deduction described in subsection (j)(1)(B)) which—

"(i) is taken into account in computing the net operating loss for such taxable year, and

"(ii) is for an amount incurred with respect to a liability which arises under a Federal or State law or out of any tort of the taxpayer and—

"(I) in the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of such taxable year, or

"(II) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of such taxable year.

A liability shall not be taken into account under the preceding sentence unless the taxpayer used an accrual method of accounting throughout the period or periods during which the acts or failures to act giving rise to such liability occurred.

"(2) SPECIAL RULE FOR NUCLEAR POWERPLANTS.—Except as provided in regulations prescribed by the Secretary, that portion of a deferred statutory or tort liability loss which is attributable to amounts incurred in the decommissioning of a nuclear powerplant (or any unit thereof) may, for purposes of subsection (b)(1)(K), be carried back to each of the taxable years during the period—

"(A) beginning with the taxable year in which such plant (or unit thereof) was placed in service, and

"(B) ending with the taxable year preceding the loss year.

"(3) COORDINATION WITH SUBSECTION (b)(2).—In applying paragraph (2) of subsection (b), a deferred statutory or tort liability loss shall be treated in a manner similar to the manner in which a foreign expropriation loss is treated.

"(4) NO CARRYBACK TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1984.—No deferred statutory or tort liability loss may be carried back to a taxable year beginning before January 1, 1984, unless such loss may be carried back to such year without regard to subsection (b)(1)(K)."

(3) CONFORMING AMENDMENTS.—

(A) Clause (i) of section 172(b)(1)(A) is amended by striking out "and (J)" and inserting in lieu thereof "(J), and (K)".

(B) Subsections (h) and (j) of section 172 are each amended by striking out "subsection (b)" in the matter preceding paragraph (1) and inserting in lieu thereof "this section".

(e) CONFORMING AMENDMENT.—Paragraph (4) of section 461(f) (relating to contested liabilities) is amended by inserting "determined after application of subsection (h)" after "taxable year)".

(f) INCLUSION IN INCOME OF NUCLEAR DECOMMISSIONING COSTS INCLUDED IN THE TAXPAYER'S RATE BASE.—

(1) IN GENERAL.—Part II of subchapter B of chapter 1 (relating to items specifically included in gross income) is amended by adding at the end thereof the following new section:

"SEC. 88. CERTAIN AMOUNTS WITH RESPECT TO NUCLEAR DECOMMISSIONING COSTS.

"In the case of any taxpayer who is required to include the amount of any nuclear decommissioning costs in the taxpayer's cost of service of ratemaking purposes, there shall be includible in the gross income of such taxpayer the amount so included for any taxable year."

(2) CONFORMING AMENDMENT.—The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 88. Certain amounts with respect to nuclear decommissioning costs."

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection and subsections (h) and (i), the amendments made by this section shall apply to amounts—

(A) incurred after the date of the enactment of this Act (determined without regard to such amendments), or

(B) which—

(i) are incurred before the date of the enactment of this Act (determined without regard to such amendments), and

(ii) are incurred after the date of the enactment of this Act (determined with regard to such amendments).

(2) ELECTION TREATED AS CHANGE IN METHOD OF ACCOUNTING.—For purposes of section 481 of the Internal Revenue Code of 1954, if paragraph (1)(B) applies to any amount, the application of the amendments made by this section shall be treated as a change in method of accounting—

(A) initiated by the taxpayer, and

(B) made with the consent of the Secretary of the Treasury.

(3) SECTION 461(h) TO APPLY IN CERTAIN CASES.—Notwithstanding paragraph (1), section 461(h) of the Internal Revenue Code of 1954 (as added by this section) shall be treated as being in effect to the extent necessary to carry out any amendments made by this section which take effect before section 461(h).

(h) EXCEPTION FOR CERTAIN EXISTING ACTIVITIES AND CONTRACTS.—If—

(1) EXISTING ACCOUNTING PRACTICES.—If, on March 1, 1984, any taxpayer was regularly computing his deduction for mining reclamation activities under a current cost method of accounting (as determined by the Secretary of the Treasury or his delegate), the liability for reclamation activities—

(A) for land disturbed before the date of the enactment of this Act, or

(B) to which paragraph (2) applies,

shall be treated as having been incurred when the land was disturbed.

(2) FIXED PRICE SUPPLY CONTRACT.—

(A) IN GENERAL.—In the case of any fixed price supply contract entered into before March 1, 1984, the amendments made by subsection (b) shall not apply to any minerals extracted from such property which are sold pursuant to such contract.

(B) NO EXTENSION OR RENEGOTIATION.—Subparagraph (A) shall not apply—

(i) to any extension of any contract beyond the period such contract was in effect on March 1, 1984, or

(ii) to any renegotiation of, or other change in, the terms and conditions of such contract in effect on March 1, 1984.

(i) TRANSITIONAL RULE FOR ACCRUED VACATION PAY.—

(1) IN GENERAL.—In the case of any taxpayer—

(A) with respect to whom a deduction was allowable (other than under section 463 of the Internal Revenue Code of 1954) for vested accrued vacation pay for the last taxable year ending before the date of the enactment of this Act, and

(B) who elects the application of section 463 of such Code for the first taxable year ending after the date of the enactment of this Act,

then, for purposes of section 463(b) of such Code, the opening balance of the taxpayer with respect to any vested accrued vacation pay shall be determined under section 463(b)(1) of such Code.

(2) VESTED ACCRUED VACATION PAY.—For purposes of this subsection, the term "vested accrued vacation pay" means any amount allowable under section 162(a) of such Code with respect to vacation pay of employees of the taxpayer (determined without regard to section 463 of such Code).

SEC. 92. TREATMENT OF CERTAIN DEFERRED PAYMENTS FOR USE OF PROPERTY OR SERVICES.

(a) GENERAL RULE.—Subpart C of part II of subchapter E of chapter 1 (relating to taxable year for which deduction is taken) is amended by adding at the end thereof the following new section:

"SEC. 467. CERTAIN PAYMENTS FOR THE USE OF PROPERTY OR SERVICES.

"(a) ACCRUAL METHOD ON PRESENT VALUE BASIS.—In the case of the lessor or lessee under any section 467 rental agreement, there shall be taken into account for purposes of this title for any taxable year the sum of—

"(1) the amount of the rent which accrues during such taxable year as determined under subsection (b), and

"(2) interest for the year on the amounts which were taken into account under this subsection for prior taxable years and which are unpaid.

"(b) ACCRUAL OF RENTAL PAYMENTS.—

"(1) ALLOCATION FOLLOWS AGREEMENT.—Except as provided in paragraph (2), the determination of the amount of the rent under any section 467 rental agreement which accrues during any taxable year shall be made—

"(A) by allocating rents in accordance with the agreement, and

"(B) by taking into account any rent to be paid after the close of the period in an amount determined under regulations which shall be based on present value concepts.

"(2) CONSTANT RENTAL ACCRUAL IN CASE OF CERTAIN TAX AVOIDANCE TRANSACTIONS, ETC.—In the case of any section 467 rental agreement to which this paragraph applies, the portion of the rent which accrues during any taxable year shall be that portion of the constant rental amount with respect to such agreement which is allocable to such taxable year.

"(3) AGREEMENTS TO WHICH PARAGRAPH (2) APPLIES.—Paragraph (2) applies to any rental payment agreement if—

"(A) such agreement is a disqualified leaseback or long-term agreement, or

"(B) such agreement does not provide for the allocation referred to in paragraph (1)(A).

"(4) DISQUALIFIED LEASEBACK OR LONG-TERM AGREEMENT.—For purposes of this subsection, the term 'disqualified leaseback or long-term agreement' means any section 467 rental agreement if—

"(A) such agreement is part of a leaseback transaction or such agreement is for a term in excess of 75 percent of the statutory recover period for the property, and

"(B) a principal purpose for providing increasing rents under the agreement is the avoidance of tax imposed by this subtitle.

"(5) EXCEPTIONS TO DISQUALIFICATION IN CERTAIN CASES.—The Secretary shall prescribe regulations setting forth circumstances under which agreements will not be treated as disqualified leaseback or long-term agreements, including circumstances relating to—

"(A) changes in amounts paid determined by reference to price indices,

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"(B) rents based on a fixed percentage of lessee receipts or similar amounts,

"(C) reasonable rent holidays, or

"(D) changes in amounts paid to unrelated 3rd parties.

"(c) RECAPTURE OF PRIOR UNDERSTATED INCLUSIONS UNDER LEASEBACK OR LONG-TERM AGREEMENTS.—

"(1) IN GENERAL.—If—

"(A) the lessor under any section 467 rental agreement disposes of any property subject to such agreement during the term of such agreement, and

"(B) such agreement is a leaseback or long-term agreement to which paragraph (2) of subsection (b) did not apply,

the recapture amount shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(2) RECAPTURE AMOUNT.—For purposes of paragraph (1), the term 'recapture amount' means the lesser of—

"(A) the prior understated inclusions, or

"(B) the excess of the amount realized (or in the case of a disposition other than a sale, exchange, or involuntary conversion, the fair market value of the property) over the adjusted basis of such property.

The amount determined under subparagraph (B) shall be reduced by the amount of any gain treated as ordinary income on the disposition under any other provision of this subtitle.

"(3) PRIOR UNDERSTATED INCLUSIONS.—For purposes of this subsection, the term 'prior understated inclusion' means the excess (if any) of—

"(A) the amount which would have been taken into account by the lessor under subsection (a) for periods before the disposition if subsection (b)(2) had applied to the agreement, over

"(B) the amount taken into account under subsection (a) by the lessor for periods before the disposition.

"(4) LEASEBACK OR LONG-TERM AGREEMENT.—For purposes of this subsection, the term 'leaseback or long-term agreement' means any agreement described in subsection (b)(3)(A).

"(5) SPECIAL RULES.—Under regulations prescribed by the Secretary—

"(A) exceptions similar to the exceptions applicable under section 1245 or 1250 (whichever is appropriate) shall apply for purposes of this subsection,

"(B) any transferee in a disposition excepted by reason of subparagraph (A) who has a transferred basis in the property shall be treated in the same manner as the transferor, and

"(C) for purposes of sections 163(d), 170(e), 341(e)(12), 453B(d)(2), and 751(c), amounts treated as ordinary income under this section shall be treated in the same manner as amounts treated as ordinary income under section 1245 or 1250.

"(d) SECTION 467 RENTAL AGREEMENTS.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the term 'section 467 rental agreements' means any rental agreement for the use of tangible property under which—

"(A) there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year following the calendar year in which such use occurs, or

"(B) there are increases in the amount to be paid as rent under the agreement.

"(2) SECTION NOT TO APPLY TO AGREEMENTS INVOLVING PAYMENTS OF $250,000 OR LESS.—This section shall not apply to any amount to be paid for the use of property if the sum of the following amounts does not exceed $250,000—

"(A) the aggregate amount of payments received as consideration for such use of property, and

"(B) the aggregate value of any other consideration to be received for such use of property.

For purposes of the preceding sentence, rules similar to the rules of clauses (ii) and (iii) of section 1274(c)(2)(C) shall apply.

"(e) DEFINITIONS.—For purposes of this section—

"(1) CONSTANT RENTAL AMOUNT.—The term 'constant rental amount' means, with respect to any section 467 rental agreement, the amount which, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement.

"(2) LEASEBACK TRANSACTION.—A transaction is a leaseback transaction if it involves a leaseback to any person who had an interest in such property at any time within 2 years before such leaseback (or to a related person).

"(3) STATUTORY RECOVERY PERIOD.—

"(A) IN GENERAL.—

"In the case of property which is:	The statutory recovery period is:
3-year property	3 years
5-year property	5 years
10-year property	10 years
15-year public utility property	15 years
18-year real property	18 years.

"(B) SPECIAL RULE FOR PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any property which is not recovery property, subparagraph (A) shall be applied as if such property were recovery property.

"(4) DISCOUNT AND INTEREST RATE.—For purposes of computing present value and interest under subsection (a)(2), the rate used shall be equal to 110 percent of the applicable Federal rate determined under section 1274(d) (compounded semiannually) which is in effect at the time the agreement is entered into with respect to debt instruments having a maturity equal to the term of the agreement.

"(5) RELATED PERSON.—The term 'related person' has the meaning given to such term by section 168(d)(4)(D).

"(6) CERTAIN OPTIONS OF LESSEE TO RENEW NOT TAKEN INTO ACCOUNT.—Except as provided in regulations prescribed by the Secretary, there shall not be taken into account in computing the term of any agreement for purposes of this section any extension which is solely at the option of the lessee.

"(f) COMPARABLE RULES WHERE AGREEMENT FOR DECREASING PAYMENTS.—Under regulations prescribed by the Secretary, rules comparable to the rules of this section shall also apply in the case of any agreement where the amount paid under the agreement for the use of property decreases during the term of the agreement.

"(g) COMPARABLE RULES FOR SERVICES.—Under regulations prescribed by the Secretary, rules comparable to the rules of subsection (a)(2) shall also apply in the case of payments for services which meet requirements comparable to the requirements of subsection (d).

"(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations providing for the application of this section in the case of contingent payments."

(b) CLERICAL AMENDMENT.—The table of sections for subpart C of part II of subchapter E of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 467. Certain payments for use of property or services."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply with respect to agreements entered into after June 8, 1984.

(2) EXCEPTIONS.—The amendments made by this section shall not apply—

(A) to any agreement entered into pursuant to a written agreement which was binding on June 8, 1984, and at all times thereafter,

(B) subject to the provisions of paragraph (3), to any agreement to lease property if—

(i) there was in effect a firm plan, evidenced by a board of directors' resolution, memorandum of agreement, or letter of intent on March 15, 1984, to enter into such an agreement, and

(ii) construction of the property was commenced (but such property was not placed in service) on or before March 15, 1984, and

(C) to any agreement to lease property if—

(i) the lessee of such property adopted a firm plan to lease the property, evidenced by a resolution of the Finance Committee of the Board of Directors of such lessee, on February 10, 1984,

(ii) the sum of the present values of the rents payable by the lessee under the lease at the inception thereof equals at least $91,223,034, assuming—

(I) the annual discount rate is 12.6 percent,

(II) the initial payment of rent occurs 12 months after the commencement of the lease, and

(III) subsequent payments of rents occur on the anniversary date of the initial payment, and

(iii) during—

(I) the first 5 years of the lease, at least 9 percent of the rents payable by the lessee under the agreement are paid, and

(II) the second 5 years of the lease, at least 16.25 percent of the rents payable by the lessee under the agreement are paid.

Paragraph (3)(B)(ii)(II) shall apply for purposes of clauses (ii) and (iii) of subparagraph (C), except that each separate agreement shall be treated as relating to all property placed in service before the property to which the agreement relates. If the lessor under the agreement described in subparagraph (C) leases the property from another person, this exception shall also apply to any agreement between the lessor and such person which is integrally related to, and contains essentially the same terms as, such agreement.

(3) SCHEDULE OF DEEMED RENTAL PAYMENTS.—

(A) IN GENERAL.—In any case to which paragraph (2)(B) applies, for purposes of the Internal Revenue Code of 1954, the lessor shall be treated as having received or accrued (and the lessee shall be treated as having paid or incurred) rents equal to the greater of—

(i) the amount of rents actually paid under the agreement during the taxable year, or

(ii) the amount of rents determined in accordance with the schedule under subparagraph (B) for such taxable year.

(B) SCHEDULE.—

(i) IN GENERAL.—The schedule under this subparagraph is as follows:

Portion of lease term:	Cumulative percentage of total rent deemed paid:
1st ⅓	10
2nd ⅓	25
3rd ⅓	45
4th ⅓	70
Last ⅓	100.

(ii) OPERATING RULES.—For purposes of this schedule—

(I) the rent allocable to each taxable year within any portion of a lease term described in such schedule shall be a level pro rata amount properly allocable to such taxable year, and

(II) any agreement relating to property which is to be placed in service in 2 or more stages shall be treated as 2 or more separate agreements.

(C) PARAGRAPH NOT TO APPLY.—This paragraph shall not apply to any agreement if the sum of the present values of all payments under the agreement is greater than the sum of the present value of all the payments deemed to be paid or received under the schedule under subparagraph (B). For purposes of computing any present value under this subparagraph, the annual discount rate shall be equal to 12 percent, compounded semiannually

SEC. 93. AMORTIZATION OF CONSTRUCTION PERIOD INTEREST AND TAXES FOR RESIDENTIAL REAL PROPERTY HELD BY CORPORATIONS.

(a) IN GENERAL.—Subsection (d) of section 189 (relating to amortization of real property construction period interest and taxes) is amended—

(1) by striking out paragraph (2), and

(2) by redesignating paragraph (3) as paragraph (2).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984, with respect to construction beginning after March 15, 1984.

SEC. 94. CAPITALIZATION OF START-UP EXPENDITURES.

(a) IN GENERAL.—Section 195 (relating to start-up expenditures) is amended to read as follows:

"SEC. 195. START-UP EXPENDITURES.

"(a) CAPITALIZATION OF EXPENDITURES.—Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

"(b) ELECTION TO AMORTIZE.—

"(1) IN GENERAL.—Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins).

"(2) DISPOSITIONS BEFORE CLOSE OF AMORTIZATION PERIOD.—In any case in which a trade or business is completely disposed of by the taxpayer before the end of the period to which paragraph (1) applies, any deferred expenses which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

"(c) DEFINITIONS.—For purposes of this section—

"(1) START-UP EXPENDITURES.—The term 'start-up expenditure' means any amount—

"(A) paid or incurred in connection with—

"(i) investigating the creation or acquisition of an active trade or business, or

"(ii) creating an active trade or business, or

"(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

"(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term 'start-up expenditure' does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

"(2) BEGINNING OF TRADE OR BUSINESS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the determination of when an active trade or business begins shall be made in accordance with such regulations as the Secretary may prescribe.

"(B) ACQUIRED TRADE OR BUSINESS.—An acquired active trade or business shall be treated as beginning when the taxpayer acquires it.

"(d) ELECTION.—

"(1) TIME FOR MAKING ELECTION.—An election under subsection (b) shall be made not later than the time prescribed by law for filing the return for the taxable year in which the trade or business begins (including extensions thereof).

"(2) SCOPE OF ELECTION.—The period selected under subsection (b) shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years."

(b) CONFORMING AMENDMENT.—The table of sections for part VI of subchapter B of chapter 1 is amended by striking out the item relating to section 195 and inserting in lieu thereof the following:

"Sec. 195. Start-up expenditures."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after June 30, 1984.

SEC. 95. LIFO CONFORMITY RULES APPLIED ON CONTROLLED GROUP BASIS.

(a) GENERAL RULE.—Section 472 (relating to last-in, first-out inventories) is amended by adding at the end thereof the following new subsection:

"(g) CONFORMITY RULES APPLIED ON CONTROLLED GROUP BASIS.—

"(1) IN GENERAL.—Except as otherwise provided in regulations, all members of the same group of financially related corporations shall be treated as 1 taxpayer for purposes of subsections (c) and (e)(2).

"(2) GROUP OF FINANCIALLY RELATED CORPORATIONS.—For purposes of paragraph (1), the term 'group of financially related corporations' means—

"(A) any affiliated group as defined in section 1504 determined by substituting '50 percent' for '80 percent' each place it appears in section 1504(a) and without regard to section 1504(b), and

"(B) any other group of corporations which consolidate or combine for purposes of financial statements."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

Subtitle H—Provisions Relating to Tax Straddles

SEC. 101. REPEAL OF EXCEPTION FROM STRADDLE RULES FOR STOCK OPTIONS AND CERTAIN STOCK.

(a) REPEAL OF EXCEPTION FOR STOCK OPTIONS.—

(1) IN GENERAL.—Paragraph (2) of section 1092(d) (defining position) is amended to read as follows:

"(2) POSITION.—The term 'position' means an interest (including a futures or forward contract or option) in personal property."

(2) SECTIONS 1092 AND 263(g) NOT TO APPLY TO STRADDLES CONSISTING OF QUALIFIED COVERED CALL OPTIONS AND THE OPTIONED STOCK.—Subsection (c) of section 1092 (defining straddle) is amended by adding at the end thereof the following new paragraph:

"(4) EXCEPTION FOR CERTAIN STRADDLES CONSISTING OF QUALIFIED COVERED CALL OPTIONS AND THE OPTIONED STOCK.—

"(A) IN GENERAL.—If—

"(i) all the offsetting positions making up any straddle consist of 1 or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and

"(ii) such straddle is not part of a larger straddle,

such straddle shall not be treated as a straddle for purposes of this section and section 263(g).

"(B) QUALIFIED COVERED CALL OPTION DEFINED.—For purposes of subparagraph (A), the term 'qualified covered call option' means any option granted by the taxpayer to purchase stock held by the taxpayer (or stock acquired by the taxpayer in connection with the granting of the option) but only if—

"(i) such option is traded on a national securities exchange which is registered with the Securities and Exchange Commission or other market which the Secretary determines has rules adequate to carry out the purposes of this paragraph,

"(ii) such option is granted more than 30 days before the day on which the option expires,

"(iii) such option is not a deep-in-the-money option,

"(iv) such option is not granted by an options dealer (within the meaning of section 1256(g)(8)) in connection with his activity of dealing in options, and

"(v) gain or loss with respect to such option is not ordinary income or loss.

"(C) DEEP-IN-THE-MONEY OPTION.—For purposes of subparagraph (B), the term 'deep-in-the-money option' means an option having a strike price lower than the lowest qualified bench mark.

"(D) LOWEST QUALIFIED BENCH MARK.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, for purposes of subparagraph (C), the term 'lowest qualified bench mark' means the highest available strike price which is less than the applicable stock price.

"(ii) SPECIAL RULE WHERE OPTION IS FOR PERIOD MORE THAN 90 DAYS AND STRIKE PRICE EXCEEDS $50.—In the case of an option—

"(I) which is granted more than 90 days before the date on which such option expires, and

"(II) with respect to which the strike price is more than $50,

the lowest qualified bench mark is the second highest available strike price which is less than the applicable stock price.

"(iii) 85 PERCENT RULE WHERE APPLICABLE STOCK PRICE $25 OR LESS.—If—

"(I) the applicable stock price is $25 or less, and

"(II) but for this clause, the lowest qualified bench mark would be less than 85 percent of the applicable stock price,

the lowest qualified bench mark shall be treated as equal to 85 percent of the applicable stock price.

"(iv) LIMITATION WHERE APPLICABLE STOCK PRICE $150 OR LESS.—If—

"(I) the applicable stock price is $150 or less, and

"(II) but for this clause, the lowest qualified bench mark would be less than the applicable stock price reduced by $10,

the lowest qualified bench mark shall be treated as equal to the applicable stock price reduced by $10.

"(E) SPECIAL YEAR-END RULE.—Subparagraph (A) shall not apply to any straddle for purposes of section 1092(a) if—

"(i) the qualified covered call options referred to in such subparagraph are closed during any taxable year,

"(ii) gain on disposition of the stock to be purchased from the tapayer under such options is includible in gross income for a later taxable year, and

"(iii) such stock was not held by the taxpayer for 30 days or more after the closing of such options.

For purposes of the preceding sentence, the rules of paragraphs (3) (other than subparagraph (B) thereof) and (4) of section 246(c) shall apply in determining the period for which the taxpayer holds the stock.

"(F) STRIKE PRICE.—For purposes of this paragraph, the term 'strike price' means the price at which the option is exercisable.

"(G) APPLICABLE STOCK PRICE.—For purposes of subparagraph (D), the term 'applicable stock price' means, with respect to any stock for which an option has been granted—

"(i) the closing price of such stock on the most recent day on which such stock was traded before the date on which such option was granted, or

"(ii) the opening price of such stock on the day on which such option was granted, but only if such price is greater than 110 percent of the price determined under clause (i).

"(H) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph. Such regulations may include modifications to the provisions of this paragraph which are appropriate to take account of changes in the practices of option exchanges or to prevent the use of options for tax avoidance purposes."

(b) REPEAL OF EXCEPTION FOR STOCK.—

(1) IN GENERAL.—Paragraph (1) of section 1092(d) (defining personal property) is amended by striking out "(other than stock)".

(2) EXCEPTION WHERE STRADDLE CONSISTS OF HOLDING STOCK.—Subsection (d) of section 1092 is amended by redesignating paragraphs (3), (4), and (5) as paragraphs (4), (5), and (6), respectively, and by inserting after paragraph (2) the following new paragraph:

"(3) SPECIAL RULES FOR STOCK.—For purposes of paragraph (1)—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'personal property' does not include stock.

"(B) EXCEPTIONS.—The term 'personal property' includes—

"(i) any stock which is part of a straddle at least 1 of the offsetting positions of which is—

"(I) an option with respect to such stock or substantially identical stock or securities, or

"(II) under regulations, a position with respect to substantially similar or related property (other than stock), and

"(ii) any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

"(C) SPECIAL RULES.—

"(i) For purposes of subparagraph (B), subsection (c) and paragraph (4) shall be applied as if stock described in clause (i) or (ii) of subparagraph (B) were personal property.

"(ii) For purposes of determining whether subsection (e) applies to any transaction with respect to stock described in clause (ii) of subparagraph (B), all includible corporations of an affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer."

(c) TREATMENT OF GAIN OR LOSS AND SUSPENSION OF HOLDING PERIOD WHERE TAXPAYER GRANTOR OF OPTION TO BUY STOCK.—Section 1092 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) TREATMENT OF GAIN OR LOSS AND SUSPENSION OF HOLDING PERIOD WHERE TAXPAYER GRANTOR OF QUALIFIED COVERED CALL OPTION.—If a taxpayer holds any stock and grants a qualified covered call option to purchase such stock with a strike price less than the applicable stock price—

"(1) Treatment of loss.—Any loss with respect to such option shall be treated as long-term capital loss if, at the time such loss is realized, gain on the sale or exchange of such stock would be treated as long-term capital gain.

"(2) Suspension of holding period.—The holding period of such stock shall not include any period during which the taxpayer is the grantor of such option."

(d) TREATMENT OF IDENTIFIED STRADDLES INVOLVING SECTION 1256 CONTRACTS.—Paragraph (4) of subsection (d) of section 1092 is amended to read as follows:

"(4) SPECIAL RULE FOR SECTION 1256 CONTRACTS.—

"(A) GENERAL RULE.—In the case of a straddle at least 1 (but not all) of the positions of which are section 1256 contracts, the provisions of this section shall apply to any section 1256 contract and any other position making up such straddle.

"(B) SPECIAL RULE FOR IDENTIFIED STRADDLES.—For purposes of subsection (a)(2) (relating to identified straddles), subparagraph (A) and section 1256 (a)(4) shall not apply to a straddle all of the offsetting positions of which consist of section 1256 contracts."

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to positions established after December 31, 1983, in taxable years ending after such date.

(2) SPECIAL RULE FOR OFFSETTING POSITION STOCK.—In the case of any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder, the amendments made by this section shall apply to positions established on or after May 23, 1983, in taxable years ending on or after such date.

(3) SUBSECTION (c).—The amendment made by subsection (c) shall apply to positions established after June 30, 1984, in taxable years ending after such date.

(4) SUBSECTION (d).—The amendment made by subsection (d) shall apply to positions established after the date of the enactment of this Act in taxable years ending after such date.

SEC. 102. SECTION 1256 EXTENDED TO CERTAIN OPTIONS.

(a) GENERAL RULE.—

(1) Section 1256 (relating to regulated futures contracts marked to market) is amended—

(A) by striking out "regulated futures contract" each place it appears and inserting in lieu thereof "section 1256 contract", and

(B) by striking out "regulated futures contracts" each place it appears and inserting in lieu thereof "section 1256 contracts".

(2) Subsection (b) of section 1256 is amended to read as follows:

"(b) SECTION 1256 CONTRACT DEFINED.—For purposes of this section, the term 'section 1256 contract' means—

"(1) any regulated futures contract,

"(2) any foreign currency contract,

"(3) any nonequity option, and

"(4) any dealer equity option."

(3) Subsection (g) of section 1256 is amended to read as follows:

"(g) DEFINITIONS.—For purposes of this section—

"(1) REGULATED FUTURES CONTRACTS DEFINED.—The term 'regulated futures contract' means a contract—

"(A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and

"(B) which is traded on or subject to the rules of a qualified board or exchange.

"(2) FOREIGN CURRENCY CONTRACT DEFINED.—

"(A) FOREIGN CURRENCY CONTRACT.—The term 'foreign currency contract' means a contract—

"(i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts,

"(ii) which is traded in the interbank market, and

"(iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.

"(B) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of subparagraph (A), including regulations excluding from the application of subparagraph (A) any contract (or type of contract) if its application thereto would be inconsistent with such purposes.

"(3) NONEQUITY OPTION.—The term 'nonequity option' means any listed option which is not an equity option.

"(4) DEALER EQUITY OPTION.—The term 'dealer equity option' means, with respect to an options dealer, any listed option which—

"(A) is an equity option,

"(B) is purchased or granted by such options dealer in the normal course of his activity of dealing in options, and

"(C) is listed on the national securities exchange on which such options dealer is registered.

"(5) LISTED OPTION.—The term 'listed option' means any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange.

"(6) EQUITY OPTION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'equity option' means any option—

"(i) to buy or sell stock, or

"(ii) the value of which is determined directly or indirectly by reference to any stock (or group of stocks) or stock index.

"(B) EXCEPTION FOR CERTAIN OPTIONS REGULATED BY COMMODITIES FUTURES TRADING COMMISSION.—The term 'equity option' does not include any option with respect to any group of stocks or stock index if—

"(i) there is in effect a designation by the Commodities Futures Trading Commission of a contract market for a contract based on such group of stocks or index, or

"(ii) the Secretary determines that such option meets the requirements of law for such a designation.

"(7) QUALIFIED BOARD OR EXCHANGE.—The term 'qualified board or exchange' means—

"(A) a national securities exchange which is registered with the Securities and Exchange Commission,

"(B) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or

"(C) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section.

"(8) OPTIONS DEALER.—

"(A) IN GENERAL.—The term 'options dealer' means any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

"(B) PERSONS TRADING IN OTHER MARKETS.—In any case in which the Secretary makes a determination under subparagraph (C) of paragraph (7), the term 'options dealer' also includes any person whom the Secretary determines performs functions similar to the persons described in subparagraph (A). Such determinations shall be made to the extent

appropriate to carry out the purposes of this section.

(b) CAPITAL GAIN TREATMENT FOR TRADERS IN SECTION 1256 CONTRACTS.—Subsection (f) of section 1256 (relating to special rules) is amended by adding at the end thereof the following new paragraphs:

"(4) CAPITAL GAIN TREATMENT FOR TRADERS IN SECTION 1256 CONTRACTS.—

"(A) IN GENERAL.—For purposes of this title, gain or loss from trading of section 1256 contracts shall be treated as gain or loss from the sale or exchange of a capital asset.

"(B) EXCEPTION FOR CERTAIN HEDGING TRANSACTIONS.—Subparagraph (A) shall not apply to any section 1256 contract to the extent such contract is held for purposes of hedging property if any loss with respect to such property in the hands of the taxpayer would be ordinary loss.

"(C) TREATMENT OF UNDERLYING PROPERTY.—For purposes of determining whether gain or loss with respect to any property is ordinary income or loss, the fact that the taxpayer is actively engaged in dealing in or trading section 1256 contracts related to such property shall not be taken into account.

"(5) SPECIAL RULE FOR DEALER EQUITY OPTIONS OF LIMITED PARTNERS OR LIMITED ENTREPRENEURS.—In the case of any gain or loss with respect to dealer equity options which are allocable to limited partners or limited entrepreneurs (within the meaning of subsection (e)(3))—

"(A) paragraph (3) of subsection (a) shall not apply to any such gain or loss, and

"(B) all such gains or losses shall be treated as short-term capital gains or losses, as the case may be."

(c) APPLICATION OF SELF-EMPLOYMENT INCOME TAX TO OPTIONS AND COMMODITIES DEALERS.—

(1) AMENDMENT TO THE INTERNAL REVENUE CODE OF 1954.—Section 1402 (relating to definitions for tax on self-employment income) is amended by adding at the end thereof the following new subsection:

"(i) SPECIAL RULES FOR OPTIONS AND COMMODITIES DEALERS.—

"(1) IN GENERAL.—In determining the net earnings from self-employment of any options dealer or commodities dealer—

"(A) notwithstanding subsection (a)(3)(A), there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts, and

"(B) the deduction provided by section 1202 shall not apply.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) OPTIONS DEALER.—The term 'options dealer' has the meaning given such term by section 1256(g)(8).

"(B) COMMODITIES DEALER.—The term 'commodities dealer' means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

"(C) SECTION 1256 CONTRACTS.—The term 'section 1256 contract' has the meaning given to such term by section 1256(b)."

(2) AMENDMENT TO THE SOCIAL SECURITY ACT.—Section 211 of the Social Security Act is amended by adding at the end thereof the following new subsection:

"(h)(1) In determining the net earnings from self-employment of any options dealer or commodities dealer—

"(A) notwithstanding subsection (a)(3)(A), there shall not be excluded any gain or loss (in the normal course of the taxpayer's dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts, and

"(B) the deduction provided by section 1202 of the Internal Revenue Code of 1954 shall not apply.

"(2) For purposes of this subsection—

"(A) The term 'options dealer' has the meaning given such term by section 1256(g)(8) of such Code.

"(B) The term 'commodities dealer' means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

"(C) The term 'section 1256 contracts' has the meaning given to such term by section 1256(b) of such Code."

(d) TREATMENT UNDER SUBCHAPTER S OF OPTIONS AND COMMODITIES DEALERS.—

(1) TAX IMPOSED ON CERTAIN CAPITAL GAINS NOT TO APPLY.—Subsection (c) of section 1374 (relating to tax imposed on certain capital gains) is amended by adding at the end thereof the following new paragraph:

"(4) TREATMENT OF CERTAIN GAINS OF OPTIONS AND COMMODITIES DEALERS.—

"(A) EXCLUSION OF CERTAIN CAPITAL GAINS.—For purposes of this section, the net capital gain of any options dealer or commodities dealer shall be determined by not taking into account any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) OPTIONS DEALER.—The term 'options dealer' has the meaning given to such term by section 1256(g)(8).

"(ii) COMMODITIES DEALER.—The term 'commodities dealer' means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

"(iii) SECTION 1256 CONTRACTS.—The term 'section 1256 contracts' has the meaning given to such term by section 1256(b)."

(2) CERTAIN GAINS NOT TREATED AS PASSIVE INVESTMENT INCOME.—Subparagraph (D) of section 1362(d)(3) (defining passive investment income) is amended by adding at the end thereof the following new clause:

"(v) SPECIAL RULE FOR OPTIONS AND COMMODITIES DEALERS.—In the case of any options or commodities dealer, passive investment income shall be determined by not taking into account any gain or loss described in section 1374(c)(4)(A)."

(3) SUBCHAPTER S ELECTION.—Notwithstanding section 1362(b), an election under section 1362(a) made by a commodities dealer or an options dealer within 75 days following the date of the enactment of this Act will be treated as made for the taxable year which includes such data of enactment.

(e) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 1256 (relating to terminations, etc.) is amended—

(A) by striking out "by taking or making delivery," in paragraph (1) and inserting in lieu thereof "by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse,",

(B) by striking out "takes delivery under" in paragraph (2) and inserting in lieu thereof "takes delivery under or exercises", and

(C) by striking out "TAKES DELIVERY ON" in the heading of paragraph (2) and inserting in lieu thereof "TAKES DELIVERY ON OR EXERCISES".

(2) Paragraph (5) of section 1092(d) is amended to read as follows:

"(5) SECTION 1256 CONTRACT.—The term 'section 1256 contract' has the meaning given such term by section 1256(b)."

(3) Subsection (c) of section 1212 (relating to carryback of losses from regulated futures contracts to offset prior gains from such contracts) is amended—

(A) by striking out "net commodity futures loss" each place it appears (including in any headings) and inserting in lieu thereof "net section 1256 contracts loss",

(B) by striking out "regulated futures contracts" each place it appears (including in any headings) and inserting in lieu thereof "section 1256 contracts",

(C) by striking out "regulated futures contract" each place it appears in paragraph (7)(A) (including the heading) and inserting in lieu thereof "section 1256 contract", and

(D) by striking out "net commodity futures gain" each place it appears (including in any headings) and inserting in lieu thereof "net section 1256 contract gain".

(4) Paragraph (2) of section 1234A (relating to gains or losses from certain terminations) is amended by striking out "a regulated futures contract" and inserting in lieu thereof "a section 1256 contract".

(5) The section heading for section 1256 is amended by striking out "REGULATED FUTURES CONTRACTS" and inserting in lieu thereof "SECTION 1256 CONTRACTS".

(6) The table of sections for part IV of subchapter P of chapter 1 is amended by striking out "Regulated futures contracts" in the item relating to section 1256 and inserting in lieu thereof "Section 1256 contracts".

(7) Paragraph (2) of section 263(g) (defining interest and carrying charges) is amended to read as follows:

"(2) INTEREST AND CARRYING CHARGES DEFINED.—For purposes of paragraph (1), the term 'interest and carrying charges' means the excess of—

"(A) the sum of—

"(i) interest on indebtedness incurred or continued to purchase or carry the personal property, and

"(ii) all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property, over

"(B) the sum of—

"(i) the amount of interest (including original issue discount) includible in gross income for the taxable year with respect to the property described in subparagraph (A),

"(ii) any amount treated as ordinary income under section 1271(a)(3)(A), 1278, or 1281(a) with respect to such property for the taxable year, and

"(iii) the excess of any dividends includible in gross income with respect to such property for the taxable year over the amount of any deduction allowable with respect to such dividends under section 243, 244, or 245.

For purposes of subparagraph (A), the term 'interest' includes any amount paid or incurred in connection with personal property used in a short sale."

(8) Subsection (g) of section 263 (relating to certain interest and carrying charges in the case of straddles) is amended by adding at the end thereof the following new paragraph:

"(4) APPLICATION WITH OTHER PROVISIONS.—

"(A) SUBSECTION (c).—In the case of any short sale, this subsection shall be applied after subsection (h).

"(B) SECTION 1277 OR 1282.—In the case of any obligation to which section 1277 or 1282 applies, this subsection shall be applied after section 1277 or 1282."

(9) Section 1234A (relating to gains or losses from certain terminations) is amended by adding at the end thereof the following

new sentence: "The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement)."

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection or subsection (g), the amendments made by this section shall apply to positions established after the date of the enactment of this Act, in taxable years ending after such date.

(2) SPECIAL RULE FOR OPTIONS ON REGULATED FUTURES CONTRACTS.—In the case of any option with respect to a regulated futures contract (within the meaning of section 1256 of the Internal Revenue Code of 1954), the amendments made by this section shall apply to positions established after October 31, 1983, in taxable years ending after such date.

(3) SPECIAL RULE FOR SELF-EMPLOYMENT TAX.—Except as provided in subsection (g)(2), the amendments made by subsection (c) shall apply to taxable years beginning after the date of the enactment of this Act.

(4) GAINS OR LOSSES FROM CERTAIN TERMINATIONS.—The amendment made by subsection (d)(9) shall apply as if included in the amendment made by section 505(a) of the Economic Recovery Tax Act of 1981, as amended by section 105(e) of the Technical Corrections Act of 1982.

(g) ELECTIONS WITH RESPECT TO PROPERTY HELD ON OR BEFORE THE DATE OF THE ENACTMENT OF THIS ACT.—At the election of the taxpayer—

(1) the amendments made by this section shall apply to all section 1256 contracts held by the taxpayer on the date of the enactment of this Act, effective for periods after such date in taxable years ending after such date, or

(2) in lieu of an election under paragraph (1), the amendments made by this section shall apply to all section 1256 contracts held by the taxpayer at any time during the taxable year of the taxpayer which includes the date of the enactment of this Act.

(h) ELECTIONS FOR INSTALLMENT PAYMENT OF TAX ATTRIBUTABLE TO STOCK OPTIONS.—

(1) IN GENERAL.—If the taxpayer makes an election under subsection (g)(2) and under this subsection—

(A) the taxpayer may pay part or all the tax for the taxable year referred to in subsection (g)(2) in 2 or more (but not exceeding 5) equal installments, and

(B) the maximum amount of tax which may be paid in installments under this subsection shall be the excess of—

(i) the tax for such taxable year determined by taking into account subsection (g)(2), over

(ii) the tax for such taxable year determined by taking into account subsection (g)(2) and by treating—

(I) all section 1256 contracts which are stock options, and

(II) any stock which was a part of a straddle including any such stock options,

as having been acquired for a purchase price equal to their fair market value on the last business day of the preceding taxable year. Stock options and stock shall be taken into account under subparagraph (B)(ii) only if such options or stock were held on the last day of the preceding taxable year and only if income on such options or stock would have been ordinary income if such options or stock were sold at a gain on such last day.

(2) DATE FOR PAYMENT OF INSTALLMENT.—

(A) If an election is made under this subsection, the first installment under paragraph (1) shall be paid on or before the due date for filing the return for the taxable year described in paragraph (1), and each succeeding installment shall be paid on or before the date which is 1 year after the date prescribed for payment of the preceding installment.

(B) If a bankruptcy case or insolvency proceeding involving the taxpayer is commenced before the final installment is paid, the total amount of any unpaid installments shall be treated as due and payable on the day preceding the day on which such case or proceeding is commenced.

(3) INTEREST IMPOSED.—For purposes of section 6601 of the Internal Revenue Code of 1954, the time for payment of any tax with respect to which an election is made under this subsection shall be determined without regard to this subsection.

(4) FORM OF ELECTION.—An election under this subsection shall be made not later than the time for filing the return for the taxable year described in paragraph (1) and shall be made in the manner and form required by regulations prescribed by Secretary of the Treasury or his delegate. The election shall set forth—

(A) the amount determined under paragraph (1)(B) and the number of installments elected by the taxpayer,

(B) the property described in paragraph (1)(B)(ii), and the date on which such property was acquired,

(C) the fair market value of the property described in paragraph (1)(B)(ii) on the last business day of the taxable year preceding the taxable year described in paragraph (1), and

(D) such other information for purposes of carrying out the provisions of this subsection as may be required by such regulations.

(5) DELAY OF IDENTIFICATION REQUIREMENT.—Section 1256(e)(2)(C) of the Internal Revenue Code of 1954 shall not apply to any stock option or stock acquired on or before the 60th day after the date of the enactment of this Act.

(i) DEFINITIONS.—For purposes of subsections (g) and (h)—

(1) SECTION 1256 CONTRACT.—The term "section 1256 contract" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as amended by this section).

(2) STOCK OPTION.—The term "stock option" means any option to buy or sell stock.

SEC. 102. REGULATIONS UNDER SECTION 1092(b).

(a) GENERAL RULE.—Subsection (b) of section 1092 (relating to character of gain or loss; wash sales) is amended to read as follows:

"(b) REGULATIONS.—

"(1) IN GENERAL.—The Secretary shall prescribe such regulations with respect to gain or loss on positions which are a part of a straddle as may be appropriate to carry out the purposes of this section and section 263(g). To the extent consistent with such purposes, such regulations shall include rules applying the principles of subsections (a) and (d) of section 1091 and of subsections (b) and (d) of section 1233.

"(2) REGULATIONS RELATING TO MIXED STRADDLES.—

"(A) ELECTIVE PROVISIONS IN LIEU OF SECTION 1233(d) PRINCIPLES.—The regulations prescribed under paragraph (1) shall provide that—

"(i) the taxpayer may offset gains and losses from positions which are part of mixed straddles—

"(I) by straddle-by-straddle identification, or

"(II) by the establishment (with respect to any class of activities) of a mixed straddle account for which gains and losses would be recognized (and offset) on a periodic basis,

"(ii) such offsetting will occur before the application of section 1256, and section 1256(a)(3) will only apply to net gain or net loss attributable to section 1256 contracts, and

"(iii) the principles of section 1233(d) shall not apply with respect to any straddle identified under clause (i)(I) or part of an account established under clause (i)(II).

"(B) LIMITATION ON NET GAIN OR NET LOSS FROM MIXED STRADDLE ACCOUNT.—In the case of any mixed straddle account referred to in subparagraph (A)(i)(II)—

"(i) NOT MORE THAN 50 PERCENT OF NET GAIN MAY BE TREATED AS LONG-TERM CAPITAL GAIN.—In no event shall more than 50 percent of the net gain from such account for any taxable year be treated as long-term capital gain.

"(ii) NOT MORE THAN 40 PERCENT OF NET LOSS MAY BE TREATED AS SHORT-TERM CAPITAL LOSS.—In no event shall more than 40 percent of the net loss from such account for any taxable year be treated as short-term capital loss.

"(C) AUTHORITY TO TREAT CERTAIN POSITIONS AS MIXED STRADDLES.—The regulations prescribed under paragraph (1) may treat as a mixed straddle positions not described in section 1256(d)(4)."

(b) REQUIREMENT THAT REGULATIONS BE ISSUED WITHIN 6 MONTHS AFTER THE DATE OF ENACTMENT.—The Secretary of the Treasury or his delegate shall prescribe initial regulations under section 1092(b) of the Internal Revenue Code of 1954 (including regulations relating to mixed straddles) not later than the date 6 months after the date of the enactment of this Act.

(c) EFFECTIVE DATE OF REGULATIONS WITH RESPECT TO MIXED STRADDLES.—The regulations described in subsection (b) with respect to the application of section 1233 of the Internal Revenue Code of 1954 to mixed straddles shall not apply to mixed straddles all of the positions of which were established before January 1, 1984.

SEC. 104. LIMITATION ON LOSSES FROM HEDGING TRANSACTIONS.

(a) GENERAL RULE.—Subsection (e) of section 1256 (relating to mark to market not to apply to hedging transactions) is amended by adding at the end thereof the following new paragraph:

"(5) LIMITATION ON LOSSES FROM HEDGING TRANSACTIONS.—

"(A) IN GENERAL.—

"(i) LIMITATION.—Any hedging loss for a taxable year which is allocable to any limited partner or limited entrepreneur (within the meaning of paragraph (3)) shall be allowed only to the extent of the taxable income of such limited partner or entrepreneur for such taxable year attributable to the trade or business in which the hedging transactions were entered into. For purposes of the preceding sentence, taxable income shall be determined by not taking into account items attributable to hedging transactions.

"(ii) CARRYOVER OF DISALLOWED LOSS.—Any hedging loss disallowed under clause (i) shall be treated as a deduction attributable to a hedging transaction allowable in the first succeeding taxable year.

"(B) EXCEPTION WHERE ECONOMIC LOSS.—Subparagraph (A)(i) shall not apply to any hedging loss to the extent that such loss exceeds the aggregate unrecognized gains from hedging transactions as of the close of the taxable year attributable to the trade or business in which the hedging transactions were entered into.

"(C) EXCEPTION FOR CERTAIN HEDGING TRANSACTIONS.—In the case of any hedging transaction relating to property other than stock or securities, this paragraph shall apply only in the case of a taxpayer described in section 465(a)(1).

"(D) HEDGING LOSS.—The term 'hedging loss' means the excess of—

"(i) the deductions allowable under this chapter for the taxable year attributable to hedging transactions (determined without regard to subparagraph (A)(ii)), over

"(ii) income received or accrued by the taxpayer during such taxable year from such transactions.

"(E) UNRECOGNIZED GAIN.—The term 'unrecognized gain' has the meaning given to such term by section 1092(a)(3)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 105. CLARIFICATION THAT SECTION 1234 APPLIES TO OPTIONS ON REGULATED FUTURES CONTRACTS AND CASH SETTLEMENT OPTIONS.

(a) GENERAL RULE.—Section 1234 (relating to options to buy or sell) is amended by adding at the end thereof the following new subsection:

"(c) TREATMENT OF OPTIONS ON SECTION 1256 CONTRACTS AND CASH SETTLEMENT OPTIONS.—

"(1) SECTION 1256 CONTRACTS.—Gain or loss shall be recognized on the exercise of an option on a section 1256 contract (within the meaning of section 1256(b)).

"(2) TREATMENT OF CASH SETTLEMENT OPTIONS.—

"(A) IN GENERAL.—For purposes of subsections (a) and (b), a cash settlement option shall be treated as an option to buy or sell property.

"(B) CASH SETTLEMENT OPTION.—For purposes of subparagraph (A), the term 'cash settlement option' means any option which on exercise settles in (or could be settled in) cash or property other than the underlying property."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to options purchased or granted after October 31, 1983, in taxable years ending after such date.

SEC. 106. WASH SALE RULES TO APPLY TO LOSSES ON CERTAIN SHORT SALES.

(a) IN GENERAL.—Section 1091 (relating to losses from wash sales of stock or securities) is amended by adding at the end thereof the following new subsection:

"(e) CERTAIN SHORT SALES OF STOCK OR SECURITIES.—Rules similar to the rules of subsection (a) shall apply to any loss realized on the closing of a short sale of stock or securities if, within a period beginning 30 days before the date of such closing and ending 30 days after such date—

"(1) substantially identical stock or securities were sold, or

"(2) another short sale of substantially identical stock or securities was entered into."

(b) LOSSES FROM WASH SALES ONLY IN CASE OF BUSINESS LOSSES.—Section 1091(a) (relating to disallowance of loss deduction for wash sales) is amended by striking out all that follows "then" and inserting in lieu thereof "no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business."

(c) EFFECTIVE DATE.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to short sales of stock or securities after the date of the enactment of this Act in taxable years ending after such date.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to sales after December 31, 1984, in taxable years ending after such date.

SEC. 107. TIME FOR IDENTIFICATION BY TAXPAYER OF CERTAIN TRANSACTIONS.

(a) IDENTIFIED STRADDLES.—Clause (i) of section 1092(a)(2)(B) (defining identified straddles) is amended to read as follows:

"(i) which is clearly identified on the taxpayer's records as an identified straddle before the earlier of—

"(I) the close of the day on which the straddle is acquired, or

"(II) such time as the Secretary may prescribe by regulations."

(b) DEALERS IN SECURITIES.—

(1) Paragraph (1) of section 1236(a) (relating to capital gain of dealers in securities) is amended to read as follows:

"(1) the security was, before the close of the day on which it was acquired (or such earlier time as the Secretary may prescribe by regulations), clearly identified in the dealer's records as a security held for investment; and".

(2) Paragraph (2) of section 1236(a) is amended by inserting "(or such earlier time)" after "such day".

(c) MIXED STRADDLES.—Subparagraph (B) of section 1256(d)(4) (defining mixed straddles) is amended by inserting "(or such earlier time as the Secretary may prescribe by regulations)" after "acquired".

(d) HEDGING TRANSACTIONS.—Subparagraph (C) of section 1256(e)(2) (defining hedging transactions) is amended by inserting "(or such earlier time as the Secretary may prescribe by regulations)" after "entered into".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to positions entered into after the date of the enactment of this Act in taxable years ending after such date.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE.—For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT.—For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

(c) NET LOSS ALLOWED WHETHER OR NOT TRANSACTION ENTERED INTO FOR PROFIT.—If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES.—Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE.—For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALER.—For purposes of this section, the term "commodities dealer" has the meaning given to such term by section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle).

(g) REGULATED FUTURES CONTRACTS.—For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES.—Subsection (b) shall not apply to any syndicate (as defined in section 1256(e)(3)(B) of the Internal Revenue Code of 1954).

Subtitle I—Depreciation

SEC. 111. RECOVERY PERIOD FOR CERTAIN REAL PROPERTY EXTENDED TO 18 YEARS.

(a) IN GENERAL.—Paragraph (2) of section 168(b) (relating to 15-year real property) is amended—

(1) by striking out "15-year real property" each place it appears in the text and heading thereof and inserting in lieu thereof "18-year real property",

(2) by striking out "15-year recovery period" in subparagraph (A)(i) and inserting in lieu thereof "18-year recovery period", and

(3) by striking out "(200 percent declining balance method in the case of low-income housing)".

(b) LOW-INCOME HOUSING.—

(1) DETERMINATION OF RECOVERY PERCENTAGE.—Subsection (b) of section 168 (relating to the amount of deduction) is amended by adding at the end thereof the following new paragraph:

"(4) LOW-INCOME HOUSING.—

"(A) IN GENERAL.—In the case of low-income housing, the applicable percentage shall be determined in accordance with the table prescribed in paragraph (2), except that in prescribing such table, the Secretary shall—

"(i) assign to the property a 15-year recovery period, and

"(ii) assign percentages generally determined in accordance with use of the 200 percent declining balance method, switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

"(B) SPECIAL RULE FOR YEAR OF DISPOSITION.—In the case of a disposition of low-income housing, the deduction allowable under subsection (a) for the taxable year in which the disposition occurs shall reflect only the months during such year the property was placed in service."

(2) LOW-INCOME HOUSING DEFINED.—Paragraph (2) of section 168(c) (defining recovery property) is amended by redesignating subparagraph (F) as subparagraph (G) and by inserting after subparagraph (E) the following new subparagraph:

"(F) LOW-INCOME HOUSING.—The term 'low-income housing' means property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B)."

(3) CONFORMING AMENDMENTS.—

(A) Subparagraph (A) of section 168(b)(2) is amended by striking out the last sentence thereof.

(B) Subparagraph (D) of section 168(c)(2) is amended to read as follows:

"(D) 18-YEAR REAL PROPERTY.—The term '18-year real property' means section 1250 class property which—

"(i) does not have a present class life of 12.5 years or less, and

"(ii) is not low-income housing."

(c) TRANSITIONAL RULE FOR COMPONENTS.—Subparagraph (B) of section 168(f)(1) is amended to read as follows:

"(B) TRANSITIONAL RULES.—

"(i) BUILDING PLACED IN SERVICE BEFORE 1981.—In the case of any building placed in service by the taxpayer before January 1, 1981, for purposes of applying subparagraph (A) to components of such buildings placed in service after December 31, 1980, and before March 16, 1984, the deduction allowable under subsection (a) with respect to such components shall be computed in the same manner as the deduction allowable with respect to the first such component placed in service after December 31, 1980.

"(ii) Buildings placed in service before March 16, 1984.—In the case of any building placed in service by the taxpayer before March 16, 1984, for purposes of applying subparagraph (A) to components of such buildings placed in service after March 15, 1984, the deduction allowable under subsection (a) with respect to such components shall be computed in the same manner as the deduction allowable with respect to the first such component placed in service after March 15, 1984.

"(iii) First component treated as separate building.—For purposes of clause (i) or (ii), the method of computing the deduction allowable with respect to the first component described in such clause shall be determined as if it were a separate building."

(d) USE OF MID-MONTH CONVENTION.—The second last sentence of subparagraph (A), and subparagraph (B), of section 168(b)(2) (relating to 15-year real property) are each amended by inserting "(using a mid-month convention)" after "months".

(e) CONFORMING AMENDMENTS.—

(1) Subsections (b)(3)(B)(iii), (f)(2)(B), (f)(2)(C)(ii)(II), (f)(2)(E), and (f)(5) of section 168 are each amended by striking out "15-year real property" each place it appears and inserting in lieu thereof "18-year real property or low-income housing".

(2) Clause (ii) of section 168(b)(3)(B) is amended by striking out "15-year real property" and inserting in lieu thereof "18-year real property or low-income housing,".

(3) Subparagraph (B) of section 168(d)(2) is amended by striking out "15-year real property" and inserting in lieu thereof "18-year real property or low-income housing".

(4) Clause (i) of section 168(f)(2)(C) (relating to recovery period for property used outside United States) is amended by striking out the item relating to 15-year real property in the table and inserting in lieu thereof the following new item:

"18-year real property or low-income housing.	*35 or 45 years.".*

(5) Sections 57(a)(12)(A) and 312(k)(3)(A) and subparagraphs (A), (B), and (C) of section 1245(A)(5) are each amended by striking out "15-year real property" each place it appears in the text and headings and inserting in lieu thereof "18-year real property and low-income housing".

(6) Subparagraph (B) of section 57(a)(12) (relating to items of tax preference) is amended to read as follows:

"(B) 18-YEAR REAL PROPERTY AND LOW-INCOME HOUSING.—With respect to each recovery property which is 18-year real property or low-income housing, the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for a taxable year had the property been depreciated using the straight-line method (without regard to salvage value) over a recovery period of—

"(i) 18 years in the case of 18-year real property, and

"(ii) 15 years in the case of low-income housing property."

(7) Subparagraph (E) of section 57(a)(12) is amended by striking out "'15-year real property'," and inserting in lieu thereof "'18-year real property', 'low-income housing',".

(8) Paragraph (2) of section 48(g) (relating to qualified rehabilitation expenditure) is amended—

(A) by striking out "property" each place it appears in subparagraph (A)(i) and inserting in lieu thereof "real property",

(B) by striking out "15" in subparagraph (A)(i) and inserting in lieu thereof "18 (15 years in the case of low-income housing)",

(C) by striking out "15 years" in subparagraph (B)(v) and inserting in lieu thereof "18 years (15 years in the case of low-income housing)", and

(D) by adding at the end thereof the following new subparagraph:

"(D) LOW-INCOME HOUSING.—For purposes of subparagraph (B), the term 'low-income housing' has the meaning given such term by section 168(c)(2)(F)."

(9) Subparagraph (A) of section 168(b)(3) (relating to election of different recovery percentage) is amended—

(A) by striking out "under paragraphs (1) and (2)" and inserting in lieu thereof "under paragraph (1), (2), or (4)", and

(B) by striking out the item in the table relating to 15-year real property and inserting in lieu thereof the following new item:

"18-year real property and low-income housing.	*18, 35, or 45."*

(10) Section 1245(a)(5)(D) is amended to read as follows:

"(D) low-income housing (within the meaning of section 168(c)(2)(F))."

(g) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply with respect to property placed in service by the taxpayer after March 15, 1984.

(2) EXCEPTION.—The amendments made by this section shall not apply to property placed in service by the taxpayer before January 1, 1987, if—

(A) the taxpayer or a qualified person entered into a binding contract to purchase or construct such property before March 16, 1984, or

(B) construction of such property was commenced by or for the taxpayer or a qualified person before March 16, 1984.

For purposes of this paragraph the term "qualified person" means any person who transfers his rights in such a contract or such property to the taxpayer, but only if property is not placed in service by such person before such rights are transferred to the taxpayer.

(3) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (2).—

(A) CERTAIN INVENTORY.—In the case of any property which—

(i) is held by a person as property described in section 1221(1), and

(ii) is disposed of by such person before January 1, 1985,

such person shall not, for purposes of paragraph (2), be treaed as having placed such property in service before such property is disposed of merely because such person rented such property or held such property for rental. No deduction for depreciation or amortization shall be allowed to such person with respect to such property.

(B) CERTAIN PROPERTY FINANCED BY BONDS.—In the case of any property with respect to which—

(i) bonds were issued to finance such property before 1984, and

(ii) an architectural contract was entered into before March 1984,

paragraph (2) shall be applied by substituting "May 2" for "March 16".

(4) SPECIAL RULE FOR COMPONENTS.—For purposes of applying section 168 (f)(1)(B) of the Internal Revenue Code of 1954 (as amended by this section) to components placed in service after December 31, 1980, property to which paragraph (2) applies shall be treated as placed in service by the taxpayer before March 16, 1984.

SEC. 112. RECAPTURE IN CASE OF INSTALLMENT SALES.

(a) GENERAL RULE.—Subsection (i) of section 453 (relating to installment method) is amended to read as follows:

"(i) RECOGNITION OF RECAPTURE INCOME IN YEAR OF DISPOSITION.—

"(1) IN GENERAL.—In the case of any installment sale of property to which subsection (a) applies—

"(A) notwithstanding subsection (a), any recapture income shall be recognized in the year of the disposition and

"(B) any gain in excess of the recapture income shall be taken into account under the installment method.

"(2) RECAPTURE INCOME.—For purposes of paragraph (1), the term 'recapture income' means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under section 1245 or 1250 for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply with respect to dispositions made after June 6, 1984.

(2) EXCEPTION.—The amendments made by this act shall not apply with respect to any disposition conducted pursuant to a contract which was binding on March 22, 1984, and at all times thereafter.

SEC. 113. PROVISIONS RELATING TO SOUND RECORDINGS AND FILMS.

(a) SOUND RECORDINGS.—

(1) IN GENERAL.—Section 48 (defining section 38 property) is amended by redesignating subsection (r) as subsection (s) and by inserting after subsection (q) the following new subsection:

"(r) SPECIAL RULES RELATING TO SOUND RECORDINGS.—

"(1) IN GENERAL.—For purposes of this title, in the case of any sound recording, the original use of which commences with taxpayer, the taxpayer may elect to treat such recording as recovery property which is 3-year property to the extent that the taxpayer has an ownership interest in such recording.

"(2) FAILURE TO MAKE ELECTION.—If a taxpayer does not make an election under paragraph (1) with respect to any sound recording—

"(A) no credit shall be allowed under section 38 with respect to such recording, and

"(B) such recording shall not be treated as recovery property.

"(3) PREDOMINANT USE TEST AND AT RISK RULES NOT TO APPLY; QUALIFIED INVESTMENT.—In the case of any sound recording—

"(A) sections 46(c)(8), 46(c)(9), and 48(a)(2) shall not apply, and

"(B) in determining the qualified investment under section 46(c)(1), there shall be used (in lieu of the basis of the property) an amount equal to the production costs which are allocable to the United States (as determined under rules similar to the rules of section 48(k)(5)(D)).

"(4) OWNERSHIP INTEREST.—For purposes of determining the credit allowable under section 38, the ownership interest of any person in a sound recording shall be determined on the basis of his proportionate share of any loss which may be incurred with respect to the production costs of such sound recording.

* Probably should read "1245(a)(5)."

"(5) SOUND RECORDING.—For purposes of this subsection, the term 'sound recording' means any sound recording described in section 280(c)(2).

"(6) PRODUCTION COSTS—

"(A) IN GENERAL.—For purposes of this subsection, the term 'production costs' includes—

"(i) a reasonable allocation of general overhead costs,

"(ii) compensation for services performed by song writers, artists, production personnel, directors, producers, and similar personnel,

"(iii) costs of 'first' distribution of records or tapes, and

"(iv) the cost of the material being recorded.

"(B) CERTAIN COSTS NOT TAKEN INTO ACCOUNT.—Except as provided in subparagraph (C), the term 'production costs' shall not include—

"(i) 'residuals' payable under contracts with labor organizations, or

"(ii) participations or royalties payable as compensation to song writers, artists, production personnel, directors, producers, and similar personnel, or

"(iii) any other contingent amounts.

"(C) CERTAIN CONTINGENT AMOUNTS TAKEN INTO ACCOUNT.—In the case of any amount which is described in subparagraph (B) and which is incurred in the taxable year in which the sound recording is placed in service or the next taxable year—

"(i) subparagraph (B) shall not apply, and

"(ii) for purposes of sections 38 and 168, the taxpayer shall be treated as having placed in service in each such taxable year 3-year recovery property with a basis equal to the amount so incurred in such taxable year.

"(7) ELECTION MADE SEPARATELY.—An election under paragraph (1) shall be made separately with respect to each sound recording and must be made by all persons having an ownership interest in such recording.

"(8) UNITED STATES.—For purposes of this subsection, the term 'United States' includes the possessions of the United States."

(2) CONFORMING AMENDMENTS.—Section 168(f) (relating to special rules), as amended by this Act, is amended by adding at the end thereof the following new paragraph:

"(14) SPECIAL RULES FOR SOUND RECORDINGS.—In the case of a sound recording (within the meaning of section 48(r)), the unadjusted basis of such property shall be equal to the production costs (within the meaning of section 48(r)(6))."

(b) FILMS AND OTHER PROPERTY.—

(1) FILM AND VIDEO TAPES NOT TREATED AS RECOVERY PROPERTY.—Section 168(e) (relating to property excluded from application of this section) is amended by adding at the end thereof the following new paragraph:

"(5) FILMS AND VIDEO TAPES NOT RECOVERY PROPERTY.—The term 'recovery property' shall not include any motion picture film or video tape."

(2) APPLICATION OF RECOVERY PROPERTY EXCEPTIONS.—

(A) Section 168(e) is amended by striking out "section" and inserting in lieu thereof "title" in the matter preceding paragraph (1).

(B) Subparagraph (A) of section 46(c)(7) is amended by inserting "recovery" before "property" the first place it appears.

(3) FILMS NOT SUBJECT TO INVESTMENT CREDIT AT-RISK RULES.—Paragraph (4) of section 48(k) is amended—

(A) by inserting ", section 46(c)(8), or section 46(c)(9)" after "section 48(a)(2)" in subparagraph (A),

(B) by inserting "or at-risk rules" after "test" in the heading thereof, and

(C) by striking out "issued" and inserting in lieu thereof "used".

(4) BASIS ADJUSTMENT FOR FILMS.—Section 48(q) (relating to basis adjustment) is amended by adding at the end thereof the following new paragraph:

"(6) SPECIAL RULE FOR QUALIFIED FILMS.—If a credit is allowed under section 38 with respect to any qualified film (within the meaning of subsection (k)(1)(B)) then, in lieu of any reduction under paragraph (1)—

"(A) to the extent that the credit is determined with respect to any amount described in clause (v) or (vi) of subsection (k)(5)(B), any deduction allowable under this chapter with respect to such amount shall be reduced by 50 percent of the amount of the credit so determined, and

"(B) the basis of the taxpayer's ownership interest (within the meaning of subsection (k)(1)(C)) shall be reduced by the excess of—

"(i) 50 percent of the amount of the credit determined under subsection (k), over

"(ii) the amount of the reduction under subparagraph (A)."

(c) EFFECTIVE DATES.—

(1) SOUND RECORDINGS.—The amendments made by subsection (a) shall apply to property placed in service after March 15, 1984, in taxable years ending after such date.

(2) FILMS AND OTHER PROPERTY.—

(B) The amendments made by paragraphs (2)and (3) shall apply as if included in the amendments made by sections 201(a), 211(a)(1), and 211(f)(1) of the Economic Recovery Tax Act of 1981.

(C) The amendment made by paragraph (4) of subsection (b) shall take effect as if included in the amendments made by section 205(a)(1) of the Tax Equity and Fiscal Responsibility Act of 1982.

(A) The amendment made by paragraph (1) shall apply to any films placed in service before, on, or after the date of the enactment of this Act, except that such amendment shall not apply to—

(i) any qualified film placed in service by the taxpayer before March 15, 1984, if the taxpayer treated such film as recovery property for purposes of section 168 of the Internal Revenue Code of 1954 on a return of tax under chapter 1 of such Code filed before March 16, 1984, or

(ii) any qualified film placed in service by the taxpayer before January 1, 1985, if—

(I) 20 percent or more of the production costs of such film were incurred before March 16, 1984, and

(II) the taxpayer treats such film as recovery property for purposes of section 168 of such Code.

No credit shall be allowable under section 38 of such Code with respect to any qualified film described in clause (ii), except to the extent provided in section 48(k) of such Code.

SEC. 114. DEFINITION OF SECTION 38 PROPERTY IN SALE-LEASE-BACK TRANSACTIONS.

(a) IN GENERAL.—Subsection (b) of section 48 (defining new section 38 property) is amended to read as follows:

"(b) NEW SECTION 38 PROPERTY.—For purposes of this subpart—

"(1) IN GENERAL.—The term 'new section 38 property' means section 38 property the original use of which commences with the taxpayer.

"(2) SPECIAL RULE FOR SALE-LEASEBACKS.—For purposes of paragraph (1), in the case of any section 38 property which—

"(A) is originally placed in service by a person, and

"(B) is sold and leased back by such person, or is leased to such person, within 3 months of the date such property was originally placed in service,

such property shall be treated as originally placed in service not earlier than the date on which such property is used under the lease.

"(3) SPECIAL RULE FOR ENERGY PROPERTY.—The principles of paragraph (2) shall be applicable in determining whether the original use of property commences with the taxpayer for purposes of section 48(l)(2)(B)(ii)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to property originally placed in service after April 11, 1984 (determined without regard to such amendment).

Subtitle J—Foreign Provisions

PART I—CHANGES IN SOURCE AND CHARACTER RULES

SEC. 121. CERTAIN AMOUNTS TREATED AS DERIVED FROM UNITED STATES SOURCES FOR PURPOSES OF LIMITATION ON FOREIGN TAX CREDIT.

(a) GENERAL RULE.—Section 904 (relating to limitation on foreign tax credit) is amended by redesignating subsections (g) and (h) as subsections (h) and (i), respectively, and by inserting after subsection (f) the following new subsection:

"(g) SOURCE RULES IN CASE OF UNITED STATES-OWNED FOREIGN CORPORATIONS.—

"(1) IN GENERAL.—The following amounts which are derived from a United States-owned foreign corporation and which would be treated as derived from sources outside the United States without regard to this subsection shall, for purposes of this section, be treated as derived from sources within the United States to the extent provided in this subsection:

"(A) Any amount included in gross income under—

"(i) section 951(a) (relating to amounts included in gross income of United States shareholders), or

"(ii) section 551 (relating to foreign personal holding company income taxed to United States shareholders).

"(B) Interest.

"(C) Dividends.

"(2) SUBPART F AND FOREIGN PERSONAL HOLDING COMPANY INCLUSIONS.—Any amount described in subparagraph (A) of paragraph (1) shall be treated as derived from sources within the United States to the extent such amount is attributable to income of the United States-owned foreign corporation from sources within the United States.

"(3) CERTAIN INTEREST ALLOCABLE TO UNITED STATES SOURCE INCOME.—Any interest which—

"(A) is paid or accrued by a United States-owned foreign corporation during any taxable year,

"(B) is paid or accrued to a United States shareholder (as defined in section 951(b)) or a related person (within the meaning of section 267(b)) to such a shareholder, and

"(C) is properly allocable (under regulations prescribed by the Secretary) to income of such foreign corporation for the taxable year from sources within the United States,

shall be treated as derived from sources within the United States.

"(4) DIVIDENDS.—

"(A) IN GENERAL.—The United States source ratio of any dividend paid or accrued by a United States-owned foreign corporation shall be treated as derived from sources within the United States.

"(B) UNITED STATES SOURCE RATIO.—For purposes of subparagraph (A), the term 'United States source ratio' means, with respect to any dividend paid out of the earnings and profits for any taxable year, a fraction—

"(i) the numerator of which is the portion of the earnings and profits for such taxable year from sources within the United States, and

"(ii) the denominator of which is the total amount of earnings and profits for such taxable year.

"(5) EXCEPTION WHERE UNITED STATES-OWNED FOREIGN CORPORATION HAS SMALL AMOUNT OF UNITED STATES SOURCE INCOME.—Paragraph (3) shall not apply to interest paid or accrued during any taxable year (and paragraph (4) shall not apply to any dividends paid out of the earnings and profits for such taxable year) if—

"(A) the United States-owned foreign corporation has earnings and profits for such taxable year, and

"(B) less than 10 percent of such earnings and profits is attributable to sources within the United States.

For purposes of the preceding sentence, earnings and profits shall be determined without any reduction for interest described in paragraph (3) (determined without regard to subparagraph (C) thereof).

"(6) UNITED STATES-OWNED FOREIGN CORPORATION.—For purposes of this subsection, the term 'United States-owned foreign corporation' means any foreign corporation if 50 percent or more of—

"(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

"(B) the total value of the stock of such corporation,

is held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30)).

"(7) DIVIDEND.—For purposes of this subsection, the term 'dividend' includes any gain treated as ordinary income under section 1246 or as a dividend under section 1248.

"(8) COORDINATION WITH SUBSECTION (f).—This subsection shall be applied before subsection (f).

"(9) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate for purposes of this subsection, including—

"(A) regulations for the application of this subsection in the case of interest or dividend payments through 1 or more entities, and

"(B) regulations providing that this subsection shall apply to interest paid or accrued to any person (whether or not a United States shareholder)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by subsection (a) shall take effect on the date of the enactment of this Act. In the case of the taxable year of any United States-owned foreign corporation in which occurs the date of the enactment of this Act—

(A) only income received or accrued by such foreign corporation after such date of enactment shall be taken into account under section 904(g) of the Internal Revenue Code of 1954 (as added by subsection (a)); except that

(B) paragraph (5) of such section 904(g) (relating to exception where small amount of United States source income) shall be applied by taking into account all income received or accrued by such foreign corporation during such taxable year.

(2) SPECIAL RULE FOR APPLICABLE CFC.—

(A) IN GENERAL.—In the case of qualified interest received or accrued by an applicable CFC before January 1, 1992—

(i) such interest shall not be taken into account under section 904(g) of the Internal Revenue Code of 1954 (as added by subsection (a)), except that

(ii) such interest shall be taken into account for purposes of applying paragraph (5) of such section 904(g) (relating to exception where small amount of United States source income).

(B) QUALIFIED INTEREST.—For purposes of subparagraph (A), the term "qualified interest" means—

(i) the aggregate amount of interest received or accrued during any taxable year by an applicable CFC on United States affiliate obligations held by such applicable CFC, multiplied by,

(ii) a fraction (not in excess of 1)—

(I) the numerator of which is the sum of the aggregate principal amount of United States affiliate obligations held by the applicable CFC on March 31, 1984, but not in excess of the applicable limit, and

(II) the denominator of which is the average daily principal amount of United States affiliate obligations held by such applicable CFC during the taxable year.

Proper adjustments shall be made to the numerator described in clause (ii) (I) for original issue discount accruing after March 31, 1984, on CFC obligations and United States affiliate obligations.

(C) ADJUSTMENT FOR RETIREMENT OF CFC OBLIGATIONS.—The amount described in subparagraph (B)(i)(I) for any taxable year shall be reduced by the sum of—

(i) the excess of (I) the aggregate principal amount of CFC obligations which are outstanding on March 31, 1984, but only with respect to obligations issued before March 8, 1984, or issued after March 7, 1984, by the applicable CFC pursuant to a binding commitment in effect on March 7, 1984, over (II) the average daily outstanding principal amount during the taxable year of the CFC obligations described in subclause (I), and

(ii) the portion of the equity of such applicable CFC allocable to the excess described in clause (i) (determined on the basis of the debt-equity ratio of such applicable CFC on March 31, 1984).

(D) APPLICABLE CFC.—For purposes of this paragraph, the term "applicable CFC" means any controlled foreign corporation (within the meaning of section 957)—

(i) which was in existence on March 31, 1984, and

(ii) the principal purpose of which on such date consisted of the issuing of CFC obligations and the holding of short-term obligations and lending the proceeds of such obligations to affiliates.

(E) AFFILIATES; UNITED STATES AFFILIATES.—For purposes of this paragraph—

(i) AFFILIATE.—The term "affiliate" means any person who is a related person (within the meaning of section 482 of the Internal Revenue Code of 1954) to the applicable CFC.

(ii) UNITED STATES AFFILIATE.—The term "United States affiliate" means any United States person which is an affiliate of the applicable CFC.

(F) UNITED STATES AFFILIATE OBLIGATIONS.—For purposes of this paragraph, the term "United States affiliate obligations" means any obligation of (and payable by) a United States affiliate.

(G) CFC OBLIGATION.—For purposes of this paragraph, the term "CFC obligation" means any obligation of (and issued by) a CFC if—

(i) the requirements of clause (i) of section 163(f)(2)(B) of the Internal Revenue Code of 1954 are met with respect to such obligation, and

(ii) in the case of an obligation issued after December 31, 1982, the requirements of clause (ii) of such section 163(f)(2)(B) are met with respect to such obligation.

(H) TREATMENT OF OBLIGATIONS WITH ORIGINAL ISSUE DISCOUNT.—For purposes of this paragraph, in the case of any obligation with original issue discount, the principal amount of such obligation as of any day shall be treated as equal to the revised issue price as of such day (as defined in section 1278(a)(4) of the Internal Revenue Code of 1954).

(I) APPLICABLE LIMIT.—For purposes of subparagraph (B)(ii)(I), the term "applicable limit" means the sum of—

(i) the equity of the applicable CFC on March 31, 1984, and

(ii) the aggregate principal amount of CFC obligations outstanding on March 31, 1984, which were issued by an applicable CFC—

(I) before March 8, 1984, or

(II) after March 7, 1984, pursuant to a binding commitment in effect on March 7, 1984.

(3) EXCEPTION FOR CERTAIN TERM OBLIGATIONS.—The amendments made by subsection (a) shall not apply to interest on any term obligations held by a foreign corporation on March 7, 1984. The preceding sentence shall not apply to any United States affiliate obligation (as defined in paragraph (2)(F)) held by an applicable CFC (as defined in paragraph (2)D)).

(4) DEFINITIONS.—Any term used in this subsection which is also used in section 904(g) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall have the meaning given such term by such section 904(g).

(5) SEPARATE APPLICATION OF SECTION 904 IN CASE OF INCOME COVERED BY TRANSITIONAL RULES.—Subsections (a), (b), and (c) of section 904 of the Internal Revenue Code of 1954 shall be applied separately to any amount not treated as income derived from sources within the United States but which (but for the provisions of paragraphs (2) or (3) of this subsection) would be so treated under the amendments made by subsection (a). Any such separate application shall be made before any separate application required under section 904(d) of such Code.

(6) APPLICATION OF PARAGRAPH (5) DELAYED IN CERTAIN CASES.—In the case of a foreign corporation—

(A) which is a subsidary of a domestic corporation which has been engaged in manufacturing for more than 50 years, and

(B) which issued obligations on—

(i) September 24, 1979, denominated in French francs,

(ii) September 10, 1981, denominated in Swiss francs,

(iii) July 14, 1982, denominated in Swiss francs, and

(iv) December 1, 1982, denominated in United States dollars,

with a total principal amount of less than 200,000,000 United States dollars.

then paragraph (5) shall not apply to income received or accrued on such obligations before January 1, 1986.

SEC. 122. CERTAIN AMOUNTS TREATED AS INTEREST FOR PURPOSES OF THE LIMITATION ON THE FOREIGN TAX CREDIT.

(a) GENERAL RULE.—Subsection (d) of section 904 (relating to limitation on foreign tax credit) is amended by adding at the end thereof the following new paragraph:

"(3) CERTAIN AMOUNTS ATTRIBUTABLE TO UNITED STATES-OWNED FOREIGN CORPORATIONS, ETC., TREATED AS INTEREST.—

"(A) IN GENERAL.—For purposes of this subsection, dividends and interest—

"(i) paid or accrued by a designated payor corporation, and

"(ii) attributable to any taxable year of such corporation,

shall be treated as interest income described in paragraph (2) to the extent that the aggregate amount of such dividends and interest does not exceed the separate limitation interest of the designated payor corporation for such taxable year.

"(B) SEPARATE LIMITATION INTEREST.—For purposes of this subsection, the term 'sepa-

rate limitation interest' means, with respect to any taxable year—

"(i) the aggregate amount of the interest income described in paragraph (2) (including amounts treated as so described by reason of this paragraph) which is received or accrued by the designated payor corporation during the taxable year, reduced by

"(ii) the deductions properly allocable (under regulations prescribed by the Secretary) to such income.

"(C) EXCEPTION WHERE DESIGNATED CORPORATION HAS SMALL AMOUNT OF SEPARATE LIMITATION INTEREST.—Subparagraph (A) shall not apply to any amount attributable to the taxable year of a designated payor corporation, if—

"(i) such corporation has earnings and profits for such taxable year, and

"(ii) less than 10 percent of such earnings and profits is attributable to separate limitation interest.

"(D) TREATMENT OF CERTAIN INTEREST.—For purposes of this paragraph, the amount of the separate limitation interest and the earnings and profits of any designated payor corporation shall be determined without any reduction for interest paid or accrued to a United States shareholder (as defined in section 951(b)) or a related person (within the meaning of section 267(b)) to such a shareholder.

"(E) DESIGNATED PAYOR CORPORATION.—For purposes of this paragraph, the term 'designated payor corporation' means—

"(i) any United States-owned foreign corporation (within the meaning of subsection (g)(6)),

"(ii) any other foreign corporation in which the taxpayer is a United States shareholder (as defined in section 951(b)) at any time during the taxable year of such foreign corporation, and

"(iii) any regulated investment company.

"(F) DETERMINATION OF YEAR TO WHICH AMOUNT IS ATTRIBUTABLE.—For purposes of determining whether an amount is attributable to a taxable year of a designated payor corporation—

"(i) any amount includible in gross income under section 551 or 951 in respect of such taxable year,

"(ii) any interest paid or accrued by such corporation during such taxable year, and

"(iii) any dividend paid out of the earnings and profits of such corporation for such taxable year,

shall be treated as attributable to such taxable year.

"(G) ORDERING RULES.—Subparagraph (A) shall be applied to amounts described therein in the order in which such amounts are described in subparagraph (F).

"(H) DIVIDEND.—For purposes of this paragraph, the term 'dividend' includes—

"(i) any amount includible in gross income under section 551 or 951, and

"(ii) any gain treated as ordinary income under section 1246 or as a dividend under section 1248.

"(I) DISTRIBUTIONS THROUGH OTHER ENTITIES.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph in the case of distributions or payments through 1 or more entities.

"(J) INTEREST FROM MEMBERS OF SAME AFFILIATED GROUP.—For purposes of this paragraph, interest received or accrued by the designated payor corporation from another memer of the same affiliated group (determined under section 1504 without regard to subsection (b)(3) thereof) shall not be treated as separate limitation interest, under such interest is attributable directly or indirectly to separate limitation interest of such other member."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

(2) SPECIAL RULES FOR INTEREST INCOME.—

(A) IN GENERAL.—Interest income received or accrued by a designated payor corporation shall be taken into account for purposes of the amendment made by subsection (a) only in taxable years beginning after the date of the enactment of this Act.

(B) EXCEPTION FOR INVESTMENT AFTER JUNE 22, 1984.—Notwithstanding subparagraph (A), the amendment made by subsection (a) shall apply to interest income received or accrued by a designated payor after the date of enactment of this Act if it is attributable to investment in the designated payor after June 22, 1984.

(3) TERM OBLIGATIONS OF DESIGNATED PAYOR CORPORATIONS WHICH ARE NOT APPLICABLE CFC.—In the case of any designated payor corporation which is not an applicable CFC (as defined in section 131(b)(2)(D)), any interest received or accrued by such corporation on a term obligation held by such corporation on March 7, 1984, shall not be taken into account.

SEC. 123. TREATMENT OF RELATED PERSON FACTORING INCOME.

(a) GENERAL RULE.—Section 864 (relating to source definitions) is amended by adding at the end thereof the following new subsection:

"(d) TREATMENT OF RELATED PERSON FACTORING INCOME.—

"(1) IN GENERAL.—For purposes of the provisions set forth in paragraph (2), if any person acquires (directly or indirectly) a trade or service receivable from a related person, any income of such person from the trade or service receivable so acquired shall be treated as if it were interest on a loan to the obligor under the receivable.

"(2) PROVISIONS TO WHICH PARAGRAPH (1) APPLIES.—The provisions set forth in this paragraph are as follows:

"(A) Part III of subchapter G of this chapter (relating to foreign personal holding companies).

"(B) Section 904 (relating to limitation on foreign tax credit).

"(C) Subpart F of part III of this subchapter (relating to controlled foreign corporations).

"(3) TRADE OR SERVICE RECEIVABLE.—For purposes of this subsection, the term 'trade or service receivable' means any account receivable or evidence of indebtedness arising out of—

"(A) the disposition by a related person of property described in section 1221(1), or

"(B) the performance of services by a related person.

"(4) RELATED PERSON.—For purposes of this subsection, the term 'related person' means—

"(A) any person who is a related person (within the meaning of section 267(b)), and

"(B) any United States shareholder (as defined in section 951(b)) and any person who is a related person (within the meaning of section 267(b)) to such a shareholder.

"(5) CERTAIN PROVISIONS NOT TO APPLY.—

"(A) CERTAIN EXCEPTIONS.—The following provisions shall not apply to any amount treated as interest under paragraph (1) or (6):

"(i) Subparagraphs (A), (B), (C), and (D) of section 904(d)(2) (relating to interest income to which separate limitation applies).

"(ii) Subparagraph (A) of section 954(b)(3) (relating to exception where foreign base company income is less than 10 percent).

"(iii) Subparagraph (B) of section 954(c)(3) (relating to certain income derived in active conduct of trade or business).

"(iv) Subparagraphs (A) and (B) of section 954(c)(4) (relating to exception for certain income received from related persons).

"(B) SPECIAL RULES FOR POSSESSIONS.—

"(i) PUERTO RICO AND POSSESSIONS TAX CREDIT.—Any amount treated as interest under paragraph (1) shall not be treated as income described in subparagraph (A) or (B) of section 936(a)(1) unless such amount is from sources within a possession of the United States (determined after the application of paragraph (1)).

"(ii) VIRGIN ISLANDS CORPORATIONS.—Subsection (b) of section 934 shall not apply to any amount treated as interest under paragraph (1) unless such amount is from sources within the Virgin Islands (determined after the application of paragraph (1)).

"(6) SPECIAL RULE FOR CERTAIN INCOME FROM LONS OF A CONTROLLED FOREIGN CORPORATION.—Any income of a controlled foreign corporation (within the meaning of section 957(a)) from a loan to a person other than a related person for the purpose of financing—

"(A) the purchase of property described in section 1221(1) of such related person, or

"(B) the payment for the performance of services by such related person,

shall be treated as interest described in paragraph (1).

"(7) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to prevent the avoidance of the provisions of this subsection or section 956(b)(3)."

(b) TREATMENT AS UNITED STATES PROPERTY.—Subsection (b) of section 956 (defining United States property) is amended by adding at the end thereof the following new paragraph:

"(3) CERTAIN TRADE OR SERVICE RECEIVABLES ACQUIRED FROM RELATED UNITED STATES PERSONS.—

"(A) IN GENERAL.—Notwithstanding paragraph (2), the term 'United States property' includes any trade or service receivable if—

"(i) such trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person, and

"(ii) the obligor under such receivable is a United States person.

"(B) DEFINITIONS.—For purposes of this paragraph, the term 'trade or service receivable' and 'related person' have the respective meanings given to such terms by section 864(d)."

(c) EFFECTIVE DATE.—(1) In general.—Except as provided in paraagraph (2), the amendments made by this section shall apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date.

(2) TRANSITIONAL RULE.—The amendments made by this section shall not apply to accounts receivable and evidences of indebtedness acquired after March 1, 1984, and before March 1, 1984, by a Belgian corporation in existence on March 1, 1984, in any taxable year ending after such date, but only to the extent that the investment in United States property of such corporation for all such taxable years is not reduced by reason of this paragraph by more than the lesser of—

(A) $15,000,000 or

(B) the amount of the Belgian corporation's investment on or before March 1, 1984, in stock of a foreign corporation formed to issue bonds outside the United States to the public.

SEC. 124. TREATMENT OF CERTAIN TRANSPORTATION INCOME.

(a) GENERAL RULE.—Section 863 (relating to items not specified in section 861 or 862)

is amended by adding at the end thereof the following new subsection:

"(c) SOURCE RULE FOR CERTAIN TRANSPORTATION INCOME.—

"(1) TRANSPORTATION BEGINNING AND ENDING IN THE UNITED STATES.—All transportation income attributable to transportation which begins and ends in the United States shall be treated as derived from sources within the United States.

"(2) TRANSPORTATION BETWEEN UNITED STATES AND ANY POSSESSION.—

"(A) IN GENERAL.—50 percent of all transportation income attributable to transportation which—

"(i) begins in the United States and ends in a possession of the United States, or

"(ii) begins in a possession of the United States and ends in the United States,

shall be treated as derived from sources within the United States.

"(B) SPECIAL RULE FOR CERTAIN LESSORS OF AIRCRAFT.—If—

"(i) the taxpayer owns an aircraft which is section 38 property and leases such aircraft to a United States person (other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer), and

"(ii) such United States person is a regularly scheduled air carrier,

subparagraph (A) shall be applied by substituting '100 percent' for '50 percent'.

"(3) TRANSPORTATION INCOME.—For purposes of this subsection, the term 'transportation income' means any income derived from, or in connection with—

"(A) the use (or hiring or leasing for use) of a vessel or aircraft, or

"(B) the performance of services directly related to the use of a vessel or aircraft.

For purposes of the preceding sentence, the term 'vessel or aircraft' includes any container used in connection with a vessel or aircraft."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to transportation beginning after the date of the enactment of this Act in taxable years ending after such date.

SEC. 125. TREATMENT OF CERTAIN DISTRIBUTIONS RECEIVED BY UNITED STATES-OWNED FOREIGN CORPORATIONS.

(a) GENERAL RULE.—Section 535 (defining accumulated taxable income) is amended by adding at the end thereof the following new subsection:

"(d) INCOME DISTRIBUTED TO UNITED STATES-OWNED FOREIGN CORPORATION RETAINS UNITED STATES CONNECTION.—

"(1) IN GENERAL.—For purposes of this part, if 10 percent or more of the earnings and profits of any foreign corporation for any taxable year—

"(A) is derived from sources within the United States, or

"(B) is effectively connected with the conduct of a trade or business within the United States,

any distribution out of such earnings and profits (and any interest payment) received (directly or through 1 or more other entities) by a United States-owned foreign corporation shall be treated as derived by such corporation from sources within the United States.

"(2) UNITED STATES-OWNED FOREIGN CORPORATION.—The term 'United States-owned foreign corporation' has the meaning given to such term by section 904(g)(6)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subparagraph (2), the amendment made by subparagraph (2), the amendment made by subsection (a) shall apply to distributions and interest payments received by a United States-owned foreign corporation (within the meaning of section 535(d) of the Internal Revenue Code of 1954) on or after May 23, 1983, in taxable years ending on or after such date.

(2) CORPORATIONS IN EXISTENCE ON MAY 23, 1983.—In the case of a United States-owned foreign corporation (as so defined) in existence on May 23, 1983, the amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 126. ALLOCATION UNDER SECTION 861 OF RESEARCH AND EXPERIMENTAL EXPENDITURES.

(a) IN GENERAL.—For purposes of section 861(b), section 862(b), and section 863(b) of the Internal Revenue Code of 1954, all amounts allowable as a deduction for qualified research and experimental expenditures shall be allocated to income from sources within the United States and deducted from such income in determining the amount of taxable income from sources within the United States.

(b) QUALIFIED RESEARCH AND EXPERIMENTAL EXPENDITURES.—For purposes of this section—

(1) IN GENERAL.—The term "qualified research and experimental expenditures" means amounts—

(A) which are research and experimental expenditures within the meaning of section 174 of such Code, and

(B) which are attributable to activities conducted in the United States.

(2) TREATMENT OF DEPRECIATION, ETC.—Rules similar to the rules of subsection (c) of section 174 of such Code shall apply.

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—This section shall apply to taxable years beginning after August 13, 1983, and on or before August 1, 1985.

(2) SPECIAL RULE.—If the taxpayer's 3rd taxable year beginning after August 13, 1981, is not described in paragraph (1), this section shall apply also to such 3rd taxable year.

PART II—WITHHOLDING PROVISIONS

SEC. 127. REPEAL OF THE 30 PERCENT TAX ON INTEREST RECEIVED BY FOREIGNERS ON CERTAIN PORTFOLIO INVESTMENTS.

(a) Repeal of Tax on Nonresident Individuals.—

(1) IN GENERAL.—Section 871 (relating to 30 percent tax on income not connected with United States business), as amended by this Act, is amended by redesignating subsection (i) as subsection (j) and by adding at the end thereof the following new subsection:

"(i) REPEAL OF TAX ON INTEREST OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—

"(1) IN GENERAL.—In the case of any portfolio interest received by a nonresident individual from sources within the United States no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

"(2) PORTFOLIO INTEREST.—For purposes of this subsection, the term 'portfolio interest' means any interest (including original issue discount) which is described in any of the following subparagraphs:

"(A) CERTAIN OBLIGATIONS WHICH ARE NOT REGISTERED.—Interest which is paid on any obligation which—

"(i) is not in registered form, and

"(ii) is described in section 163(f)(2)(B).

"(B) CERTAIN REGISTERED OBLIGATIONS.—Interest which is paid on an obligation—

"(i) which is in registered form, and

"(ii) with respect to which the United States person who is, or would otherwise be, required to deduct and withhold tax from such interest under section 1441(a) has received a statement (which meets the requirements of paragraph (4)) that the beneficial owner of the obligation is not a United States person.

"(3) PORTFOLIO INTEREST NOT TO INCLUDE INTEREST RECEIVED BY 10-PERCENT SHAREHOLDERS.— For purposes of this subsection—

"(A) In general.—The term 'portfolio interest' shall not include any interest described in subparagraph (A) or (B) of paragraph (2) which is received by a 10-percent shareholder.

"(B) 10-PERCENT SHAREHOLDER.—The term '10-percent shareholder' means—

"(i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or

"(ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

"(C) ATTRIBUTION RULES.—For purposes of determining ownership of stock under subparagraph (B) (i) the rules of section 318(a) shall apply, except that—

"(i) Section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation therein, and

"(ii) any stock which a person is treated as owner after application of section 318(a)(4) shall not, for purposes of applying paragraphs (2) and (3) of section 318(a), be treated as actually owned by such person.

Under regulations prescribed by the Secretary, rules similar to the rules of the preceding sentence shall be applied in determining the ownership of the capital or profits interest in a partnership for purposes of subparagraph (B)(ii).

(4) CERTAIN STATEMENTS.—A statement with respect to any obligation meets the requirements of this paragraph if such statement is made by—

"(A) the beneficial owner of such obligation, or

"(B) a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business.

The preceding sentence shall not apply to any statement with respect to payment of interest on any obligation by any person if, at least one month before such payment, the Secretary has published a determination that any statement from such person (or any class including such person) does not meet the requirements of this paragraph.

"(5) SECRETARY MAY PROVIDE SUBSECTION NOT TO APPLY IN CASES OF INADEQUATE INFORMATION EXCHANGE.—

"(A) IN GENERAL.—If the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the Secretary may provide in writing (and publish a statement) that the provisions of this subsection shall not apply to payments of interest to any person within such foreign country (or payments addressed to, or for the account of, persons within such foreign country) during the period—

"(i) beginning on the date specified by the Secretary, and

"(ii) ending on the date that the Secretary determines that the exchange of information between the United States and the foreign country is adequate to prevent the evasion of United States income tax by United States persons.

"(B) EXCEPTION FOR CERTAIN OBLIGATIONS.—Subparagraph (A) shall not apply to the payment of interest on any obligation which is issued on or before the date of the publication of the Secretary's determination under such subparagraph.

"(6) REGISTERED FORM.—For purposes of this subsection, the term 'registered form' has the same meaning given such term by section 163(f).".

(2) CONFORMING AMENDMENT.—Paragraph (1) of section 871(a) (relating to tax on income other than capital gains) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (i), there".

(b) FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Section 881 (relating to tax on income of foreign corporations not connected with United States business), as amended by this Act, is amended by redesignating subsection (c) as subsection (d) and by adding after subsection (b) the following new subsection:

"(c) REPEAL OF TAX ON INTEREST OF FOREIGN CORPORATIONS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—

"(1) IN GENERAL.—In the case of any portfolio interest received by a foreign corporation from sources within the United States, no tax shall be imposed under paragraph (1) of subsection (a).

"(2) PORTFOLIO INTEREST.—For purposes of this subsection, the term 'portfolio interest' means any interest (including orginal issue discount) which is described in any of the following subparagraphs:

"(A) CERTAIN OBLIGATIONS WHICH ARE NOT REGISTERED.—Interest which is paid on any obligation which is described in section 871(i)(2)(A).

"(B) CERTAIN REGISTERED OBLIGATIONS.—Interest which is paid on an obligation—

"(i) which is in registered form, and

"(ii) with respect to which the person who is, or would otherwise be, required to deduct and withhold tax from such interest under section 1442(a) has received a statement which meets the requirements of section 871(i)(4) that the beneficial owner of the obligation is not a United States person.

"(3) PORTFOLIO INTEREST SHALL NOT INCLUDE INTEREST RECEIVED BY CERTAIN PERSONS.—For purposes of this subsection, the term 'portfolio interest' shall not include any portfolio interest which—

"(A) except in the case of interest paid on an obligation of the United States, is received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, or

"(B) is received by a 10-percent shareholder (within the meaning of section 871(i)(3)(B)).

"(4) SPECIAL RULES FOR CONTROLLED FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—In the case of any portfolio interest received by a controlled foreign corporation, the following provisions shall not apply:

"(i) Subparagraph (A) of section 954(b)(3) (relating to exception where foreign base company income is less than 10 percent).

"(ii) Paragraph (4) of section 954(b) (relating to corporations not found or avoided of to avoid tax).

"(iii) Subparagraph (B) of section 954(c)(3) (relating to certain income derived in active conduct of trade or business).

"(iv) Subparagraph (C) of section 954(c)(3) (relating to certain income derived by an insurance company).

"(v). Subparagraphs (A) and (B) of section 954(c)(4) (relating to exception for certain income received from related persons).

"(B) INTEREST RECEIVED FROM RELATED PERSONS.—This subsection shall not apply to any portfolio interest received by a controlled foreign corporation from a related person (within the meaning of section 864(d)(4)).

"(C) CONTROLLED FOREIGN CORPORATION.—The term 'controlled foreign corporation' has the meaning given such term by section 957(a).

"(5) SECRETARY MAY CEASE APPLICATION OF THIS SUBSECTION.—Under rules similar to the rules of section 871(i)(5), the Secretary may provide that this subsection shall not apply to payments of interest described in section 871(i)(5).

"(6) REGISTERED FORM.—For purposes of this subsection, the term "registered form' has the meaning given such term by section 163(f)."

(2) CONFORMING AMENDMENT.—Subsection (a) of section 881 (relating to imposition of tax) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (c), there".

(c) AMENDMENT OF SECTION 864(c)(2).—Paragraph (2) of section 864(c) (relating to effectively connected income, etc.) is amended by striking out "section 871(a)(1)' or section 881(a)" and inserting in lieu thereof "section 871(a)(1), section 871(i) section 881(a), or section 881(c)".

(d) AMENDMENT OF SECTION 2105.—Subsection (b) of section 2105 (relating to property without the United States) is amended to read as follows:

"(b) BANK DEPOSITS AND CERTAIN OTHER DEBT OBILGATIONS.—For purposes of this subchapter—

"(1) amounts described in section 861(c), if any interest thereon would be treated by reason of section 861(a)(1)(A) as income from sources without the United States were such interest received by the decedent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if, without regard to whether a statement meeting the requirements of section 871(i)(4) has been received, any interest thereon would be eligible for the exemption from tax under section 871(i)(1) were such interest received by the decedent at the time of his death,

shall not be deemed property within the United States.".

(e) WITHHOLDING.—

(1) NONRESIDENT ALIENS.—Subsection (c) of section 1441 (relating to withholding of tax on nonresident aliens) is amended by adding at the end thereof the following new paragraph:

"(9) INTEREST INCOME FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—In the case of portfolio interest (within the meaning of 871(i)(2)) no tax shall be required to be deducted and withheld from such interest unless the person required to deduct and withhold tax from such interest knows, or has reason to know, that such interest is not portfolio interest by reason of section 871(i)(3).".

(2) FOREIGN CORPORATIONS.—The last sentence of section 1442(a) is amended—

(A) by striking out "and" after "section 881(a)(4),", and

(B) by inserting ", and the references in section 1441(c)(9) to section 871(i)(1) and 871(i)(3) shall be treated as referring to sections 881(c)(1) and 881(c)(3)".

(f) REGISTER OBLIGATIONS.—Subparagraph (C)(i) of section 163(f)(2) (relating to authority to include other obligations) is amended to read as follows:

"(i) in the case of—

"(I) subparagraph (A), such obligation is of a type which the Secretary has determined by regulations to be used frequently in avoiding Federal taxes, or

"(II) subparagraph (B), such obligation is of a type specified by the Secretary in regulations and".

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to interest received after the date of the enactment of this Act with respect to obligations issued after such date in taxable years ending after such date.

(2) SUBSECTION (d).—The amendment made by subsection (d) shall apply to obligations issued after the date of the enactment of this Act with respect to the estates of decedents dying after such date.

SPECIAL RULE FOR CERTAIN UNITED STATES AFFILIATE OBLIGATIONS.—

(A) IN GENERAL.—For purposes of the Internal Revenue Code of 1954, payments of interest on a United States affiliate obligation to an application CFC in existence on or before June 22, 1984, shall be treated as payments to a resident of the country in which the applicable CFC is incorporated.

(B) EXCEPTION.—Subparagraph (A) shall not apply to any applicable CFC which did not meet requirements which are based on the principles set forth in Revenue Rulings 69-501, 69-377, 70-645, and 73-110.

(C) DEFINITIONS.—

(i) The term "applicable CFC" has the meaning given such term by section 131(b)(2)(D) of this Act, except that such section shall be applied by substituting "the date of interest payment" for "March 31, 1984," in clause (i) thereof.

(ii) The term "United States affiliate obligation" means an obligation described in section 131(b)(2)(F) of this Act which was issued before June 22, 1984.

SEC. 128. TREATMENT OF UNITED STATES SOURCE ORIGINAL ISSUE DISCOUNT IN CASE OF FOREIGN PERSONS.

(a) NONRESIDENT ALIEN INDIVIDUALS.—

"(1) IN GENERAL.—Subparagraph (C) of section 871(a)(1) (relating to income not connected with United States business) is amended to read as follows:

"(C) in the case of—

"(i) a sale or exchange of an original issue discount obligation, the amount of any gain not in excess of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and

"(ii) the payment of interest on an original issue discount obligation, an amount equal to the original issue discount accrued on such obligation since the last payment of interest thereon (except that such original issue discount shall be taken into account under this clause only to the extent that the tax thereon does not exceed the interest payment less the tax imposed by subparagraph (A) thereon), and".

(2) DEFINITIONS AND SPECIAL RULES.—Section 871 is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) SPECIAL RULES FOR ORIGINAL ISSUE DISCOUNT.—For purposes of this section and section 881—

"(1) ORIGINAL ISSUE DISCOUNT OBLIGATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'original issue discount obligation' means any bond or other evidence of indebtedness having original issue discount (within the meaning of section 1273).

"(B) EXCEPTIONS.—The term 'original issue discount obligation' shall not include—

"(i) CERTAIN SHORT-TERM OBLIGATIONS.—Any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

"(ii) TAX-EXEMPT OBLIGATIONS.—Any obligation the interest on which is exempt from tax under section 103 or under any other provision of law without regard to the identity of the holder.

"(2) DETERMINATION OF PORTION OF ORIGINAL ISSUE DISCOUNT ACCRUING DURING ANY PERIOD.—The determination of the amount of the original issue discount which accrues during any period shall be made under the rules of section 1272 (or the corresponding

provisions of prior law) without regard to any exception for short-term obligations.

"(3) SOURCE OF ORIGINAL ISSUE DISCOUNT.—Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount described in subsection (a)(1)(C) is from sources within the United States shall be made at the time of the payment (or sale or exchange) as if such payment (or sale or exchange) involved the payment of interest.

"(4) STRIPPED BONDS.—The provisions of section 1286 (relating to the treatment of stripped bonds and stripped coupons as obligations with original issue discount) shall apply for purposes of this section."

(b) FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Paragraph (3) of section 881(a) (relating to tax on income of foreign corporations not connected with United States business) is amended to read as follows:

"(3) in the case of—

"(A) a sale or exchange of an original issue discount obligation, the amount of any gain not in excess of the original issue discount accruing while such obligation was held by the foreign corporation (to the extent such discount was not therefore taken into account under subparagraph (B)), and

"(B) the payment of interest on an original issue discount obligation, an amount equal to the original issue discount accrued on such obligation since the last payment of interest thereon (except that such original issue discount shall be taken into account under this subparagraph only to the extent that the tax thereon does not exceed the interest payment less the tax imposed by paragraph (1) thereon), and".

(2) CROSS REFERENCE.—Subsection (c) of section 881 (relating to doubling of tax) is amended to read as follows:

"(c) CROSS REFERENCE.—

"For doubling of tax on corporations of certain foreign countries, see section 891.

"For special rules for original issue discount, see section 871(g)."

(c) DEDUCTION FOR ORIGINAL ISSUE DISCOUNT HELD BY RELATED FOREIGN PERSON.—Subsection (e) of section 163 (relating to original issue discount), as amended by this Act, is amended by redesignating paragraph (3) as paragraph (4), and by inserting after paragraph (2) the following new paragraph:

"(3) SPECIAL RULE FOR ORIGINAL ISSUE DISCOUNT ON OBLIGATION HELD BY RELATED FOREIGN PERSON.—

"(A) IN GENERAL.—If any debt instrument having original issue discount is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid.

"(B) RELATED FOREIGN PERSON.—For purposes of subparagraph (A), the term 'related foreign person' means any person—

"(i) who is not a United States person, and

"(ii) who is related (within the meaning of section 267(b)) to the issuer."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to payments made on or after the 60th day after the date of the enactment of this Act with respect to obligations issued after March 31, 1972.

(2) SUBSECTION (c).—The amendment made by subsection (c) shall apply to obligations issued after June 9, 1984.

SEC. 12A. WITHHOLDING OF TAX ON DISPOSITIONS OF UNITED STATES REAL PROPERTY INTERESTS.

(a) WITHHOLDING OF TAX.—

(1) IN GENERAL.—Subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) is amended by adding at the end thereof the following new section:

"SEC. 1445. WITHHOLDING OF TAX ON DISPOSITIONS OF UNITED STATES REAL PROPERTY INTERESTS.

"(a) GENERAL RULE.—Except as otherwise provided in this section, in the case of any disposition of a United States real property interest (as defined in section 897(c)) by a foreign person, the transferee shall be required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.

"(b) EXEMPTIONS.—

"(1) IN GENERAL.—No person shall be required to deduct and withhold any amount under subsection (a) with respect to a disposition if paragraph (2), (3), (4), (5), or (6) applies to the transaction.

"(2) TRANSFEROR FURNISHES NONFOREIGN AFFIDAVIT.—Except as provided in paragraph (7), this paragraph applies to the disposition if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty or perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person.

"(3) NONPUBLICLY TRADED DOMESTIC CORPORATION FURNISHES AFFIDAVIT THAT IT IS NOT A UNITED STATES REAL PROPERTY HOLDING CORPORATION.—Except as provided in paragraph (7), this paragraph applies in the case of a disposition of any interest in any domestic corporation, if the domestic corporation furnishes to the transferee an affidavit by the domestic corporation stating, under penalty or perjury, that the domestic corporation is not and has not been a United States real property holding corporation (as defined in section 897(c)(2)) during the applicable period specified in section 897(c)(1)(A)(ii).

"(4) TRANSFEREE RECEIVES QUALIFYING STATEMENT.—

"(A) IN GENERAL.—This paragraph applies to the disposition if the transferee receives a qualifying statement at such time, in such manner, and subject to such terms and conditions as the Secretary may by regulations prescribe.

"(B) QUALIFYING STATEMENT.—For purposes of subparagraph (A), the term 'qualifying statement' means a statement by the Secretary that—

"(i) the transferor either—

"(I) has reached agreement with the Secretary (or such agreement has been reached by the transferee) for the payment of any tax imposed by section 871(b)(1) or 882(a)(1) on any gain recognized by the transferor on the disposition of the United States real property interest, or

"(II) is exempt from any tax imposed by section 871(b)(1) or 882(a)(1) on any gain recognized by the transferor on the disposition of the United States real property interest, and

"(ii) the transferor or transferee has satisfied any transferor's unsatisfied withholding liability or has provided adequate security to cover such liability.

"(5) RESIDENCE WHERE AMOUNT REALIZED DOES NOT EXCEED $300,000.—This paragraph applies to the disposition if—

"(A) the property is acquired by the transferee for use by him as a residence, and

"(B) the amount realized for the property does not exceed $300,000.

"(6) STOCK REGULARLY TRADED ON ESTABLISHED SECURITIES MARKET.—This paragraph applies if the disposition is of a share of a class of stock that is regularly traded on an established securities market.

"(7) SPECIAL RULES FOR PARAGRAPHS (2) AND (3).—Paragraph (2) or (3) (as the case may be) shall not apply to any disposition—

"(A) if—

"(i) the transferee has actual knowledge that the affidavit referred to in such paragraph is false, or

"(ii) the transferee receives a notice (as described in subsection (d)) from a transferor's agent or a transferee's agent that such affidavit is false, or

"(B) if the Secretary by regulations requires the transferee to furnish a copy of such affidavit to the Secretary and the transferee fails to furnish a copy of such affidavit to the Secretary at such time and in such manner as required by such regulations.

"(c) LIMITATIONS ON AMOUNT REQUIRED TO BE WITHHELD.—

"(1) CANNOT EXCEED TRANSFEROR'S MAXIMUM TAX LIABILITY.—

"(A) IN GENERAL.—The amount required to be withheld under this section with respect to any disposition shall not exceed the amount (if any) determined under subparagraph (B) as the transferor's maximum tax liability.

"(B) REQUEST.—At the request of the transferor or transferee, the Secretary shall determine, with respect to any disposition, the transferor's maximum tax liability.

"(C) REFUND OF EXCESS AMOUNTS WITHHELD.—Subject to such terms and conditions as the Secretary may by regulations prescribe, a transferor may seek and obtain a refund of any amounts withheld under this section in excess of the transferor's maximum tax liability.

"(2) AUTHORITY OF SECRETARY TO PRESCRIBE REDUCED AMOUNT.—At the request of the transferor or transferee, the Secretary may prescribe a reduced amount to be withheld under this section if the Secretary determines that to substitute such reduced amount will not jeopardize the collection of the tax imposed by section 871(b)(1) or 882(a)(1).

"(3) PROCEDURAL RULES.—

"(A) REGULATIONS.—Requests for—

"(i) qualifying statements under subsection (b)(4),

"(ii) determinations of transferor's maximum tax liability under paragraph (1), and

"(iii) reductions under paragraph (2) in the amount required to be withheld,

shall be made at the time and manner, and shall include such information, as the Secretary shall prescribe by regulations.

"(B) REQUESTS TO BE HANDLED WITHIN 90 DAYS.—The Secretary shall take action with respect to any request described in subparagraph (A) within 90 days after the Secretary receives the request.

"(d) LIABILITY OF TRANSFEROR'S AGENTS OR TRANSFEREE'S AGENTS.—

"(1) NOTICE OF FALSE AFFIDAVIT; FOREIGN CORPORATIONS.—If—

"(A) the transferor furnishes the transferee an affidavit described in paragraph (2)(A) of subsection (b) or a domestic corporation furnishes the transferee an affidavit described in paragraph (3) of subsection (b), and

"(B) any transferor's agent or transferee's agent has actual knowledge that such affidavit is false or the transferor is a foreign corporation,

such agent shall so notify the transferee at such time and in such manner as the Secretary shall require by regulations.

"(2) FAILURE TO FURNISH NOTICE.—

"(A) IN GENERAL.—If any transferor's agent or transferee's agent is required by paragraph (1) to furnish notice, but fails to furnish such notice at such time or times and in such manner as may be required by regulations, such agent shall have the same duty to deduct and withhold that the transferee would have had if such agent had complied with paragraph (1).

"(B) LIABILITY LIMITED TO AMOUNT OF COMPENSATION.—An agent's liability under subparagraph (A) shall be limited to the amount of compensation the agent derives from the transaction.

"(3) TRANSFEROR'S AGENT.—For purposes of this subsection, the term 'transferor's agent' means any person who represents the transferor—

"(A) in any negotiation with the transferee or any transferee's agent related to the transaction, or

"(B) in settling the transaction.

"(4) TRANSFEREE'S AGENT.—For purposes of this subsection, the term 'transferee's agent' means any person who represents the transferee—

"(A) in any negotiation with the transferor or any transferor's agent related to the transaction, or

"(B) in settling the transaction.

"(5) SETTLEMENT OFFICER NOT TREATED AS TRANSFEROR'S AGENT.—For purposes of this subsection, a person shall not be treated as a transferor's agent or transferee's agent with respect to any transaction merely because such person performs 1 or more of the following acts:

"(A) The receipt and the disbursement of any portion of the consideration for the transaction.

"(B) The recording of any document in connection with the transaction.

"(e) SPECIAL RULES RELATING TO DISTRIBUTIONS, ETC., BY CORPORATIONS, PARTNERSHIPS, TRUSTS, OR ESTATES.—

"(1) CERTAIN DOMESTIC PARTNERSHIPS, TRUSTS, AND ESTATES.—A domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate shall be required to deduct and withhold under subsection (a) a tax equal to 10 percent of any amount of which such partnership, trustee, or executor has custody which is—

"(A) attributable to the disposition of a United States real property interest (as defined in section 897(c), other than a disposition described in paragraph (4) or (5)), and

"(B) either—

"(i) includible in the distributive share of a partner of the partnership who is a foreign person,

"(ii) includible in the income of a beneficiary of the trust or estate who is a foreign person, or

"(iii) includible in the income of a foreign person under the provisions of section 671.

"(2) CERTAIN DISTRIBUTIONS BY FOREIGN CORPORATIONS.—In the case of any distribution by a foreign corporation on which gain is recognized under subsection (d) or (e) of section 897, the foreign corporation shall deduct and withhold under subsection (a) a tax equal to 28 percent of the amount of gain recognized on such distribution under such subsection.

"(3) DISTRIBUTIONS BY CERTAIN DOMESTIC CORPORATIONS TO FOREIGN SHAREHOLDERS.—If a domestic corporation which is or has been a United States real property holding corporation (as defined in section 897(c)(2)) during the applicable period specified in section 897(c)(1)(A)(ii) distributes property to a foreign person in a transaction to which section 302 or part II of subchapter C applies, such corporation shall deduct and withhold under subsection (a) a tax equal to 10 percent of the amount realized by the foreign shareholder.

"(4) TAXABLE DISTRIBUTIONS BY DOMESTIC OR FOREIGN PARTNERSHIPS, TRUSTS, OR ESTATES.—A domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate shall be required to deduct and withhold under subsection (a) a tax equal to 10 percent of the fair market value (as of the time of the taxable distribution) of any United States real property interest distributed to a partner of the partnership or a beneficiary of the trust or estate, as the case may be, who is a foreign person in a transaction which would constitute a taxable distribution under the regulations promulgated by the Secretary pursuant to section 897(g).

"(5) RULES RELATING TO DISPOSITIONS OF INTEREST IN PARTNERSHIPS, TRUSTS, OR ESTATES.—To the extent provided in regulations, the transferee of a partnership interest or of a beneficial interest in a trust or estate shall be required to deduct and withhold under subsection (a) a tax equal to 10 percent of the amount realized on the disposition.

"(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations providing for exceptions from provisions of this subsection.

"(f) DEFINITIONS.—For purposes of this section—

"(1) TRANSFEROR.—The term 'transferor' means the person disposing of the United States real property interest.

"(2) TRANSFEREE.—The term 'transferee' means the person acquiring the United States real property interest.

"(3) FOREIGN PERSON.—The term 'foreign person' means any person other than a United States person.

"(4) TRANSFEROR'S MAXIMUM TAX LIABILITY.—The term 'transferor's maximum tax liability' means, with respect to the disposition of any interest, the sum of—

"(A) the maximum amount which the Secretary determines could be imposed as tax under section 871(b)(1) or 882(a)(1) by reason of the disposition, plus

"(B) the amount the Secretary determines to be the transferor's unsatisfied withholding liability with respect to such interest.

"(5) TRANSFEROR'S UNSATISFIED WITHHOLDING LIABILITY.—The term 'transferor's unsatisfied withholding liability' means the withholding obligation imposed by this section on the transferor's acquisition of the United States real property interest or on the acquisition of a predecessor interest, to the extent such obligation has not been satisfied."

(2) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 3 is amended by adding at the end thereof the following new item:

"Sec. 1445. Withholding of tax on dispositions of United States real property interests."

(b) REPORTING REQUIREMENTS LIMITED TO FOREIGN PERSONS HOLDING DIRECT INVESTMENTS IN UNITED STATES REAL PROPERTY.—

(1) IN GENERAL.—Section 6039C (relating to returns with respect to United States real property interests) is amended to read as follows:

"SEC. 6039C. RETURNS WITH RESPECT TO FOREIGN PERSONS HOLDING DIRECT INVESTMENTS IN UNITED STATES REAL PROPERTY INTERESTS.

"(a) GENERAL RULE.—To the extent provided in regulations, any foreign person holding direct investments in United States real property interests for the calendar year shall make a return setting forth—

"(1) the name and address of such person,

"(2) a description of all United States real property interests held by such person at any time during the calendar year, and

"(3) such other information as the Secretary may by regulations prescribe.

"(b) DEFINITION OF FOREIGN PERSONS HOLDING DIRECT INVESTMENTS IN UNITED STATES REAL PROPERTY INTERESTS.—For purposes of this section, a foreign person shall be treated as holding direct investments in United States real property interests during any calendar year if—

"(1) such person did not engage in a trade or business in the United States at any time during such calendar year, and

"(2) the fair market value of the United States real property interests held directly by such person at any time during such year equals or exceeds $50,000.

"(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) UNITED STATES REAL PROPERTY INTEREST.—The term 'United States real property interest' has the meaning given to such term by section 897(c).

"(2) FOREIGN PERSON.—The term 'foreign person' means any person who is not a United States person.

"(3) ATTRIBUTION OF OWNERSHIP.—For purposes of subsection (b)(2)—

"(A) INTERESTS HELD BY PARTNERSHIPS, ETC.—United States real property interests held by a partnership, trust, or estate shall be treated as owned proportionately by its partners or beneficiaries.

"(B) INTERESTS HELD BY FAMILY MEMBERS.—United States real property interests held by the spouse or any minor child of an individual shall be treated as owned by such individual.

"(4) TIME AND MANNER OF FILING RETURN.—All returns required to be made under this section shall be made at such time and in such manner as the Secretary shall by regulations prescribe.

"(d) SPECIAL RULE FOR UNITED STATES INTEREST AND VIRGIN ISLANDS INTEREST.—A nonresident alien individual or foreign corporation subject to tax under section 897(a) shall pay any tax and file any return required by this title—

"(1) to the United States, in the case of any interest in real property located in the United States and an interest (other than an interest solely as a creditor) in a domestic corporation (with respect to the United States) described in section 897(c)(1)(A)(ii), and

"(2) to the Virgin Islands, in the case of any interest in real property located in the Virgin Islands and an interest (other than an interest solely as a creditor) in a domestic corporation (with respect to the Virgin Islands) described in section 897(c)(1)(A)(ii)."

(2) CLERICAL AMENDMENT.—The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out the item relating to section 6039C and inserting in lieu thereof the following:

"Sec. 6039C. Returns with respect to foreign persons holding direct investments in United States real property interests."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsection (a) shall apply to any disposition on or after January 1, 1985.

(2) REPORTING REQUIREMENTS.—The amendments made by subsection (b) shall apply to calendar year 1980 and subsequent calendar years.

SEC. 130 TREATMENT OF PAYMENTS TO GUAM AND VIRGIN ISLANDS CORPORATIONS.

(a) GENERAL RULE.—Subsection (b) of section 881 (relating to exception for Guam corporations) is amended to read as follows:

"(b) EXCEPTION FOR CERTAIN GUAM AND VIRGIN ISLANDS CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this section, a corporation created or organized in Guam or the Virgin Islands or under the law of Guam or the Virgin Islands shall not be treated as a foreign corporation for any taxable year if—

"(A) at all times during such taxable year less than 25 percent in value of the stock of

such corporation is owned (directly or indirectly) by foreign persons, and

"(B) at least 20 percent of the gross income of such corporation is shown to the satisfaction of the Secretary to have been derived from sources within Guam or the Virgin Islands (as the case may be) for the 3-year period ending with the close of the preceding taxable year of such corporation (or for such part of such period as the corporation has been in existence).

"(2) PARAGRAPH (1) NOT TO APPLY TO TAX IMPOSED IN GUAM.—For purposes of applying this subsection with respect to income tax liability incurred to Guam—

"(A) Paragraph (1) shall not apply, and

"(B) for purposes of this section, the term 'foreign corporation' does not include a corporation created or organized in Guam or under the law of Guam.

"(3) DEFINITIONS.—

"(A) FOREIGN PERSON.—For purposes of paragraph (1), the term 'foreign person' means any person other than—

"(i) a United States person, or

"(ii) a person who would be a United States person if references to the United States in section 7701 included references to a possession of the United States.

"(B) INDIRECT OWNERSHIP RULES.—For purposes of paragraph (1), the rules of section 318(a)(2) shall apply except that '5 percent' shall be substituted for '50 percent' in subparagraph (C) thereof.

"(4) CROSS REFERENCE.—

"For tax imposed in the Virgin Islands, see sections 934 and 934A."

(b) WITHHOLDING OF TAX.—Subsection (c) of section 1442 (relating to exception for Guam corporations) is amended to read as follows:

"(c) EXCEPTION FOR CERTAIN GUAM AND VIRGIN ISLANDS CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this section, the term 'foreign corporation' does not include a corporation created or organized in Guam or the Virgin Islands or under the law of Guam or the Virgin Islands if the requirements of subparagraphs (A) and (B) of section 881(b)(1) are met with respect to such corporation.

"(2) PARAGRAPH (1) NOT TO APPLY TO TAX IMPOSED IN GUAM.—For purposes of applying this subsection with respect to income tax liability incurred to Guam—

"(A) paragraph (1) shall not apply, and

"(B) for purposes of this section, the term 'foreign corporation' does not include a corporation created or organized in Guam or under the law of Guam.

"(3) CROSS REFERENCE.—

"For tax imposed in the Virgin Islands, see sections 934 and 934A."

(c) TECHNICAL AMENDMENT.—Subparagraph (B) of section 7651(5) is amended by inserting "(other than section 881(b)(1))" after "For purposes of this title".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to payments made after March 1, 1984, in taxable years ending after such date.

PART III—TAXATION OF CERTAIN TRANSFERS OF PROPERTY OUTSIDE THE UNITED STATES

SEC. 131. TAXATION OF CERTAIN TRANSFERS OF PROPERTY OUTSIDE THE UNITED STATES.

(a) IN GENERAL.—Subsection (a) of section 367 (relating to transfers of property from the United States) is amended to read as follows:

"(a) TRANSFERS OF PROPERTY FROM THE UNITED STATES.—

"(1) GENERAL RULE.—If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

"(2) EXCEPTION FOR CERTAIN STOCK OR SECURITIES.—Except to the extent provided in regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization.

"(3) EXCEPTION FOR TRANSFERS OF CERTAIN PROPERTY USED IN THE ACTIVE CONDUCT OF A TRADE OR BUSINESS.—

"(A) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, paragraph (1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.

"(B) PARAGRAPH NOT TO APPLY TO CERTAIN PROPERTY.—Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to any—

"(i) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.),

"(ii) installment obligation, accounts receivable, or similar property,

"(iii) foreign currency or other property denominated in foreign currency,

"(iv) intangible property (within the meaning of section 936(h)(3)(B)), or

"(v) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.

"(C) TRANSFER OF FOREIGN BRANCH WITH PREVIOUSLY DEDUCTED LOSSES.—Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that—

"(i) the sum of losses—

"(I) which were incurred by the foreign branch before the transfer, and

"(II) with respect to which a deduction was allowed to the taxpayer, exceeds

"(ii) the sum of—

"(I) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and

"(II) the amount which is recognized under section 904(f)(3) on account of the transfer.

Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside the United States having the same character as such losses had.

"(4) SPECIAL RULE FOR TRANSFER OF PARTNERSHIP INTERESTS.—Except as provided in regulations prescribed by the Secretary, a transfer by a United States person of an interest in a partnership to a foreign corporation in an exchange described in paragraph (1) shall, for purposes of this subsection, be treated as a transfer to such corporation of such person's pro rata share of the assets of the partnership.

"(5) SECRETARY MAY EXEMPT CERTAIN TRANSACTIONS FROM APPLICATION OF THIS SUBSECTION.—Paragraph (1) shall not apply to the transfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation."

(b) SPECIAL RULES FOR TRANSFERS OF INTANGIBLES.—Subsection (d) of section 367 (relating to special rule for transfer of intangibles by possession corporations) is amended to read as follows:

"(d) SPECIAL RULES RELATING TO TRANSFERS OF INTANGIBLES.—

"(1) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361—

"(A) subsection (a) shall not apply to the transfer of such property, and

"(B) the provisions of this subsection shall apply to such transfer.

"(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO SALE OF CONTINGENT PAYMENTS.—

"(A) IN GENERAL.—If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

"(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

"(ii) receiving amounts which reasonably reflect the amounts which would have been received—

"(I) annually in the form of such payments over the useful life of such property, or

"(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

"(B) EFFECT ON EARNINGS AND PROFITS.—For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under subparagraph (A)(ii).

"(C) AMOUNTS RECEIVED TREATED AS UNITED STATES SOURCE ORDINARY INCOME.—For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States."

(c) TREATMENT OF LIQUIDATIONS UNDER SECTION 336.—Section 367 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TREATMENT OF LIQUIDATIONS UNDER SECTION 336.—In the case of any distribution described in section 336 by a domestic corporation which is made to a person who is not a United States person, to the extent provided in regulations, gain shall be recognized under principles similar to the principles of this section."

(d) SECRETARY MUST BE NOTIFIED OF TRANSACTIONS DESCRIBED IN SECTION 367.—

"(1) NOTIFICATION REQUIREMENT.—Subpart A of part III of subchapter A of chapter 61 is amended by adding after section 6038A the following new section:

"SEC. 6038B. NOTICE OF CERTAIN TRANSFERS TO FOREIGN PERSONS.

"(a) IN GENERAL.—Each United States person who—

"(1) transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361, or

"(2) makes a distribution described in section 336 to a person who is not a United States person,

shall furnish to the Secretary, at such time and in such manner as the Secretary shall by regulations prescribe, such information with respect to such exchange or distribution as the Secretary may require in such regulations.

"(b) PENALTY FOR FAILURE TO FURNISH INFORMATION.—

"(1) IN GENERAL.—If any United States person fails to furnish the information described in subsection (a) at the time and in the manner required by regulations, such person shall pay a penalty equal to 25 percent of the amount of the gain realized on the exchange.

"(2) REASONABLE CAUSE EXCEPTION.—Paragraph (1) shall not apply to any failure if the United States person shows such failure is due to reasonable cause and not to willful neglect.".

(2) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTION WHERE SECRETARY NOT NOTIFIED.—Subsection (c) of section 6501 (relating to exceptions to limitations on assessment and collection) is amended by adding at the end thereof the following new paragraph:

"(8) FAILURE TO NOTIFY SECRETARY UNDER SECTION 6038B.—In the case of any tax imposed on any exchange by reason of subsection (a) or (d) of section 367, the time for assessment of such tax shall not expire before the date which is 3 years after the date on which the Secretary is notified of such exchange under section 6038B(a)."

(3) CONFORMING AMENDMENT.—The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by adding after the item relating to section 6038A the following new item:

"Sec. 6038B. Notice of certain transfers to foreign persons."

(e) REPEAL OF DECLARATORY JUDGMENT PROVISIONS INVOLVING TRANSFERS OF PROPERTY FROM THE UNITED STATES.—

(1) IN GENERAL.—Section 7477 is hereby repealed.

(2) CONFORMING AMENDMENTS.—

(A) Section 7482(b)(1) (relating to venue for review of Tax Court decisions) is amended by striking out subparagraph (D) and by redesignating subparagraphs (E) and (F) as subparagraphs (D) and (E), respectively.

(B) The table of sections for part IV of subchapter C of chapter 76 is amended by striking out the item relating to section 7477.

(f) TRANSFERS TO AVOID INCOME TAX.—

(1) IN GENERAL.—Section 1492 (relating to nontaxable transfers) is amended—

(A) by striking out paragraphs (2) and (3) and by inserting in lieu thereof—

"(2) To a transfer—

"(A) described in section 367, or

"(B) not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367, or", and

(B) by redesignating paragraph (4) as paragraph (3).

(2) CONFORMING AMENDMENT.—Subsection (b) of section 1494 (relating to abatement or refund) is amended to read as follows:

"(b) ABATEMENT OR REFUND.—Under regulations prescribed by the Secretary, the tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367."

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to transfers or exchanges after December 31, 1984, in taxable years ending after such date.

(2) SPECIAL RULE FOR CERTAIN TRANFERS OF INTANGIBLES.—

(A) IN GENERAL.—If, after June 6, 1984, and before January 1, 1985, a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B) of the Internal Revenue Code of 1954) to a foreign corporation or in a transfer described in section 1491, such transfer shall be treated for purposes of sections 367(a), 1492(2), and 1494(b) of such Code as pursuant to a plan having as one of its principal purposes the avoidance of Federal income tax.

(B) WAIVER.—Subject to such terms and conditions as the Secretary of the Treasury or his delegate may prescribe, the Secretary may waive the application of subparagraph (A) with respect to any transfer.

(3) RULING REQUEST BEFORE MARCH 1, 1984.—The amendments made by this section (and the provisions of paragraph (2) of this subsection) shall not apply to any transfer or exchange of property described in a request filed before March 1, 1984, under section 367(a), 1492(2), or 1494(b) of the Internal Revenue Code of 1954 (as in effect before such amendments).

PART IV—MISCELLANEOUS FOREIGN CORPORATE PROVISIONS

SEC. 132. AMENDMENTS RELATED TO FOREIGN PERSONAL HOLDING COMPANIES.

(a) ATTRIBUTION FROM FAMILY MEMBERS AND PARTNERSHIPS.—Section 554 (relating to stock ownership) is amended by adding at the end thereof the following new subsection:

"(c) SPECIAL RULES FOR APPLICATION OF SUBSECTION (a)(2).—For purposes of the stock ownership requirement provided in section 552(a)(2)—

"(1) stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered by reason of so much of subsection (a)(2) as relates to attribution through family membership as owned by a citizen or by a resident alien individual who is not the spouse of the nonresident individual and who does not otherwise own stock in such corporation (determined after the application of subsection (a), other than attribution through family membership), and

"(2) stock of a corporation owned by any foreign person shall not be considered by reason of so much of subsection (a)(2) as relates to attribution through partners as owned by a citizen or resident of the United States who does not otherwise own stock in such corporation (determined after application of subsection (a) and paragraph (1), other than attribution through partners)."

(b) INCLUSION IN INCOME OF UNITED STATES PERSONS HOLDING INTEREST THROUGH FOREIGN ENTITY.—Section 551 (relating to foreign personal holding company income taxed to United States shareholders) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) STOCK HELD THROUGH FOREIGN ENTITY.—For purposes of this section, stock of a foreign personal holding company owned (directly or through the application of this subsection) by—

"(1) a partnership, estate, or trust which is not a United States shareholder, or

"(2) a foreign corporation which is not a foreign personal holding company,

shall be considered as being owned proportionately by its partners, beneficiaries, or shareholders. In any case to which the preceding sentence applies, the Secretary may by regulations provide for such adjustments in the application of this part as may be necessary to carry out the purposes of the preceding sentence."

(c) COORDINATION OF SUBPART F WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—

(1) IN GENERAL.—Subsection (d) of section 951 (relating to coordination with foreign personal holding company provisions) is amended to read as follows:

"(d) COORDINATION WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholder), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A)."

(2) CERTAIN DIVIDENDS AND INTEREST NOT TAKEN INTO ACCOUNT FOR PERSONAL HOLDING COMPANY DETERMINATION.—Section 552 (defining foreign personal holding company) is amended by adding at the end thereof the following new subsection:

"(c) CERTAIN DIVIDENDS AND INTEREST NOT TAKEN INTO ACCOUNT.—For purposes of subsection (a)(1) and section 553(a)(1), gross income and foreign personal holding company income shall not include any dividends and interest which—

"(1) are described in subparagraph (A) of section 954(c)(4), and

"(2) are received from a related person which is not a foreign personal holding company (determined without regard to this subsection)."

(d) EFFECTIVE DATES.—

(1) SUBSECTIONS (a) and (b).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by subsections (a) and (b) shall apply to taxable years of foreign corporations beginning after December 31, 1983.

(B) 1-YEAR EXTENSION FOR CERTAIN TRUSTS CREATED BEFORE JUNE 30, 1953.—

(i) IN GENERAL.—The amendment made by subsection (b) shall apply to taxable years of a foreign corporation beginning after December 31, 1984, with respect to stock of such corporation which is held (directly or indirectly, within the meaning of section 554 of the Internal Revenue Code of 1954) by a trust created before June 30, 1953, if—

(I) none of the beneficiaries of such trust was a citizen or resident of the United States at the time of its creation or within 5 years thereafter, and

(II) such trust does not, after July 1, 1983, acquire (directly or indirectly) stock of any foreign personal holding company other than a company described in clause (ii).

(ii) DESCRIPTION OF COMPANY.—A company is described in this clause if—

(I) substantially all of the assets of such company are stock or assets previously held by such trust, or

(II) such company ceases to be a foreign personal holding company before January 1, 1985.

(2) SUBSECTION (c).—

(A) The amendment made by paragraph (1) of subsection (c) shall apply to taxable years of United States shareholders beginning after the date of the enactment of this Act.

(B) The amendment made by paragraph (2) of subsection (c) shall apply to taxable years of foreign corporations beginning after March 15, 1984.

SEC. 133. AMENDMENTS RELATED TO SECTION 1248.

(a) SECTION 1248 TO APPLY TO CERTAIN INDIRECT TRANSFERS OF STOCK IN A FOREIGN CORPORATION.—Section 1248 (relating to gain from certain sales or exchanges of stock in foreign corporations) is amended by adding at the end thereof the following new subsection:

"(i) TREATMENT OF CERTAIN INDIRECT TRANSFERS.—

"(1) IN GENERAL.—If any shareholder of a 10-percent corporate shareholder of a foreign corporation exchanges stock of the 10-percent corporate shareholder for stock of the foreign corporation, for purposes of this section, the stock of the foreign corporation received in such exchange shall be treated as if it had been—

"(A) issued to the 10-percent corporate shareholder, and

"(B) then distributed by the 10-percent corporate shareholder to such shareholder in redemption of his stock.

"(2) 10-PERCENT CORPORATE SHAREHOLDER DEFINED.—For purposes of this subsection, the term '10-percent corporate shareholder

means any domestic corporation which, as of the day before the exchange referred to in paragraph (1), satisfies the stock ownership requirements of subsection (a)(2) with respect to the foreign corporation."

(b) ELIMINATION OF DOUBLE TAXATION OF EARNINGS AND PROFITS OF CERTAIN FOREIGN CORPORATIONS.—

(1) Section 959 (relating to exclusion from gross income of previously taxed earnings and profits) is amended by adding at the end thereof the following new subsection:

"(e) COORDINATION WITH AMOUNTS PREVIOUSLY TAXED UNDER SECTION 1248.—For purposes of this section and section 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the gross income of such person under section 951(a)(1)(A)."

(2) Section 1248 is amended by adding at the end thereof the following new subsection:

"(j) CROSS REFERENCE.—

"For provision excluding amounts previously taxed under this section from gross income when subsequently distributed, see section 959(e)."

(c) CLARIFICATION OF SECTION 1248(c)(2)(D).—Subparagraph (D) of section 1248(c)(2) (relating to earnings and profits of subsidiaries of foreign corporations) is amended by striking out "section 958(d)(2)" and inserting in lieu thereof "section 958(a)".

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to exchanges after the date of the enactment of this Act in taxable years ending after such date.

(2) SUBSECTIONS (b) AND (c).—Except as provided in paragraph (3), the amendments made by subsections (b) and (c) shall apply with respect to transactions to which subsection (a) or (f) of section 1248 of the Internal Revenue Code of 1954 applies occurring after the date of the enactment of this Act.

(3) ELECTION OF EARLIER DATE FOR CERTAIN TRANSACTIONS.—

(A) IN GENERAL.—If the appropriate election is made under subparagraph (B), the amendments made by subsection (b) shall apply with respect to transactions to which subsection (a) or (f) of section 1248 of such Code applies occurring after October 9, 1975.

(B) ELECTION.—

(i) Subparagraph (A) shall apply with respect to transactions to which subsection (a) of section 1248 of such Code applies if the foreign corporation described in such subsection (or its successor in interest) so elects.

(ii) Subparagraph (A) shall apply with respect to transactions to which subsection (f) of section 1248 of such Code applies if the domestic corporation described in section 1248(f)(1) of such Code (or its successor) so elects.

(iii) Any election under clause (i) or (ii) shall be made not later than 180 days after the date of the enactment of this Act and shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe.

SEC. 134. DEFINITION OF FOREIGN INVESTMENT COMPANY.

(a) GENERAL RULE.—Paragraph (2) of section 1246(b) (defining foreign investment company) is amended to read as follows:

"(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in—

"(A) securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),

"(B) commodities, or

"(C) any interest (including a futures or forward contract or option) in property described in subparagraph (A) or (B),

at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30))."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to sales and exchanges (and distributions) on or after September 29, 1983, in taxable years ending on or after such date.

(2) STOCK HELD ON SEPTEMBER 29, 1983.—In the case of a sale or exchange (or distribution) not later than the date which is 1 year after the date of the enactment of this Act, the amendment made by subsection (a) shall not apply with respect to stock held by the taxpayer continuously from September 29, 1983, to the date of such sale or exchange (or distribution).

SEC. 135. APPLICATION OF COLLAPSIBLE CORPORATION RULES TO FOREIGN CORPORATIONS.

(a) IN GENERAL.—Subsection (f) of section 341 (relating to collapsible corporations) is amended by adding at the end thereof the following new paragraph:

"(8) SPECIAL RULE FOR FOREIGN CORPORATIONS.—Except to the extent provided in regulations prescribed by the Secretary—

"(A) any consent given by a foreign corporation under paragraph (1) shall not be effective, and

"(B) paragraph (3) shall not apply if the transferee is a foreign corporation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 136. STAPLED STOCK; STAPLED ENTITIES.

(a) GENERAL RULE.—Part IX of subchapter B of chapter 1 is amended by inserting after section 269A the following new section:

"SEC. 269B. STAPLED ENTITIES.

"(a) GENERAL RULE.—Except as otherwise provided by regulations, for purposes of this title—

"(1) if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation,

"(2) in applying section 1563, stock in a second corporation which constitutes a stapled interest with respect to stock of a first corporation shall be treated as owned by such first corporation, and

"(3) in applying subchapter M for purposes of determining whether any stapled entity is a regulated investment company or a real estate investment trust, all entities which are stapled entities with respect to each other shall be treated as 1 entity.

"(b) SECRETARY TO PRESCRIBE REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations may include (but shall not be limited to) regulations providing the extent to which 1 of such entities shall be treated as owning the other entity (to the extent of the stapled interest).

"(c) DEFINITIONS.—For purposes of this section—

"(1) ENTITY.—The term entity' means any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity.

"(2) STAPLED ENTITIES.—The term 'stapled entities' means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

"(3) STAPLED INTERESTS.—Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferred or required to be transferred.

"(d) SPECIAL RULE FOR TREATIES.—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section."

(b) CLERICAL AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 is amended by inserting after the item relating to section 269A the following new item:

"Sec. 269B. Stapled entities."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall take effect on the date of the enactment of this Act.

(2) INTERESTS STAPLED AS OF JUNE 30, 1983.—Except as otherwise provided in this subsection, in the case of any interests which on June 30, 1983, were stapled interests (as defined in section 269B(c)(3) of the Internal Revenue Code of 1954 (as added by this section)), the amendments made by this section shall take effect on January 1, 1985 (January 1, 1987, in the case of stapled interests in a foreign corporation).

(3) CERTAIN STAPLED ENTITIES WHICH INCLUDE REAL ESTATE INVESTMENT TRUST.—Paragraph (3) of section 269B(a) of such Code shall not apply in determining the application of the provisions of part II of subchapter M of chapter 1 of such Code to any real estate investment trust which is part of a group of stapled entities if—

(A) all members of such group were stapled entities as of June 30, 1983, and

(B) as of June 30, 1983, such group included one or more real estate investment trusts.

(4) CERTAIN STAPLED ENTITIES WHICH INCLUDE PUERTO RICAN CORPORATIONS.—

(A) Paragraph (1) of section 269B(a) of such Code shall not apply to a domestic corporation and a qualified Puerto Rican corporation which, on June 30, 1983, were stapled entities.

(B) For purposes of subparagraph (A), the term "qualified Puerto Rican corporation" means any corporation organized in Puerto Rico—

(i) which is described in section 957(c) of such Code or would be so described if any dividends it received from any other corporation described in such section 957(c) were treated as gross income of the type described in such section 957(c), and

(ii) does not, at any time during the taxable year, own (within the meaning of section 958 of such Code but before applying paragraph (2) of section 269B(a) of such Code) any stock of any corporation which is not described in such section 957(c).

(5) TREATY RULE NOT TO APPLY TO STAPLED ENTITIES ENTITLED TO TREATY BENEFITS AS OF JUNE 30, 1983.—In the case of any entity which was a stapled entity as of June 30, 1983, subsection (d) of section 269B of such Code shall not apply to any treaty benefit to which such entity was entitled as of June 30, 1983.

(6) ELECTIONS TO TREAT STAPLED FOREIGN ENTITIES AS SUBSIDIARIES.—

(A) IN GENERAL.—In the case of any foreign corporation and domestic corporation which as of June 30, 1983, were stapled entities, such domestic corporation may elect (in lieu of applying paragraph (1) of section 269B(a) of such Code) to be treated as owning all interests in the foreign corpora-

tion which constitute stapled interests with respect to stock of the domestic corporation.

(B) ELECTION.—Any election under subparagraph (A) shall be made not later than 180 days after the date of the enactment of this Act and shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe.

(C) ELECTION IRREVOCABLE.—Any election under subparagraph (A), once made, may be revoked only with the consent of the Secretary of the Treasury or his delegate.

(7) OTHER STAPLED ENTITIES WHICH INCLUDE REAL ESTATE INVESTMENT TRUST.—

(A) IN GENERAL.—Paragraph (3) of section 269B(a) of such Code shall not apply in determining the application of the provisions of part II of subchapter M of chapter 1 of such Code to any qualified real estate investment trust which is a part of a group of stapled entities—

(i) which was created pursuant to a written board of directors resolution adopted before April 15, 1984, and

(ii) all members of such group were stapled entities as of June 16, 1985.

(B) QUALIFIED REAL ESTATE INVESTMENT TRUST.—The term "qualified real estate investment trust" means any real estate trust—

(i) at least 75 percent of the gross income of which is derived from interest on obligations secured by mortgages on real property (as defined in section 856 of such Code),

(ii) with respect to which the interest on the obligations described in clause (i) made or acquired by such trust (other than to persons who are independent contractors, as defined in section 856(d)(3) of such Code) is at an arm's length rate or a rate not more than 1 percentage point greater than the associated borrowing costs of the trust, and

(iii) with respect to which any real property held by the trust is not used in the trade or business of any other member of the group of stapled entities.

SEC. 137. SERVICES RELATING TO INSURANCE POLICIES ARE TREATED AS PERFORMED IN COUNTRY OF RISK.

(a) IN GENERAL.—Subsection (e) of section 954 (defining foreign base company services income) is amended by adding at the end thereof the following new sentence: "For purposes of paragraph (2), any services performed with respect to any policy of insurance or reinsurance with respect to which the primary insured is a related person (within the meaning of section 864(d)(4)) shall be treated as having been performed in the country within which the insured hazards, risks, losses, or liabilities occur, and except as provided in regulations prescribed by the Secretary, rules similar to the rules of section 953(b) shall be applied in determining the income from such services."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years of controlled foreign corporations beginning after the date of the enactment of this Act.

PART V—TREATMENT OF ALIEN INDIVIDUALS

SEC. 138. DEFINITION OF RESIDENT ALIEN AND NONRESIDENT ALIEN.

(a) GENERAL RULE.—Section 7701 (relating to definitions) is amended by redesignating subsections (b), (c), and (d) as subsections (c), (d), and (e), respectively, and by inserting after subsection (a) the following new subsection:

"(b) DEFINITION OF RESIDENT ALIEN AND NONRESIDENT ALIEN.—

"(1) IN GENERAL.—For purposes of this title (other than subtitle B)—

"(A) RESIDENT ALIEN.—An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i) or (ii):

"(i) LAWFULLY ADMITTED FOR PERMANENT RESIDENCE.—Such individual is a lawful permanent resident of the United States at any time during such calendar year.

"(ii) SUBSTANTIAL PRESENCE TEST.—Such individual meets the substantial presence test of paragraph (3).

"(B) NONRESIDENT ALIEN.—An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

"(2) SPECIAL RULES FOR FIRST AND LAST YEAR OF RESIDENCY.—

"(A) FIRST YEAR OF RESIDENCY.—

"(i) IN GENERAL.—If an alien individual is a resident of the United States under paragraph (1)(A) with respect to any calendar year, but was not a resident of the United States at any time during the preceding calendar year, such alien individual shall be treated as a resident of the United States only for the portion of such calendar year which begins on the residency starting date.

"(ii) RESIDENCY STARTING DATE FOR INDIVIDUALS LAWFULLY ADMITTED FOR PERMANENT RESIDENCE.—In the case of an individual who is a lawfully permanent resident of the United States at any time during the calendar year, but does not meet the substantial presence test of paragraph (3), the residency starting date shall be the first day in such calendar year on which he was present in the United States while a lawful permanent resident of the United States.

"(iii) RESIDENCY STARTING DATE FOR INDIVIDUALS MEETING SUBSTANTIAL PRESENCE TEST.—In the case of an individual who meets the substantial presence test of paragraph (3) with respect to any calendar year, the residency starting date shall be the first day during such calendar year on which the individual is present in the United States.

"(B) LAST YEAR OF RESIDENCY.—An alien individual shall not be treated as a resident of the United States during a portion of any calendar year if—

"(i) such portion is after the last day in such calendar year on which the individual was present in the United States (or, in the case of an individual described in paragraph (1)(A)(i), the last day on which he was so described),

"(ii) during such portion the individual has a closer connection to a foreign country than to the United States, and

"(iii) the individual is not a resident of the United States at any time during the next calendar year.

"(C) CERTAIN NOMINAL PRESENCE DISREGARDED.—

"(i) IN GENERAL.—For purposes of subparagraphs (A)(iii) and (B), an individual shall not be treated as present in the United States during any period for which the individual establishes that he has a closer connection to a foreign country than to the United States.

"(ii) NOT MORE THAN 10 DAYS DISREGARDED.—Clause (i) shall not apply to more than 10 days on which the individual is present in the United States.

"(3) SUBSTANTIAL PRESENCE TEST.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this subsection referred to as the 'current year') if—

"(i) such individual was present in the United States on at least 31 days during the calendar year, and

"(ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

"In the case of days in:	The applicable multiplier is:
Current year	1
1st preceding year	1/3
2nd preceding year	1/6

"(B) EXCEPTION WHERE INDIVIDUAL IS PRESENT IN THE UNITED STATES DURING LESS THAN ONE-HALF OF CURRENT YEAR AND CLOSER CONNECTION TO FOREIGN COUNTRY IS ESTABLISHED.—An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if—

"(i) such individual is present in the United States on fewer than 183 days during the current year, and

"(ii) it is established that for the current year such individual has a tax home (as defined in section 911(d)(3) without regard to the second sentence thereof) in a foreign country and has a closer connection to such foreign country than to the United States.

"(C) SUBPARAGRAPH (B) NOT TO APPLY IN CERTAIN CASES.—Subparagraph (B) shall not apply to any individual with respect to any current year if at any time during such year—

"(i) such individual had an application for adjustment of status pending, or

"(ii) such individual took other steps to apply for status as a lawful permanent resident of the United States.

"(D) EXCEPTION FOR EXEMPT INDIVIDUALS OR FOR CERTAIN MEDICAL CONDITIONS.—An individual shall not be treated as being present in the United States on any day if—

"(i) such individual is an exempt individual for such day, or

"(ii) such individual was unable to leave the United States on such day because of a medical condition which arose while such individual was present in the United States.

"(4) EXEMPT INDIVIDUAL DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—An individual is an exempt individual for any day if, for such day, such individual is—

"(i) a foreign government-related individual,

"(ii) a teacher or trainee, or

"(iii) a student.

"(B) FOREIGN GOVERNMENT-RELATED INDIVIDUAL.—The term 'foreign government-related individual' means any individual temporarily present in the United States by reason of—

"(i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,

"(ii) being a full-time employee of an international organization, or

"(iii) being a member of the immediate family of an individual described in clause (i) or (ii).

"(C) TEACHER OR TRAINEE.—The term 'teacher or trainee' means any individual—

"(i) who is temporarily present in the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act (other than as a student), and

"(ii) who substantially complies with the requirements for being so present.

"(D) STUDENT.—The term 'student' means any individual—

"(i) who is temporarily present in the United States—

"(I) under subparagraph (F) of section 101(15) of the Immigration and Nationality Act, or

"(II) as a student under subparagraph (J) of such section 101(15), and

"(ii) who substantially complies with the requirements for being so present.

"(E) SPECIAL RULES FOR TEACHERS, TRAINEES, AND STUDENTS.—

"(i) LIMITATION ON TEACHERS AND TRAINEES.—An individual shall not be treated as an exempt individual by reason of clause (ii) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A).

"(ii) LIMITATION ON STUDENTS.—For any calendar year after the 5th calendar year for which an individual was an exempt individual under clause (ii) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (D)(ii).

"(5) LAWFUL PERMANENT RESIDENT.—For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if—

"(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

"(B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

"(6) PRESENCE IN THE UNITED STATES.—For purposes of this subsection—

"(A) IN GENERAL.—Except as provided in subparagraph (B) or (C), an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.

"(B) COMMUTERS FROM CANADA OR MEXICO.—If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

"(C) TRANSIT BETWEEN 2 FOREIGN POINTS.—If an individual, who is in transit between 2 points outside the United States, is physically present in the United States for less than 24 hours, such individual shall not be treated as present in the United States on any day during such transit.

"(7) ANNUAL STATEMENTS.—The Secretary may prescribe regulations under which an individual who (but for subparagraph (B) or (D) of paragraph (3)) would meet the substantial presence test of paragraph (3) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B) or (D) of paragraph (3), as the case may be.

"(8) TAXABLE YEAR.—

"(A) IN GENERAL.—For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

"(B) FISCAL YEAR TAXPAYER.—If—

"(i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and

"(ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year,

he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year.

"(9) COORDINATION WITH SECTION 877.—If—

"(A) an alien individual was treated as a resident of the United States during any period which includes at least 3 consecutive calendar years (hereinafter referred to as the 'initial residency period'), and

"(B) such individual ceases to be treated as a resident of the United States but subsequently becomes a resident of the United States before the close of the 3rd calendar year beginning after the close of the initial residency period,

such individual shall be taxable for the period after the close of the initial residency period and before the day on which he subsequently became a resident of the United States in the manner provided in section 877(b). The preceding sentence shall apply only if the tax imposed pursuant to section 877(b) exceeds the tax which, without regard to this paragraph, is imposed pursuant to section 871.

"(10) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

(2) TRANSITIONAL RULE FOR APPLYING SUBSTANTIAL PRESENCE TEST.—

(A) If an alien individual was not a resident of the United States as of the close of calendar year 1984, the determination of whether such individual meets the substantial presence test of section 7701(b)(3) of the Internal Revenue Code of 1954 (as added by this section) shall be made by only taking into account presence after 1984.

(B) If an alien individual was a resident of the United States as of the close of calendar year 1984, but was not a resident of the United States as of the close of calendar year 1983, the determination of whether such individual meets such substantial presence test shall be made by only taking into account presence in the United States after 1983.

(3) TRANSITIONAL RULE FOR APPLYING LAWFUL RESIDENCE TEST.—In the case of any individual who—

"(A) was a lawful permanent resident of the United States (within the meaning of section 7701(b)(5) of the Internal Revenue Code of 1954, as added by this section) throughout calendar year 1984, or

(B) was present in the United States at any time during 1984 while such individual was a lawful permanent resident of the United States (within the meaning of such section 7701(b)(5)),

for purposes of section 7701(b)(2)(A) of such Code (as so added), such individual shall be treated as a resident of the United States during 1984.

SEC. 138. TREATMENT OF COMMUNITY INCOME.

(a) GENERAL RULE.—Subsection (a) of section 879 (relating to tax treatment of certain community income in the case of a resident or citizen of the United States who is married to a nonresident alien individual) is amended by striking out so much of such subsection as precedes paragraph (1) thereof and inserting in lieu thereof the following:

"(a) GENERAL RULE.—In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community shall be treated as follows:".

(b) CLERICAL AMENDMENTS.—

(1) The heading of section 879 is amended to read as follows:

"SEC. 879. TAX TREATMENT OF CERTAIN COMMUNITY INCOME IN THE CASE OF NONRESIDENT ALIEN INDIVIDUALS."

(2) The table of sections for subpart A of part II of subchapter N of chapter 1 is amended by striking out the item relating to section 879 and inserting in lieu thereof the following:

"Sec. 879. Tax treatment of certain community income in the case of nonresident alien individuals."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

Subtitle K—Reporting, Penalty, and Other Provisions

PART I—PROVISIONS RELATING TO TAX SHELTERS

SEC. 141. REGISTRATION OF TAX SHELTERS.

(a) IN GENERAL.—Subchapter B of chapter 61 (relating to miscellaneous provisions involving information and returns) is amended by redesignating section 6111 as section 6112 and by inserting after section 6110 the following new section:

"SEC. 6111. REGISTRATION OF TAX SHELTERS.

"(a) REGISTRATION.—

"(1) IN GENERAL.—Any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs.

"(2) INFORMATION INCLUDED IN REGISTRATION.—Any registration under paragraph (1) shall include—

"(A) information identifying and describing the tax shelter,

"(B) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and

"(C) such other information as the Secretary may prescribe.

"(b) FURNISHING OF TAX SHELTER IDENTIFICATION NUMBER; INCLUSION ON RETURN.—

"(1) SELLERS, ETC.—Any person who sells (or otherwise transfers) an interest in a tax shelter shall (at such times and in such manner as the Secretary shall prescribe) furnish to each investor who purchases (or otherwise acquires) an interest in such tax shelter from such person the identification number assigned by the Secretary to such tax shelter.

"(2) INCLUSION OF NUMBER ON RETURN.—Any person claiming any deduction, credit, or other tax benefit by reason of a tax shelter shall include (in such manner as the Secretary may prescribe) on the return of tax on which such deduction, credit, or other benefit is claimed the identification number assigned by the Secretary to such tax shelter.

"(c) TAX SHELTER.—For purposes of this section—

"(1) IN GENERAL.—The term 'tax shelter' means any investment—

"(A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and

"(B) which is—

"(i) required to be registered under a Federal or State law regulating securities,

"(ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or

"(iii) a substantial investment.

"(2) TAX SHELTER RATIO DEFINED.—For purposes of this subsection, the term 'tax shelter ratio' means, with respect to any year, the ratio which—

"(A) the aggregate amount of the deductions and 200 percent of the credits which are represented to be potentially allowable to any investor under subtitle A for all periods up to (and including) the close of such year, bears to

"(B) the investment base as of the close of such year.

"(3) INVESTMENT BASE.—

"(A) IN GENERAL.—Except as provided in this paragraph, the term 'investment base' means, with respect to any year, the amount of money and the adjusted basis of other property (reduced by any liability to which such other property is subject) contributed by the investor as of the close of such year.

"(B) CERTAIN BORROWED AMOUNTS EXCLUDED.—For purposes of subparagraph (A), there shall not be taken into account any amount borrowed from any person—

"(i) who participated in the organization, sale, or management of the investment, or

"(ii) who is a related person (as defined in section 168(e)(4)) to any person described in clause (i),

unless such amount is unconditionally required to be repaid by the investor before the close of the year for which the determination is being made.

"(C) CERTAIN OTHER AMOUNTS INCLUDED OR EXCLUDED.—

"(i) AMOUNTS HELD IN CASH EQUIVALENTS, ETC.—No amount shall be taken into account under subparagraph (A) which is to be held in cash equivalent or marketable securities.

"(ii) AMOUNTS INCLUDED OR EXCLUDED BY SECRETARY.—The Secretary may by regulation—

"(I) exclude from the investment base any amount described in subparagraph (A), or

"(II) include in the investment base any amount not described in subparagraph (A), if the Secretary determines that such exclusion or inclusion is necessary to carry out the purposes of this section.

"(4) SUBSTANTIAL INVESTMENT.—An investment is a substantial investment if—

"(A) the aggregate amount which may be offered for sale exceeds $250,000, and

"(B) there are expected to be 5 or more investors.

"(d) OTHER DEFINITIONS.—For purposes of this section—

"(1) TAX SHELTER ORGANIZER.—The term 'tax shelter organizer' means—

"(A) the person principally responsible for organizing the tax shelter,

"(B) if the requirements of subsection (a) are not met by a person described in subparagraph (A) at the time prescribed therefor, any other person who participated in the organization of the tax shelter, and

"(C) if the requirements of subsection (a) are not met by a person described in subparagraph (A) or (B) at the time prescribed therefor, any person participating in the sale or management of the investment at a time when the tax shelter was not registered under subsection (a).

"(2) YEAR.—The term 'year' means—

"(A) the taxable year of the tax shelter, or

"(B) if the tax shelter has no taxable year, the calendar year.

"(e) REGULATIONS.—The Secretary may prescribe regulations which provide—

"(1) rules for the aggregation of similar investments offered by the same person or persons for purposes of applying subsection (c)(4),

"(2) that only 1 person shall be required to meet the requirements of subsection (a) in cases in which 2 or more persons would otherwise be required to meet such requirements,

"(3) exemptions from the requirements of this section, and

"(4) such rules as may be necessary or appropriate to carry out the purposes of this section in the case of foreign tax shelters."

(b) PENALTIES.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6707. FAILURE TO FURNISH INFORMATION REGARDING TAX SHELTERS.

"(a) FAILURE TO REGISTER TAX SHELTER.—

"(1) IMPOSITION OF PENALTY.—If a person who is required to register a tax shelter under section 6111(a)—

"(A) fails to register such tax shelter on or before the date described in section 6111(a)(1), or

"(B) files false or incomplete information with the Secretary with respect to such registration,

such person shall pay a penalty with respect to such registration in the amount determined under paragraph (2). No penalty shall be imposed under the preceding sentence with respect to any failure which is due to reasonable cause.

"(2) AMOUNT OF PENALTY.—The penalty imposed under paragraph (1) with respect to any tax shelter shall be an amount equal to the greater of—

"(A) $500, or

"(B) the lesser of (i) 1 percent of the aggregate amount invested in such tax shelter, or (ii) $10,000.

The $10,000 limitation in subparagraph (B) shall not apply where there is an intentional disregard of the requirements of section 6111(a).

"(b) FAILURE TO FURNISH TAX SHELTER IDENTIFICATION NUMBER.—

"(1) SELLERS, ETC.—Any person who fails to furnish the identification number of a tax shelter which such person is required to furnish under section 6111(b)(1) shall pay a penalty of $100 for each such failure.

"(2) FAILURE TO INCLUDE NUMBER ON RETURN.—Any person who fails to include an identification number on a return on which such number is required to be included under section 6111(b)(2) shall pay a penalty of $50 for each such failure, unless such failure is due to reasonable cause."

(c) CONFORMING AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 61 is amended by striking out the item relating to section 6111 and inserting in lieu thereof the following new items:

"Sec. 6111. Registration of tax shelters.

"Sec. 6112. Cross references."

(2) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6707. Failure to furnish information regarding tax shelters."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to any tax shelter (within the meaning of section 6111 of the Internal Revenue Code of 1954, as added by this section) any interest in which is first sold to any investor after August 31, 1984.

(2) SUBSTANTIAL INVESTMENT TEST.—For purposes of determining whether any investment is a tax shelter by reason of section 6111(c)(1)(B)(iii) of such Code (as added by this section), only offers for sale after August 31, 1984, shall be taken into account.

(3) FURNISHING OF SHELTER IDENTIFICATION NUMBER FOR INTERESTS SOLD BEFORE SEPTEMBER 1, 1984.—With respect to interests sold before September 1, 1984, any liability to act under paragraph (1) of section 6111(b) of such Code (as added by this section) which would (but for this sentence) arise before such date shall be deemed to arise on December 31, 1984.

SEC. 142. ORGANIZERS AND SELLERS OF POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

(a) IN GENERAL.—Subchapter B of chapter 61 (relating to miscellaneous provisions involving information and returns) is amended by redesignating section 6112 as section 6113 and by inserting after section 6111 the following new section:

"SEC. 6112. ORGANIZERS AND SELLERS OF POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

"(a) IN GENERAL.—Any person who—

"(1) organizes any potentially abusive tax shelter, or

"(2) sells any interest in such a shelter

shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

"(b) POTENTIALLY ABUSIVE TAX SHELTER.—For purposes of this section, the term 'potentially abusive tax shelter' means—

"(1) any tax shelter (as defined in section 6111) with respect to which registration is required under section 6111, and

"(2) any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.

"(c) SPECIAL RULES.—

"(1) AVAILABILITY FOR INSPECTION; RETENTION OF INFORMATION ON LIST.—Any person who is required to maintain a list under subsection (a)—

"(A) shall make such list available to the Secretary for inspection upon request by the Secretary, and

"(B) except as otherwise provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for 7 years.

"(2) LISTS WHICH WOULD BE REQUIRED TO BE MAINTAINED BY 2 OR MORE PERSONS.—The Secretary shall prescribe regulations which provide that, in cases in which 2 or more persons are required under subsection (a) to maintain the same list (or portion thereof), only 1 person shall be required to maintain such list (or portion)."

(b) PENALTY FOR FAILURE TO MAINTAIN LIST.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6708. FAILURE TO MAINTAIN LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS.

"(a) IN GENERAL.—Any person who fails to meet any requirement imposed by section 6112 shall pay a penalty of $50 for each person with respect to whom there is such a failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection for any calendar year shall not exceed $50,000.

"(b) PENALTY IN ADDITION TO OTHER PENALTIES.—The penalty imposed by this section shall be in addition to any other penalty provided by law."

(c) CONFORMING AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 61 is amended by striking out the item relating to section 6112 and inserting in lieu thereof the following new items:

"Sec. 6112. Organizers and sellers of potentially abusive tax shelters must keep lists of investors.

"Sec. 6113. Cross reference."

(2) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6708. Failure to maintain lists of investors in potentially abusive tax shelters."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to any in-

terest which is first sold to any investor after August 31, 1984.

SEC. 143. INCREASE IN PENALTY FOR PROMOTING ABUSIVE TAX SHELTERS; INJUNCTION AGAINST AIDING OR ABETTING UNDERSTATEMENT OF TAX LIABILITY.

(a) INCREASE IN PROMOTER PENALTY.—Subsection (a) of section 6700 (relating to promotion of abusive tax shelters) is amended by striking out "10 percent" and inserting in lieu thereof "20 percent".

(b) INJUNCTION AGAINST AIDING OR ABETTING UNDERSTATEMENTS OF TAX LIABILITY.—

(1) Subsections (a) and (b) of section 7408 (relating to action to enjoin promoters of abusive tax shelters, etc.) are each amended by inserting "or section 6701 (relating to penalties for aiding and abetting understatement of tax liability)" after "etc.)".

(2) Subsection (a) of section 7408 is amended by inserting "or section 6701" before the period at the end of the second sentence.

(3) Subsection (b) of section 7408 is amended by inserting before the period "or section 6701".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the day after the date of the enactment of this Act.

SEC. 144. INCREASED RATE OF INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO CERTAIN TAX MOTIVATED TRANSACTIONS.

(a) GENERAL RULE.—Section 6621 (relating to determination of rate of interest) is amended by adding at the end thereof the following new subsection:

"(d) INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—

"(1) IN GENERAL.—In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

"(2) SUBSTANTIAL UNDERPAYMENT ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—For purposes of this subsection, the term 'substantial underpayment attributable to tax motivated transactions' means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

"(3) TAX MOTIVATED TRANSACTIONS.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'tax motivated transaction' means—

"(i) any valuation overstatement (within the meaning of section 6659(c)),

"(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

"(iii) any straddle (as defined in section 1092(c), without regard to subsections (d) and (e) of section 1092), and

"(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.

"(B) REGULATORY AUTHORITY.—The Secretary may by regulations specify other types of transactions which will be treated as tax motivated for purposes of this subsection and may by regulations provide that specified transactions being treated as tax motivated will no longer be so treated. In prescribing regulations under the preceding sentence, the Secretary shall take into account—

"(i) the ratio of tax benefits to cash invested,

"(ii) the methods of promoting the use of this type of transaction, and

"(iii) other relevant considerations.

"(C) EFFECTIVE DATE FOR REGULATIONS.—Any regulations prescribed under subparagraph (A)(iv) or (B) shall apply only to interest accruing after a date (specified in such regulations) which is after the date on which such regulations are prescribed.

"(4) JURISDICTION OF TAX COURT.—In the case of any proceeding in the Tax Court for a redetermination of a deficiency, the Tax Court shall also have jurisdiction to determine the portion (if any) of such deficiency which is a substantial underpayment attributable to tax motivated transactions."

(b) CROSS REFERENCE.—Section 6214 (relating to determinations by Tax Court) is amended by adding at the end thereof the following new subsection:

"(e) CROSS REFERENCE.—

"For provision giving Tax Court jurisdiction to determine whether any portion of deficiency is a substantial underpayment attributable to tax motivated transactions, see section 6621(d)(4)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to interest accruing after December 31, 1984.

PART II—INFORMATION REPORTING PROVISIONS

SEC. 145. RETURNS RELATING TO MORTGAGE INTEREST RECEIVED IN TRADE OR BUSINESS FROM INDIVIDUALS.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050H. RETURNS RELATING TO MORTGAGE INTEREST RECEIVED IN TRADE OR BUSINESS FROM INDIVIDUALS.

"(a) MORTGAGE INTEREST OF $600 OR MORE.—Any person—

"(1) who is engaged in a trade or business, and

"(2) who, in the course of such trade or business, receives from any individual interest aggregating $600 or more for any calendar year on any mortgage,

shall make the return described in subsection (b) with respect to each individual from whom such interest was received at such time as the Secretary may by regulations prescribe.

"(b) FORM AND MANNER OF RETURNS.—A return is described in this subsection if such return—

"(1) is in such form as the Secretary may prescribe,

"(2) contains—

"(A) the name and address of the individual from whom the interest described in subsection (a)(2) was received,

"(B) the amount of such interest received for the calendar year, and

"(C) such other information as the Secretary may prescribe.

"(c) APPLICATION TO GOVERNMENTAL UNITS.—For purposes of subsection (a)—

"(1) TREATED AS PERSONS.—The term 'person' includes any governmental unit (and any agency or instrumentality thereof).

"(2) SPECIAL RULES.—In the case of a governmental unit or any agency or instrumentality thereof—

"(A) subsection (a) shall be applied without regard to the trade or business requirement contained therein, and

"(B) any return required under subsection (a) shall be made by the officer or employee appropriately designated for the purpose of making such return.

"(d) STATEMENTS TO BE FURNISHED TO INDIVIDUALS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every person making a return under subsection (a) shall furnish to each individual whose name is set forth in such return a written statement showing—

"(1) the name and address of the person making such return, and

"(2) the aggregate amount of interest described in subsection (a)(2) received by the person making such return from the individual to whom the statement is furnished.

The written statement required under the preceding sentence shall be furnished on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

"(e) MORTGAGE DEFINED.—For purposes of this section, except as provided in regulations prescribed by the Secretary, the term 'mortgage' means any obligation secured by real property.

"(f) RETURNS WHICH WOULD BE REQUIRED TO BE MADE BY 2 OR MORE PERSONS.—Except to the extent provided in regulations prescribed by the Secretary, in the case of interest received by any person on behalf of another person, only the person first receiving such interest shall be required to make the return under subsection (a)."

(b) PENALTIES—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(A) by striking out "or" at the end of clause (iii),

(B) by inserting "or" at the end of clause (iv), and

(C) by inserting after clause (iv) the following new clause:

"(v) section 6050H(a) (relating to mortgage interest received in trade or business from individuals),".

(2) Clause (iii) of section 6652(a)(3)(A) (relating to penalty in case of intentional disregard) is amended by inserting "or section 6050H" after "section 6041A(b)".

(3) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6052(b)" and inserting in lieu thereof "6052(b), or 6050H(d)", and

(B) by striking out "or 6052(a)" and inserting in lieu thereof "6052(a), or 6050H(a)".

(c) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050H. Returns relating to mortgage interest received in trade or business from individuals."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to amounts received after December 31, 1984.

(2) SPECIAL RULE FOR OBLIGATIONS IN EXISTENCE ON DECEMBER 31, 1984.—In the case of any obligation in existence on December 31, 1984, no penalty shall be imposed under section 6652 of the Internal Revenue Code of 1954 by reason of the amendments made by this section on any failure to supply a taxpayer identification number with respect to amounts received before January 1, 1986.

SEC. 146. RETURNS RELATING TO CASH RECEIVED IN TRADE OR BUSINESS.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050I. RETURNS RELATING TO CASH RECEIVED IN TRADE OR BUSINESS.

"(a) CASH RECEIPTS OF MORE THAN $10,000.—Any person—

"(1) who is engaged in a trade or business, and

"(2) who, in the course of such trade or business, receives more than $10,000 in cash in 1 transaction (or 2 or more related transactions),

shall make the return described in subsection (b) with respect to such transaction (or related transactions) at such time as the Secretary may by regulations prescribe.

"(b) FORM AND MANNER OF RETURNS.—A return is described in this subsection if such return—

"(1) is in such form as the Secretary may prescribe,

"(2) contains—

"(A) the name, address, and TIN of the person from whom the cash was received,

"(B) the amount of cash received,

"(C) the date and nature of the transaction, and

"(D) such other information as the Secretary may prescribe.

"(c) EXCEPTIONS.—

"(1) CASH RECEIVED BY FINANCIAL INSTITUTIONS.—Subsection (a) shall not apply to—

"(A) cash received in a transaction reported under title 31, United States Code, if the Secretary determines that reporting under this section would duplicate the reporting to the Treasury under title 31, or

"(B) cash received by any financial institution (as defined in subparagraphs (A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of section 5312(a)(2) of title 31, United States Code).

"(2) TRANSACTIONS OCCURRING OUTSIDE THE UNITED STATES.—Except to the extent provided in regulations prescribed by the Secretary, subsection (a) shall not apply to any transaction if the entire transaction occurs outside the United States.

"(d) CASH INCLUDES FOREIGN CURRENCY.—For purposes of this section, the term 'cash' includes foreign currency.

"(e) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every person making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement showing—

"(1) the name and address of the person making such return, and

"(2) the aggregate amount of cash described in subsection (a) received by the person making such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made."

(b) PENALTIES—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(A) by striking out "or" at the end of clause (iv),

(B) by inserting "or" at the end of clause (v), and

(C) by inserting after clause (v) the following new clause:

"(vi) section 6050I(a) (relating to cash received in trade or business),".

(2) Clause (iii) of section 6652(a)(3)(A) (relating to penalty in case of intentional disregard) is amended by striking out "or section 6050H" and inserting in lieu thereof ", 6050H or 6050I".

(3) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6050H(d)" and inserting in lieu thereof "6050H(d), or 6050I(e)", and

(B) by striking out "or 6050H(a)" and inserting in lieu thereof "6050H(a), or 6050I(a)".

(c) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050I. Returns relating to cash received in trade or business."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts received after December 31, 1984.

SEC. 147. PROVISIONS RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS.

(a) CLARIFICATION THAT REGULATIONS MAY REQUIRE REPORTS TO IDENTIFY YEARS TO WHICH CONTRIBUTIONS RELATE.—Subsection (i) of section 408 (relating to individual retirement accounts) is amended by inserting "(and the years to which they relate)" after "contributions".

(b) INCREASE IN PENALTY FOR FAILURE TO FILE REPORTS.—Subsection (a) of section 6693 (relating to failure to provide reports on individual retirement accounts and annuities) is amended by striking out "$10" and inserting in lieu thereof "$50".

(c) CONTRIBUTIONS REQUIRED TO BE MADE ON OR BEFORE UNEXTENDED RETURN FILING DATE.—Subparagraph (A) of section 219(f)(3) (relating to time when contributions deemed made) is amended by striking out "including" and inserting in lieu thereof "not including".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contributions made after December 31, 1984.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to failures occurring after the date of the enactment of this Act.

SEC. 148. RETURNS RELATING TO FORECLOSURES AND ABANDONMENTS OF SECURITY.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050J. RETURNS RELATING TO FORECLOSURES AND ABANDONMENTS OF SECURITY.

(a) IN GENERAL.—Any person who, in connection with a trade or business conducted by such person, lends money secured by property and who—

"(1) in full or partial satisfaction of any indebtedness, acquires an interest in any property which is security for such indebtedness, or

"(2) has reason to know that the property in which such person has a security interest has been abandoned,

shall make a return described in subsection (c) with respect to each of such acquisitions or abandonments, at such time as the Secretary may by regulations prescribe.

"(b) EXCEPTION.—Subsection (a) shall not apply to any loan to an individual secured by an interest in tangible personal property which is not held for investment and which is not used in a trade or business.

"(c) FORM AND MANNER OF RETURN.—The return required under subsection (a) with respect to any acquisition or abandonment of property—

"(1) shall be in such form as the Secretary may prescribe,

"(2) shall contain—

"(A) the name and address of each person who is a borrower with respect to the indebtedness which is secured,

"(B) a general description of the nature of such property and such indebtedness,

"(C) in the case of a return required under subsection (a)(1)—

"(i) the amount of such indebtedness at the time of such acquisition, and

"(ii) the amount of indebtedness satisfied in such acquisition,

"(D) in the case of a return required under subsection (a)(2), the amount of such indebtedness at the time of such abandonment, and

"(E) such other information as the Secretary may prescribe.

"(d) APPLICATIONS TO GOVERNMENTAL UNITS.—For purposes of this section—

"(1) TREATED AS PERSONS.—The term 'person' includes any governmental unit (and any agency or instrumentality thereof).

"(2) SPECIAL RULES.—In the case of a governmental unit or any agency or instrumentality thereof—

"(A) subsection (a) shall be applied without regard to the trade or business requirement contained therein, and

"(B) any return under this section shall be made by the officer or employee appropriately designated for the purpose of making such return.

"(e) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS REQUIRED TO BE FURNISHED.—Every person required to make a return under subsection (a) shall furnish to each person whose name is required to be set forth in such return a written statement showing the name and address of the person required to make such return. The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

"(f) TREATMENT OF OTHER DISPOSITIONS.—To the extent provided by regulations prescribed by the Secretary, any transfer of the property which secures the indebtedness to a person other than the lender shall be treated as an abandonment of such property."

(b) PENALTIES.—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(A) by striking out "or" at the end of clause (v),

(B) by adding "or" at the end of clause (vi), and

(C) by inserting after clause (vi) the following new clause:

"(vii) section 6050J(a) (relating to foreclosures and abandonments of security),".

(2) Clause (iii) of section 6652(a)(3)(A) (relating to penalty in case of intentional disregard) is amended by striking out "or 6050I" and inserting in lieu thereof ", 6050I, or 6050J".

(3) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6050I(e)" and inserting in lieu thereof "6050I(e), or 6050J(e)", and

(B) by striking out "or 6050I(a)" and inserting in lieu thereof "6050I(a), or 6050J(a)".

(c) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050J. Returns relating to foreclosures and abandonments of security."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to acquisitions of property and abandonments of property after December 31, 1984.

SEC. 149. RETURNS RELATING TO EXCHANGES OF PARTNERSHIP INTERESTS WHERE UNREALIZED RECEIVABLES, ETC., INVOLVED.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information and returns) is amended by adding at the end thereof the following new section

"SEC. 6050K. RETURNS RELATING TO EXCHANGES OF CERTAIN PARTNERSHIP INTERESTS.

"(a) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, if there is an exchange described in section 751(a) of any interest in a partnership during any calendar year, such partnership shall make a return for such calendar year stating—

"(1) the name and address of the transferee and transferor in such exchange, and

"(2) such other information as the Secretary may by regulations prescribe.

Such return shall be made at such time and in such manner as the Secretary may require by regulations.

"(b) STATEMENT TO BE FURNISHED TO TRANSFEROR AND TRANSFEREE.—Every partnership making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement showing—

"(1) the name and address of the partnership making the return, and

"(2) the information shown on the return with respect to such person.

The statement required under the preceding sentence shall be furnished to the person on or before January 31 following the calendar year for which the return under subsection (a) was made.

"(c) REQUIREMENT THAT TRANSFEROR NOTIFY PARTNERSHIP.—

"(1) IN GENERAL.—In the case of any exchange described in subsection (a), the transferor of the partnership interest shall promptly notify the partnership of such exchange.

"(2) PARTNERSHIP NOT REQUIRED TO MAKE RETURN UNTIL NOTICE.—A partnership shall not be required to make a return under this subsection with respect to any exchange until the partnership is notified of such exchange."

(b) PENALTIES.—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended by striking out "or" at the end of clause (vi), by adding "or" at the end of clause (vii), and by inserting after clause (vii) the following new clause:

"(viii) section 6050K (relating to exchanges of certain partnership interests),".

(2) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6050J(e)" and inserting in lieu thereof "6050J(e), or 6050K(b)", and

(B) by striking out "or 6050J(a)" and inserting in lieu thereof "6050J(a), or 6050K(a)".

(3) Section 6678 (relating to failure to furnish certain statements) is amended by adding at the end thereof the following new subsection:

"(c) FAILURE TO NOTIFY PARTNERSHIP OF EXCHANGE OF PARTNERSHIP INTEREST.—In the case of any person who fails to furnish the notice required by section 6050K(c)(1) on the date prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, such person shall pay a penalty of $50 for each such failure."

(c) CONFORMING AMENDMENT.—The table of subsections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050K. Returns relating to exchanges of certain partnership interests."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to exchanges after December 31, 1984.

SEC. 150. STATEMENTS REQUIRED IN CASE OF CERTAIN SUBSTITUTE PAYMENTS.

(a) IN GENERAL.—Section 6045 (relating to returns of brokers) is amended by adding at the end thereof the following new subsection:

"(d) STATEMENTS REQUIRED IN CASE OF CERTAIN SUBSTITUTE PAYMENTS.—If any broker—

"(1) transfers securities of a customer for use in a short sale or similar transaction, and

"(2) receives (on behalf of the customer) a payment in lieu of—

"(A) a dividend,

"(B) tax-exempt interest, or

"(C) such other items as the Secretary may prescribe by regulations,

during the period such short sale or similar transaction is open,

the broker shall furnish such customer a written statement (at such time and in the manner as the Secretary shall prescribe by regulations) identifying such payment as being in lieu of the dividend, tax-exempt interest, or such other item. The Secretary may prescribe regulations which require the broker to make a return which includes the information contained in such written statement."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments received after December 31, 1984.

SEC. 151. REPORTING OF STATE AND LOCAL REFUNDS NOT REQUIRED WITH RESPECT TO NON-ITEMIZERS.

(a) IN GENERAL.—Subsection (b) of section 6050E (relating to State and local income tax refunds) is amended by adding at the end thereof the following: "No statement shall be required under this subsection with respect to any individual if it is determined (in the manner provided by regulations) that such individual did not claim itemized deductions under chapter 1 for the taxable year giving rise to the refund, credit, or offset."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to payments of refunds, and credits and offsets made, after December 31, 1982.

SEC. 152. FURNISHING OF TIN UNDER BACKUP WITHHOLDING.

(a) IN GENERAL.—Section 3406(e)(1) (relating to backup withholding) is amended by inserting at the end thereof the following new sentence: "The Secretary may require that a TIN required to be furnished under subsection (a)(1)(A) be provided under penalties of perjury only with respect to interest, dividends, patronage dividends, and amounts subject to broker reporting."

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

PART III—OTHER COMPLIANCE PROVISIONS

SEC. 155. SUBSTANTIATION OF CHARITABLE CONTRIBUTIONS; MODIFICATIONS OF INCORRECT VALUATION PENALTY.

(a) SUBSTANTIATION OF CONTRIBUTIONS OF PROPERTY.—

(1) IN GENERAL.—Not later than December 31, 1984, the Secretary shall prescribe regulations under section 170(a)(1) of the Internal Revenue Code of 1954, which require any individual, closely held corporation, or personal service corporation claiming a deduction under section 170 of such Code for a contribution described in paragraph (2)—

(A) to obtain a qualified appraisal for the property contributed,

(B) to attach an appraisal summary to the return on which such deduction is first claimed for such contribution, and

(C) to include on such return such additional information (including the cost basis and acquisition date of the contributed property) as the Secretary may prescribe in such regulations.

Such regulations shall require the taxpayer to retain any qualified appraisal.

(2) CONTRIBUTIONS TO WHICH PARAGRAPH (1) APPLIES.—For purposes of paragraph (1), a contribution is described in this paragraph—

"(A) if such contribution is of property (other than publicly traded securities), and

"(B) if the claimed value of such property (plus the claimed value of all similar items of property donated to 1 or more donees) exceeds $5,000.

In the case of any property which is nonpublicly traded stock, subparagraph (B) shall be applied by substituting "$10,000" for "$5,000".

"(3) APPRAISAL SUMMARY.—For purposes of this subsection, the appraisal summary shall be in such form and include such information as the Secretary prescribes by regulations. Such summary shall be signed by the qualified appraiser preparing the qualified appraisal and shall contain the TIN of such appraiser. Such summary shall be acknowledged by the donee of the property appraised in such manner as the Secretary prescribes in such regulations.

"(4) QUALIFIED APPRAISAL.—The term "qualified appraisal" means an appraisal prepared by a qualified appraiser which includes—

"(A) a description of the property appraised,

"(B) the fair market value of such property on the date of contribution and the specific basis for the valuation,

"(C) a statement that such appraisal was prepared for income tax purposes,

"(D) the qualifications of the qualified appraiser,

"(E) the signature and TIN of such appraiser, and

"(F) such additional information as the Secretary prescribes in such regulations.

"(5) QUALIFIED APPRAISER.—

"(A) IN GENERAL.—For purposes of this subsection, the term "qualified appraiser" means an appraiser qualified to make appraisals of the type of property donated, who is not—

"(i) the taxpayer,

"(ii) a party to the transaction in which the taxpayer acquired the property,

"(iii) the donee,

"(iv) any person employed by any of the foregoing persons or related to any of the foregoing persons under section 267(b) of the Internal Revenue Code of 1954, or

"(v) to the extent provided in such regulations, any person whose relationship to the taxpayer would cause a reasonable person to question the independence of such appraiser.

"(B) APPRAISAL FEES.—For purpose of this subsection, an appraisal shall not be treated as a qualified appraisal if all or part of the fee paid for such appraisal is based on a percentage of the appraised value of the property. The preceding sentence shall not apply to fees based on a sliding scale that are paid to a generally recognized association regulating appraisers.

(6) OTHER DEFINITIONS.—For purposes of this subsection—

(A) CLOSELY HELD CORPORATION.—The term "closely held corporation" means any corporation (other than an S corporation) with respect to which the stock ownership requirement of paragraph (2) of section 542(a) of such Code is met.

(B) PERSONAL SERVICE CORPORATION.—The term "personal service corporation" means any corporation (other than an S corporation) which is a service organization (within the meaning of section 414(m)(3) of such Code).

"(C) PUBLICLY TRADED SECURITIES.—The term "publicly traded securities" means securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

(D) NONPUBLICLY TRADED STOCK.—The term "nonpublicly traded stock" means any stock of a corporation which is not a publicly traded security.

(E) THE SECRETARY.—The term "Secretary" means the Secretary of the Treasury or is delegate.

(b) INFORMATION REPORT REQUIRED ON DISPOSITION BY DONEE.—

(1) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information and returns) is amended by adding at the end thereof the following new section:

"SEC. 6050L. RETURNS RELATING TO CERTAIN DISPOSITIONS OF DONATED PROPERTY.

"(a) GENERAL RULE.—If the donee of any charitable deduction property sells, exchanges, or otherwise disposes of such property within 2 years after its receipt, the donee shall make a return (in accordance with forms and regulations prescribed by the Secretary) showing—

"(1) the name, address, and TIN of the donor,

"(2) a description of the property,

"(3) the date of the contribution,

"(4) the amount received on the disposition, and

"(5) the date of such disposition.

"(b) CHARITABLE DEDUCTION PROPERTY.—For purposes of this section, the term 'charitable deduction property' means any property (other than publicly traded securities) contributed in a contribution for which a deduction was claimed under section 170 if the claimed value of such property (plus the claimed value of all similar items of property donated by the donor to 1 or more donees) exceeds $5,000.

"(c) STATEMENT TO BE FURNISHED TO DONORS.—Every person making a return under subsection (a) shall furnish a copy of such return to the donor at such time and in such manner as the Secretary may by regulations prescribe.

"(d) DEFINITION OF PUBLICLY TRADED SECURITIES.—The term 'publicly traded securities' means securities for which (as of the date of the contribution) market quotations are readily available on an established securities market."

(2) PENALTIES.—

(A) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(i) by striking out "or" at the end of clause (vii),

(ii) By adding "or" at the end of clause (viii), and

(iii) by inserting after clause (viii) the following new clause:

"(ix) section 6050L (relating to returns relating to certain dispositions of donated property),"

(B) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(i) by striking out "or 6050K(b)" and inserting in lieu thereof "6050K(b), or 6050L(c)", and

(ii) by striking out "or 6050K(a)" and inserting in lieu thereof "6050K(a), or 6050L(a)".

(3) Clerical amendment.—The table of sections of subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050L. Returns relating to certain dispositions of donated property."	

(c) MODIFICATIONS OF INCORRECT VALUATION PENALTY.—

(1) MODIFICATIONS OF SECTION 6659.—

(A) ELIMINATION OF REQUIREMENT THAT PROSPERTY BE ACQUIRED WITHIN THE LAST 5 YEARS.—Subsection (c) of section 6659 is amended to read as follows:

"(c) VALUATION OVERSTATEMENT DEFINED.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)."

(B) SPECIAL RULES FOR OVERSTATEMENT OF CHARITABLE DEDUCTION.—Section 6659 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) SPECIAL RULES FOR OVERSTATEMENT OF CHARITABLE DEDUCTION.—

"(1) AMOUNT OF APPLICABLE PERCENTAGE.—In the case of any underpayment attributable to a valuation overstatement with respect to charitable deduction property, the applicable percentage for purposes of subsection (a) shall be 30 percent.

"(2) LIMITATION ON AUTHORITY TO WAIVE.—In the case of any underpayment attributable to a valuation overstatement with respect to charitable deduction property, the Secretary may not waive any portion of the addition to tax provided by this section unless the Secretary determines that—

"(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and

"(B) in addition to obtaining such appraisal, the taxpayer made a good-faith investigation of the value of the contributed property.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) CHARITABLE DEDUCTION PROPERTY.—The term 'charitable deduction property' means any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. For purposes of paragraph (2), such term shall not include any securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

"(B) QUALIFIED APPRAISER.—The term 'qualified appraiser' means any appraiser meeting the requirements of the regulations prescribed under section 170(a)(1).

"(C) QUALIFIED APPRAISAL.—The term 'qualified appraisal' means any appraisal meeting the requirements of the regulations prescribed under section 170(a)(1).".

(2) EXTENSION OF INCORRECT VALUATION PENALTY TO ESTATE AND GIFT TAX.—

(A) Subchapter A of chapter 68 (relating to additions to the tax and additional amounts) is amended by inserting after section 6659 the following new section:

"SEC. 6660. ADDITION TO TAX IN THE CASE OF VALUATION UNDERSTATEMENT FOR PURPOSES OF THE ESTATE OR GIFT TAXES.

"(a) ADDITION TO THE TAX.—In the case of any underpayment of a tax imposed by subtitle B (relating to estate and gift taxes) which is attributable to a valuation understatement, there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributed.

"(b) APPLICABLE PERCENTAGE.—For purposes of subsection (a), the applicable percentage shall be determined under the following table:

"If the valuation claimed is the following percent of the correct valuation—	*The applicable percentage is:*
50 percent or more but not more than 66⅔ percent.	*10*
40 percent or more but less than 50 percent.	*20*
Less than 40 percent	*30.*

"(c) VALUATION UNDERSTATEMENT DEFINED.—For purposes of this section, there is a valuation understatement if the value of any property claimed on any return is 66⅔ percent or less of the amount determined to be the correct amount of such valuation.

"(d) UNDERPAYMENT MUST BE AT LEAST $1,000.—This section shall not apply if the underpayment is less than $1,000 for any taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent).

"(e) AUTHORITY TO WAIVE.—The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith."

(B) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 68 is amended by inserting after the item relating to section 6659 the following new item:

"Sec. 6660. Addition to tax in the case of valuation understatement for purposes of estate or gift taxes."	

(d) EFFECTIVE DATES.—

(1) SUBSECTIONS (a) AND (b).—The amendments made by subsections (a) and (b) shall apply to contributions made after December 31, 1984, in taxable years ending after such date.

(2) SUBSECTION (c).—The amendments made by subsection (c) shall apply to returns filed after December 31, 1984.

SEC. 156. AUTHORIZATION TO DISREGARD APPRAISALS OF PERSONS PENALIZED FOR AIDING IN UNDERSTATEMENTS OF TAX LIABILITY.

(a) IN GENERAL.—Section 330 of title 31, United States Code, is amended by adding at the end thereof the following new subsection:

"(c) After notice and opportunity for a hearing to any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code of 1954, the Secretary may—

"(1) provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service, and

"(2) bar such appraiser from presenting evidence or testimony in any such proceeding."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to penalties assessed after the date of the enactment of this Act.

SEC. 157. LIMITATION ON MAILING OF DEPOSITS OF TAXES.

(a) IN GENERAL.—Subsection (e) of section 7502 (relating to mailing of deposits) is amended by adding at the end thereof the following new paragraph:

"(3) NO APPLICATION TO CERTAIN DEPOSITS.—Paragraph (1) shall not apply with respect to any deposit of $20,000 or more by any person who is required to deposit the tax more than once a month."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to deposits required to be made after July 31, 1984.

SEC. 158. INTEREST ON CERTAIN ADDITIONS TO TAX.

(a) IN GENERAL.—Paragraph (2) of section 6601(e) (relating to interest on penalties and

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc. (984)

additions to tax) is amended to read as follows:

"(2) INTEREST ON PENALTIES, ADDITIONAL AMOUNTS, OR ADDITIONS TO THE TAX.—

"(A) IN GENERAL.—Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax (other than an addition to tax imposed under section 6651(a)(1), 6659, 6660, or 6661) only if such assessable penalty, additional amount, or addition to the tax is not paid within 10 days from the date of notice and demand therefor, and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.

"(B) INTEREST ON CERTAIN ADDITIONS TO TAX.—Interest shall be imposed under this section with respect to any addition to tax imposed by section 6651(a)(1), 6659, 6660, or 6661 for the period which—

"(i) begins on the date on which the return of the tax with respect to which such addition to tax is imposed is required to be filed (including any extensions), and

"(ii) ends on the date of payment of such addition to tax."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to interest accrued after the date of the enactment of this Act, except with respect to additions to tax for which notice and demand is made before such date.

SEC. 159. PENALTY FOR FRAUDULENT WITHHOLDING EXEMPTION CERTIFICATE OR FAILURE TO SUPPLY INFORMATION.

(a) IN GENERAL.—Section 7205 (relating to penalty for fraudulent withholding exemption certificate) is amended—

"(1) by striking out "in lieu of" each place it appears and inserting in lieu thereof "in addition to", and

"(2) by striking out "(except the penalty provided by section 6682)" each place it appears.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to actions and failures to act occurring after the date of the enactment of this Act.

SEC. 160. APPLICATION OF PENALTY FOR FRIVOLOUS PROCEEDINGS TO PENDING TAX COURT PROCEEDINGS.

Paragraph (2) of section 292(e) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended to read as follows:

"(2) PENALTY.—The amendments made by subsections (b) and (d)(2) shall apply to any action or proceeding in the United States Tax Court which—

"(A) is commenced after December 31, 1982, or

"(B) is pending in the United States Tax Court on the day which is 120 days after the date of the enactment of the Tax Reform Act of 1984."

SEC. 161. FAILURE TO REQUEST CHANGE OF METHOD OF ACCOUNTING.

(a) IN GENERAL.—Section 446 (relating to general rule for methods of accounting) is amended by adding at the end thereof the following new subsection:

"(f) FAILURE TO REQUEST CHANGE OF METHOD OF ACCOUNTING.—If the taxpayer does not file with the Secretary a request to change the method of accounting, the absence of the consent of the Secretary to a change in the method of accounting shall not be taken into account—

"(1) to prevent the imposition of any penalty, or the addition of any amount to tax, under this title, or

"(2) to diminish the amount of such penalty or addition to tax."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 162. CLARIFICATION OF CHANGE OF VENUE FOR CERTAIN TAX OFFENSES.

Section 3237(b) of title 18 of the United States Code is amended to read as follows:

"(b) Notwithstanding subsection (a), where an offense is described in section 7203 of the Internal Revenue Code of 1954, or where venue for prosecution of an offense described in section 7201 or 7206 (1), (2), or (5) of such Code (whether or not the offense is also described in another provision of law) is based solely on a mailing to the Internal Revenue Service, and prosecution is begun in a judicial district other than the judicial district in which the defendant resides, he may upon motion filed in the district in which the prosecution is begun, elect to be tried in the district in which he was residing at the time the alleged offense was committed: Provided, That the motion is filed within twenty days after arraignment of the defendant upon indictment or information."

SEC. 163. EXTENSION OF STATUTE OF LIMITATIONS WITH RESPECT TO CERTAIN EXPENDITURES RELATING TO CONTRIBUTIONS IN AID OF CONSTRUCTION.

(a) IN GENERAL.—Section 118 (relating to contributions to the capital of a corporation) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) STATUTE OF LIMITATIONS.—If the taxpayer for any taxable year treats an amount as a contribution to the capital of the taxpayer described in subsection (b), then—

"(1) the statutory period for the assessment of any deficiency attributable to any part of such amount shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of—

"(A) the amount of the expenditure referred to in subparagraph (A) of subsection (b)(2),

"(B) the taxpayer's intention not to make the expenditures referred to in such subparagraph, or

"(C) a failure to make such expenditure within the period described in subparagraph (B) of subsection (b)(2); and

"(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment."

(b) TECHNICAL AMENDMENTS.—

(1) Section 6501 is amended by striking out subsections (l) and (o) and by redesignating subsection (m), (n), and (p) as subsections (k), (l), and (m), respectively, and by inserting after subsection (m) (as so redesignated) the following new subsection:

"(n) CROSS REFERENCES.—

"(1) For period of limitations for assessment and collection in the case of a joint income return filed after separate returns have been filed, see section 6013(b) (3) and (4).

"(2) For extension of period in the case of partnership items (as defined in section 6231(a)(3)), see section 6229.

"(3) For extension of period in the case of certain contributions in aid of construction, see section 118(c)."

(2) Subsection (f) of section 6511 is amended by striking out "section 6501(n)(1)" and inserting in lieu thereof "section 6501(l)(1)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to expenditures with respect to which the second taxable year described in section 118(b)(2)(B) of the Internal Revenue Code of 1954 ends after December 31, 1984.

Subtitle L—Miscellaneous Provisions

SEC. 171. INCLUSION OF TAX BENEFIT ITEMS IN INCOME.

(a) IN GENERAL.—Section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts) is amended to read as follows:

"SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

"(a) DEDUCTIONS.—Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce income subject to tax.

"(b) CREDITS.—

"(1) IN GENERAL.—If—

"(A) a credit was allowable with respect to any amount for any prior taxable year, and

"(B) during the taxable year there is a downward price adjustment or similar adjustment,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the adjustment.

"(2) EXCEPTION WHERE CREDIT DID NOT REDUCE TAX.—Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

"(3) EXCEPTION FOR INVESTMENT TAX CREDIT AND FOREIGN TAX CREDIT.—This subsection shall not apply with respect to the credit determined under section 46 and the foreign tax credit.

"(c) TREATMENT OF CARRYOVERS.—For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery takes place shall be treated as reducing income subject to tax or reducing tax imposed by this chapter, as the case may be.

"(d) SPECIAL RULES FOR ACCUMULATED EARNINGS TAX AND FOR PERSONAL HOLDING COMPANY TAX.—In applying subsection (a) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

"(1) any excluded amount under subsection (a) allowed for the purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not such amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

"(2) where any excluded amount under subsection (a) was not allowable as a deduction for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then such excluded amount shall be allowable if it did not result in a reduction of the tax under section 531 or the tax under section 541."

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by striking out the item relating to section 111 and inserting in lieu thereof:

"Sec. 111. Recovery of tax benefit items."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts recovered after December 31, 1983, in taxable years ending after such date.

SEC. 172. LOANS WITH BELOW-MARKET INTEREST RATES.

(a) GENERAL RULE.—Subchapter C of chapter 80 (relating to provisions affecting more than 1 subtitle) is amended by adding at the end thereof the following new section:

"SEC. 7872. TREATMENT OF LOANS WITH BELOW-MARKET INTEREST RATES.

"(a) TREATMENT OF GIFT LOANS AND DEMAND LOANS.—

"(1) IN GENERAL.—For purposes of this title, in the case of any below-market loan to which this section applies and which is a gift loan or a demand loan, the foregone interest shall be treated as—

"(A) transferred from the lender to the borrower, and

"(B) retransferred by the borrower to the lender as interest.

"(2) TIME WHEN TRANSFERS MADE.—Except as otherwise provided in regulations prescribed by the Secretary, any foregone interest attributable to periods during any calendar year shall be treated as transferred (and retransferred) under paragraph (1) on the last day of such calendar year.

"(b) TREATMENT OF OTHER BELOW-MARKET LOANS.—

"(1) IN GENERAL.—For purposes of this title, in the case of any below-market loan to which this section applies and to which subsection (a)(1) does not apply, the lender shall be treated as having transferred on the date the loan was made (or, if later, on the first day on which this section applies to such loan), and the borrower shall be treated as having received on such date, cash in an amount equal to the excess of—

"(A) the amount loaned, over

"(B) the present value of all payments which are required to be made under the terms of the loan.

"(2) OBLIGATION TREATED AS HAVING ORIGINAL ISSUE DISCOUNT.—For purposes of this title—

"(A) IN GENERAL.—Any below-market loan to which paragraph (1) applies shall be treated as having original issue discount in an amount equal to the excess described in paragraph (1).

"(B) AMOUNT IN ADDITION TO OTHER ORIGINAL ISSUE DISCOUNT.—Any original issue discount which a loan is treated as having by reason of subparagraph (A) shall be in addition to any other original issue discount on such loan (determined without regard to subparagraph (A)).

"(c) BELOW-MARKET LOANS TO WHICH SECTION APPLIES.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, this section shall apply to—

"(A) GIFTS.—Any below-market loan which is a gift loan.

"(B) COMPENSATION-RELATED LOANS.—Any below-market loan directly or indirectly between—

"(i) an employer and an employee, or

"(ii) an independent contractor and a person for whom such independent contractor provides services.

"(C) CORPORATION-SHAREHOLDER LOANS.—Any below-market loan directly or indirectly between a corporation and any shareholder of such corporation.

"(D) TAX AVOIDANCE LOANS.—Any below-market loan if one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.

"(E) OTHER BELOW-MARKET LOANS.—To the extent provided in regulations, any below-market loan which is not described in subparagraph (A), (B), or (C) if the interest arrangements of such loan have a significant effect on any Federal tax liability of the lender or the borrower.

"(2) $10,000 DE MINIMIS EXCEPTION FOR GIFT LOANS BETWEEN INDIVIDUALS.—

"(A) IN GENERAL.—In the case of any gift loan directly between individuals, this section shall not apply to any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000.

"(B) DE MINIMIS EXCEPTION NOT TO APPLY TO LOANS ATTRIBUTABLE TO ACQUISITION OF INCOME-PRODUCING ASSETS.—Subparagraph (A) shall not apply to any gift loan directly attributable to the purchase or carrying of income-producing assets.

"(C) CROSS REFERENCE.—

"For limitation on amount treated as interest where loans do not exceed $100,000, see subsection (d)(1).

"(3) $10,000 DE MINIMIS EXCEPTION FOR COMPENSATION-RELATED AND CORPORATE-SHAREHOLDER LOANS.—

"(A) IN GENERAL.—In the case of any loan described in subparagraph (B) or (C) of paragraph (1), this section shall not apply to any day on which the aggregate outstanding amount of loans between the borrower and lender does not exceed $10,000.

"(B) EXCEPTION NOT TO APPLY WHERE 1 OF PRINCIPAL PURPOSES IS TAX AVOIDANCE.—Subparagraph (A) shall not apply to any loan the interest arrangements of which have as 1 of their principal purposes the avoidance of any Federal tax.

"(d) SPECIAL RULES FOR GIFT LOANS.—

"(1) LIMITATION ON INTEREST ACCRUAL FOR PURPOSES OF INCOME TAXES WHERE LOANS DO NOT EXCEED $100,000.—

"(A) IN GENERAL.—For purposes of subtitle A, in the case of a gift loan directly between individuals, the amount treated as retransferred by the borrower to the lender as of the close of any year shall not exceed the borrower's net investment income for such year.

"(B) LIMITATION NOT TO APPLY WHERE 1 OF PRINCIPAL PURPOSES IS TAX AVOIDANCE.—Subparagraph (A) shall not apply to any loan the interest arrangements of which have as 1 of their principal purposes the avoidance of any Federal tax.

"(C) SPECIAL RULE WHERE MORE THAN 1 GIFT LOAN OUTSTANDING.—For purposes of subparagraph (A), in any case in which a borrower has outstanding more than 1 gift loan, the net investment income of such borrower shall be allocated among such loans in proportion to the respective amounts which would be treated as retransferred by the borrower without regard to this paragraph.

"(D) LIMITATION NOT TO APPLY WHERE AGGREGATE AMOUNT OF LOANS EXCEED $100,000.—This paragraph shall not apply to any loan made by a lender to a borrower for any day on which the aggregate outstanding amount of loans between the borrower and lender exceeds $100,000.

"(E) NET INVESTMENT INCOME.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'net investment income' has the meaning given such term by section 163(d)(3).

"(ii) DE MINIMIS RULE.—If the net investment income of any borrower for any year does not exceed $1,000, the net investment income of such borrower for such year shall be treated as zero.

"(iii) ADDITIONAL AMOUNTS TREATED AS INTEREST.—In determining the net investment income of a person for any year, any amount which would be included in the gross income of such person for such year by reason of section 1272 if such section applied to all deferred payment obligations shall be treated as interest received by such person for such year.

"(iv) DEFERRED PAYMENT OBLIGATIONS.—The term 'deferred payment obligation' includes any market discount bond, short-term obligation, United States savings bond, annuity, or similar obligation.

"(2) SPECIAL RULE FOR GIFT TAX.—In the case of any gift loan which is a term loan, subsection (b)(1) (and not subsection (a)) shall apply for purposes of chapter 12.

"(e) DEFINITIONS OF BELOW-MARKET LOAN AND FOREGONE INTEREST.—For purposes of this section—

"(1) BELOW-MARKET LOAN.—The term 'below-market loan' means any loan if—

"(A) in the case of a demand loan, interest is payable on the loan at a rate less than the applicable Federal rate, or

"(B) in the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan.

"(2) FOREGONE INTEREST.—The term 'foregone interest' means, with respect to any period during which the loan is outstanding, the excess of—

"(A) the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the applicable Federal rate and were payable annually on the day referred to in subsection (a)(2), over

"(B) any interest payable on the loan properly allocable to such period.

"(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PRESENT VALUE.—The present value of any payment shall be determined in the manner provided by regulations prescribed by the Secretary—

"(A) as of the date of the loan, and

"(B) by using a discount rate equal to the applicable Federal rate.

"(2) APPLICABLE FEDERAL RATE.—

"(A) TERM LOANS.—In the case of any term loan, the applicable Federal rate shall be the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually.

"(B) DEMAND LOANS.—In the case of a demand loan, the applicable Federal rate shall be the Federal short-term rate in effect under section 1274(d) for the period for which the amount of foregone interest is being determined.

"(3) GIFT LOAN.—The term 'gift loan' means any below-market loan when the foregoing of interest is in the nature of a gift.

"(4) AMOUNT LOANED.—The term 'amount loaned' means the amount received by the borrower.

"(5) DEMAND LOAN.—The term 'demand loan' means any loan which is payable in full at any time on the demand of the lender. Such term also includes (for purposes other than determining the applicable Federal rate under paragraph (2)) any loan which is not transferrable and the benefits of the interest arrangements of which is conditioned on the future performance of substantial services by an individual.

"(6) TERM LOAN.—The term 'term loan' means any loan which is not a demand loan.

"(7) HUSBAND AND WIFE TREATED AS 1 PERSON.—A husband and wife shall be treated as 1 person.

"(8) LOANS TO WHICH SECTION 483 OR 1274 APPLIES.—This section shall not apply to any loan to which section 483 or 1274 applies.

"(9) NO WITHHOLDING.—No amount shall be withheld under chapter 24 with respect to any amount treated as transferred or retransferred under subsection (a).

"(10) SPECIAL RULE FOR TERM LOANS.—If this section applies to any term loan on any day, this section shall continue to apply to such loan notwithstanding paragraphs (2) and (3) of subsection (c). In the case of a gift loan, the preceding sentence shall only apply for purposes of chapter 12.

"(g) REGULATIONS.—

"(1) IN GENERAL.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including—

"(A) regulations providing that where, by reason of varying rates of interest, condi-

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tional interest payments, waivers of interest, disposition of the lender's or borrower's interest in the loan, or other circumstances, the provisions of this section do not carry out the purposes of this section, adjustments to the provisions of this section will be made to the extent necessary to carry out the purposes of this section,

"(B) regulations for the purpose of assuring that the positions of the borrower and lender are consistent as to the application (or nonapplication) of this section, and

"(C) regulations exempting from the application of this section any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower.

"(2) ESTATE TAX COORDINATION.—Under regulations prescribed by the Secretary, any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 in a manner consistent with the provisions of subsection (b)."

(b) CLERICAL AMENDMENT.—The table of sections for subchapter C of chapter 80 is amended by adding at the end thereof the following new item:

"Sec. 7872. Treatment of loans with below-market interest rates."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to—

(A) term loans made after June 6, 1984, and

(B) demand loans outstanding after June 6, 1984.

(2) EXCEPTION FOR DEMAND LOANS OUTSTANDING ON JUNE 6, 1984, AND REPAID WITHIN 60 DAYS AFTER DATE OF ENACTMENT.—The amendments made by this section shall not apply to any demand loan which—

(A) was outstanding on June 6, 1984, and

(B) was repaid before the date 60 days after the date of the enactment of this Act.

(3) EXCEPTION FOR CERTAIN EXISTING LOANS TO CONTINUING CARE FACILITIES.—Nothing in this subsection shall be construed to apply the amendments made by this section to any loan made before June 6, 1984, to a continuing care facility by a resident of such facility which is contingent on continued residence at such facility.

(4) APPLICABLE FEDERAL RATE FOR PERIODS BEFORE JANUARY 1, 1985.—For periods before January 1, 1985, the applicable Federal rate under paragraph (2) of section 7872(f) of the Internal Revenue Code of 1954, as added by this section, shall be 10 percent, compounded semiannually.

(5) TREATMENT OF RENEGOTIATIONS, ETC.—For purposes of this subsection, any loan renegotiated, extended, or revised after June 6, 1984, shall be treated as a loan made after such date.

(6) DEFINITION OF TERM AND DEMAND LOANS.—For purposes of this subsection, the terms 'demand loan' and 'term loan' have the respective meanings given such terms by paragraphs (5) and (6) of section 7872(f) of the Internal Revenue Code of 1954, as added by this section, but the second sentence of such paragraph (5) shall not apply.

SEC. 172. ELIGIBILITY FOR INCOME AVERAGING.

(a) BASE PERIOD SHORTENED TO 3 YEARS.—Paragraph (2) of section 1302(c) (relating to definition of averagable income; related definitions) is amended by striking out "4 taxable years" and inserting in lieu thereof "3 taxable years".

(b) INCREASE IN PERCENTAGE OF AVERAGE BASE INCOME TAKEN INTO ACCOUNT.—Section 1301 (relating to limitation on tax) is amended by striking out "120 percent" and inserting in lieu thereof "140 percent".

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 1301 (relating to limitation on tax) is amended—

(A) by striking out "5 times" and inserting in lieu thereof "4 times", and

(B) by striking out "20 percent" and inserting in lieu thereof "25 percent".

(2) Paragraph (1) of section 1302(a) (defining averagable income) is amended by striking out "120 percent" and inserting in lieu thereof "140 percent".

(3) Paragraph (1) of section 1302(b) (defining average base period income) is amended by striking out "one-fourth" and inserting in lieu thereof "⅓".

(4) Paragraph (3) of section 1302(c) is amended by striking out "4 taxable years" and inserting in lieu thereof "3 taxable years".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to computation years beginning after December 31, 1983, and to base period years applicable to such computation years.

SEC. 174. AMENDMENTS TO SECTION 267.

(a) ALLOWANCE OF DEDUCTION WHERE EXPENSES AND INTEREST ARE PAID TO RELATED CASH-BASIS TAXPAYERS AFTER 2½-MONTH PERIOD.—

(1) IN GENERAL.—Subsection (a) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended to read as follows:

"(a) IN GENERAL.—

"(1) DEDUCTION FOR LOSSES DISALLOWED.—No deduction shall be allowed in respect of any loss from the sale or exchange of property (other than a loss in case of a distribution in corporate liquidation), directly or indirectly, between persons specified in any of the paragraphs of subsection (b).

"(2) MATCHING OF DEDUCTION AND PAYEE INCOME ITEM IN THE CASE OF EXPENSES AND INTEREST.—If—

"(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

"(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph)."

(2) CONFORMING AMENDMENT.—Subsection (e) of section 267 (relating to rule where last day of 2½-month period falls on Sunday, etc.) is hereby repealed.

(b) EXTENSION OF SECTION 267 TO CERTAIN RELATED ENTRIES.—

(1) PASS-THRU ENTITIES.—Section 267 is amended by striking out subsection (f) and inserting in lieu thereof the following:

"(e) SPECIAL RULES FOR PASS-THRU ENTITIES.—

"(1) IN GENERAL.—In the case of any amount paid or incurred by, to, or on behalf of, a pass-thru entity, for purposes of applying subsection (a)(2)—

"(A) such entity,

"(B) in the case of—

"(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or

"(ii) an S corporation, any person who owns (directly or indirectly) any of the stock of such corporation,

"(C) any person who owns (directly or indirectly) any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest, and

"(D) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to a person described in subparagraph (B) or (C),

shall be treated as persons specified in a paragraph of subsection (b). Subparagraph (C) shall apply to a transaction only if such transaction is related either to the operations of the partnership described in such subparagraph or to an interest in such partnership.

"(2) PASS-THRU ENTITY.—For purposes of this section, the term 'pass-thru entity' means—

"(A) a partnership, and

"(B) an S corporation.

"(3) CONSTRUCTIVE OWNERSHIP IN THE CASE OF PARTNERSHIPS.—For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) shall apply, except that—

"(A) paragraph (3) of subsection (c) shall not apply, and

"(B) interests owned (directly or indirectly) by or for a C corporation shall be considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) 5 percent or more in value of the stock of such corporation.

"(4) SUBSECTION (a)(2) NOT TO APPLY TO CERTAIN GUARANTEED PAYMENTS OF PARTNERSHIPS.—In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 707(c) applies to such amount.

"(5) EXCEPTION FOR CERTAIN EXPENSES AND INTEREST OF PARTNERSHIPS OWNING LOW-INCOME HOUSING.—

"(A) IN GENERAL.—This subsection shall not apply with respect to qualified expenses and interest paid or incurred by a partnership owning low-income housing to—

"(i) any qualified 5-percent or less partner of such partnership, or

"(ii) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to any qualified 5-percent or less partner of such partnership.

"(B) QUALIFIED 5-PERCENT OR LESS PARTNER.—For purposes of this paragraph, the term 'qualified 5-percent or less partner' means any partner who has (directly or indirectly) an interest of 5 percent or less in the aggregate capital and profits interests of the partnership but only if—

"(i) such partner owned the low-income housing at all times during the 2-year period ending on the date such housing was transferred to the partnership, or

"(ii) such partnership acquired the low-income housing pursuant to a purchase, assignment, or other transfer from the Department of Housing and Urban Development or any State or local housing authority.

For purposes of the preceding sentence, a partner shall be treated as holding any interest in the partnership which is held (directly or indirectly) by any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to such partner.

"(C) QUALIFIED EXPENSES AND INTEREST.—For purpose of this paragraph, the term 'qualified expenses and interest' means any expense or interest incurred by the partnership with respect to low-income housing held by the partnership but—

"(i) only if the amount of such expense or interest (as the case may be) is unconditionally required to be paid by the partnership not later than 10 years after the date such amount was incurred, and

"(ii) in the case of such interest, only if such interest is incurred at an annual rate not in excess of 12 percent.

"(D) LOW-INCOME HOUSING.—For purposes of this paragraph, the term 'low-income housing' means—

"(i) any interest in low-income housing (as defined in paragraph (5) of section 189(e)), and

"(ii) any interest in a partnership owning low-income housing (as so defined)."

(2) CERTAIN CONTROLLED GROUPS.—

(A) Paragraph (3) of section 267(b) is amended to read as follows:

"(3) Two corporations which are members of the same controlled group (as defined in subsection (f));".

(B) Section 267 is amended by adding at the end thereof the following new subsection:

"(f) CONTROLLED GROUP DEFINED; SPECIAL RULES APPLICABLE TO CONTROLLED GROUPS.—

"(1) CONTROLLED GROUP DEFINED.—For purposes of this section, the term 'controlled group' has the meaning given to such term by section 1563(a), except that—

"(A) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and

"(B) the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563.

"(2) DEFERRAL (RATHER THAN DENIAL) OF LOSS FROM SALE OR EXCHANGE BETWEEN MEMBERS.—In the case of any loss from the sale or exchange of property which is between members of the same controlled group and to which subsection (a)(1) applies (determined without regard to this paragraph but with regard to paragraph (3))—

"(A) subsections (a)(1) and (d) shall not apply to such loss, but

"(B) such loss shall be deferred until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.

"(3) LOSS DEFERRAL RULES NOT TO APPLY IN CERTAIN CASES.—

"(A) TRANSFER TO DISC.—For purposes of applying subsection (a)(1), the term 'controlled group' shall not include a DISC.

"(B) CERTAIN SALES OF INVENTORY.—Except to the extent provided in regulations prescribed by the Secretary, subsection (a)(1) shall not apply to the sale or exchange of property between members of the same controlled group if—

"(i) such property in the hands of the transferor is property described in section 1221(1),

"(ii) such sale or exchange is in the ordinary course of the transferor's trade or business,

"(iii) such property in the hands of the transferee is property described in section 1221(1), and

"(iv) the transferee or the transferor is a foreign corporation.

"(C) CERTAIN FOREIGN CURRENCY LOSSES.—To the extent provided in regulations, subsection (a)(1) shall not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of such group if such loan is payable in a foreign currency or is denominated in such a currency and such loss is attributable to a reduction in value of such foreign currency."

(3) CORPORATION AND PARTNERSHIP OWNED BY SAME PERSONS.—Paragraph (10) of section 267(b) is amended—

(A) by striking out "An S corporation" and inserting in lieu thereof "A corporation", and

(B) by striking out "the S corporation" and inserting in lieu thereof "the corporation".

(4) S CORPORATION AND C CORPORATION OWNED BY SAME PERSONS.—Paragraph (12) of section 267(b) is amending by striking out "the same individual" and inserting in lieu thereof "the same persons".

(5) TECHNICAL AMENDMENTS.—

(A) Paragraph (3) of section 170(a) is amended by striking out "section 267(b)" and inserting in lieu thereof "section 267(b) or 707(b)".

(B) Clause (iii) of section 614(c)(9)(B) is amended by striking out "section 267(b)" and inserting in lieu thereof "section 267(b) or 707(b)".

(C) Subsection (d) of section 1235 is amended—

(i) by striking out "section 267(b)" in the matter preceding paragraph (1) and inserting in lieu thereof "section 267(b) or persons described in section 707(b)",

(ii) by striking out "section 267 (b) and (c)" and inserting in lieu thereof "section 267 (b) and (c) and section 707(b)", and

(iii) by striking out "section 267(b)" in paragraph (1) and inserting in lieu thereof "section 267(b) or 707(b)".

(D) Subparagraph (F) of section 368(a)(2) is amended by striking out clause (viii).

(c) EFFECTIVE DATES.—

(1) SUBSECTIONS (a) AND (b)(1).—The amendments made by subsections (a) and (b)(1) shall apply to amounts allowable as deductions under chapter 1 of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1983. For purposes of the preceding sentence, the allowability of a deduction shall be determined without regard to any disallowance or postponement of deductions under section 267 of such Code.

(2) SUBSECTION (b) (OTHER THAN PARAGRAPH (1)).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by subsection (b) (other than paragraph (1) thereof) shall apply to transactions after December 31, 1983, in taxable years ending after such date.

(B) EXCEPTION FOR TRANSFERS TO FOREIGN CORPORATIONS ON OR BEFORE MARCH 1, 1984.—The amendments made by subsection (b)(2) shall not apply to property transferred to a foreign corporation on or before March 1, 1984.

(3) EXCEPTION FOR EXISTING INDEBTEDNESS, ETC.—

(A) IN GENERAL.—The amendments made by this section shall not apply to any amount paid or incurred—

(i) on indebtedness incurred on or before September 29, 1983, or

(ii) pursuant to a contract which was binding on September 29, 1983, and at all times thereafter before the amount is paid or incurred.

(B) TREATMENT OF RENEGOTIATIONS, EXTENSIONS, ETC.—If any indebtedness (or contract described in subparagraph (A)) is renegotiated, extended, renewed, or revised after September 29, 1983, subparagraph (A) shall not apply to any amount paid or incurred on such indebtedness (or pursuant to such contract) after the date of such renegotiation, extension, renewal, or revision.

SEC. 175. AMENDMENTS TO SECTION 1239.

(a) PATENT APPLICATIONS TREATED AS DEPRECIABLE PROPERTY.—Section 1239 (relating to gain from sale of depreciable property between certain related taxpayers) is amended by adding at the end thereof the following new subsection:

"(e) PATENT APPLICATIONS TREATED AS DEPRECIABLE PROPERTY.—For purposes of this section, a patent application shall be treated as property which, in the hands of the transferee, is of a character which is subject to the allowance for depreciation provided in section 167."

(b) TAXPAYER AND CERTAIN TRUSTS TREATED AS RELATED PERSONS.—Subsection (b) of section 1239 is amended to read as follows:

"(b) RELATED PERSONS.—For purposes of subsection (a), the term 'related person' means—

"(1) a husband and wife,

"(2) a person and all entities which are 80-percent owned entities with respect to such person,

"(3) a taxpayer and any trust in which such taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest (within the meaning of section 318(a)(3)(B)(i))."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales or exchanges after March 1, 1984, in taxable years ending after such date.

SEC. 176. RECAPTURE OF NET ORDINARY LOSSES UNDER SECTION 1231.

(a) GENERAL RULE.—Section 1231 (relating to property used in the trade or business and involuntary conversions) is amended by adding at the end thereof the following new subsection:

"(c) RECAPTURE OF NET ORDINARY LOSSES.—

"(1) IN GENERAL.—The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.

"(2) NON-RECAPTURED NET SECTION 1231 LOSSES.—For purposes of this subsection, the term 'non-recaptured net section 1231 losses' means the excess of—

"(A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years beginning after December 31, 1981, over

"(B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.

"(3) NET SECTION 1231 GAIN.—For purposes of this subsection, the term 'net section 1231 gain' means the excess of—

"(A) the section 1231 gains, over

"(B) the section 1231 losses.

"(4) NET SECTION 1231 LOSS.—For purposes of this subsection, the term 'net section 1231 loss' means the excess of—

"(A) the section 1231 losses, over

"(B) the section 1231 gains.

"(5) SPECIAL RULES.—For purposes of determining the amount of the net section 1231 gain or loss for any taxable year, the rules of paragraph (4) of subsection (a) shall apply."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to net section 1231 gains for taxable years beginning after December 31, 1984.

SEC. 177. REPEAL OF EXEMPTION FROM FEDERAL TAX OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION.

(a) REPEAL OF EXEMPTION.—Subsection (d) of section 303 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(d)) is amended—

(1) by striking out "by the United States,",

(2) by striking out "possession thereof," and inserting in lieu thereof "possession of the United States", and

(3) by striking out the last sentence.

(b) TREATMENT OF DIVIDENDS PAID BY FEDERAL HOME LOAN BANK WHICH ARE ALLOCABLE TO DIVIDENDS FROM THE FEDERAL HOME LOAN MORTGAGE CORPORATION.—Subsection (a) of section 246 (relating to denial of dividends received deduction for dividends from certain corporations) is amended to read as follows:

"(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—

"(1) IN GENERAL.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from a corporation which, for the taxable year of the corporation in

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which the distribution is made, or for the next preceding taxable year of the corporation, is a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations).

"(2) SUBSECTION NOT TO APPLY TO CERTAIN DIVIDENDS OF FEDERAL HOME LOAN BANKS.—

"(A) DIVIDENDS OUT OF CURRENT EARNINGS AND PROFITS.—In the case of any dividend paid by any FHLB out of earnings and profits of the FHLB for the taxable year in which such dividend was paid, paragraph (1) shall not apply to that portion of such dividend which bears the same ratio to the total dividend as—

"(i) the dividends received by the FHLB from the FHLMC during such taxable year, bears to

"(ii) the total earnings and profits of the FHLB for such taxable year.

"(B) DIVIDENDS OUT OF ACCUMULATED EARNINGS AND PROFITS.—For purposes of subparagraph (A), in the case of any dividend which is paid out of any accumulated earnings and profits of any FHLB, paragraph (1) shall not apply to that portion of the dividend which bears the same ratio to the total dividend as—

"(i) the amount of dividends received by such FHLB from the FHLMC which are out of earnings and profits of the FHLMC—

"(I) for taxable years ending after December 31, 1984, and

"(II) which were not taken into account under subparagraph (A), bears to

"(ii) the total accumulated earnings and profits of the FHLB as of the time such dividend is paid.

For purposes of clause (ii), the accumulated earnings and profits of the FHLB as of January 1, 1985, shall be treated as equal to its retained earnings as of such date.

"(C) DEFINITIONS.—For purposes of this paragraph—

"(i) FHLB.—The term 'FHLB' means any Federal Home Loan Bank.

"(ii) FHLMC.—The term 'FHLMC' means the Federal Home Loan Mortgage Corporation.

"(iii) TAXABLE YEAR OF FHLB.—The taxable year of an FHLB shall, except as provided in regulations prescribed by the Secretary, be treated as the calendar year."

(c) TREATMENT OF NET OPERATING LOSSES OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION.—

(1) IN GENERAL.—Subparagraph (H) of section 172(b)(1) (relating to years to which net operating losses may be carried) is amended—

(A) by inserting ", or a net operating loss of the Federal Home Loan Mortgage Corporation for any taxable year beginning after December 31, 1984" after "1981",

(B) by striking out "the FNMA mortgage disposition loss (within the meaning of subsection (i))" in clause (i) and inserting in lieu thereof "the mortgage disposition loss (within the meaning of subsection (i))", and

(C) by striking out "FNMA mortgage disposition loss" in clause (ii) and inserting in lieu thereof "mortgage disposition loss".

(2) CONFORMING AMENDMENT.—Subsection (i) of section 172 is amended—

(A) by striking out "FNMA mortgage disposition loss" each place it appears in paragraphs (1) and (2) (including in headings) and inserting in lieu thereof "mortgage disposition loss", and

(B) by striking out "FNMA MORTGAGE DISPOSITION LOSS" in the subsection heading and inserting in lieu thereof "MORTGAGE DISPOSITION LOSS OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION OR THE FEDERAL HOME LOAN MORTGAGE CORPORATION".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall take effect on January 1, 1985.

(2) ADJUSTED BASIS OF ASSETS.—

(A) IN GENERAL.—Except as otherwise provided in subparagraph (B), the adjusted basis of any asset of the Federal Home Loan Mortgage Corporation held on January 1, 1985, shall—

(i) for purposes of determining any loss, be equal to the lesser of the adjusted basis of such asset or the fair market value of such asset as of such date, and

(ii) for purposes of determining any gain, be equal to the higher of the adjusted basis of such asset or the fair market value of such asset as of such date.

(B) SPECIAL RULE FOR TANGIBLE DEPRECIABLE PROPERTY.—In the case of any tangible property which—

(i) is of a character subject to the allowance for depreciation provided by section 167 of the Internal Revenue Code of 1954, and

(ii) is held by the Federal Home Loan Mortgage Corporation on January 1, 1985,

the adjusted basis of such property shall be equal to the lesser of the basis of such property or the fair market value of such property as of such date.

(3) TREATMENT OF PARTICIPATION CERTIFICATES.—

(A) IN GENERAL.—Paragraph (2) shall not apply to any right to receive income with respect to any mortgage pool participation certificate or other similar interest in any mortgage (not including any mortgage).

(B) TREATMENT OF CERTAIN SALES AFTER MARCH 15, 1984, AND BEFORE JANUARY 1, 1985.—If any gain is realized on the sale or exchange of any right described in subparagraph (A) after March 15, 1984, and before January 1, 1985, the gain shall not be recognized when realized but shall be recognized on January 1, 1985.

(4) NO ACCUMULATED EARNINGS AND PROFITS ON JANUARY 1, 1985.—For purposes of the Internal Revenue Code of 1954, the accumulated profits of the Federal Home Loan Mortgage Corporation as of January 1, 1985, shall be treated as zero.

(5) ADJUSTED BASIS.—For purposes of this subsection, the adjusted basis of any asset shall be determined under part II of subchapter O of the Internal Revenue Code of 1954.

(6) NO CARRYBACKS FOR YEARS BEFORE 1985.—No net operating loss, capital loss, or excess credit of the Federal Home Loan Mortgage Corporation for any taxable year beginning after December 31, 1984, shall be allowed as a carryback to any taxable year beginning before January 1, 1985.

(7) NO DEDUCTION ALLOWED FOR INTEREST ON REPLACEMENT OBLIGATIONS.—

(A) IN GENERAL.—The Federal Home Loan Mortgage Corporation shall not be allowed any deduction for interest accruing after December 31, 1984, on any replacement obligation.

(B) REPLACEMENT OBLIGATION DEFINED.—For purposes of subparagraph (A), the term "replacement obligation" means any obligation to any person created after March 15, 1984, which the Secretary of the Treasury or his delegate determines replaces any equity or debt interest of a Federal Home Loan Bank or any other person in the Federal Home Loan Mortgage Corporation existing on such date. The preceding sentence shall not apply to any obligation with respect to which the Federal Home Loan Mortgage Corporation establishes that there is no tax avoidance effect.

SEC. 178. SPECIAL RULE RELATING TO SALES OR EXCHANGES OF CERTAIN ECONOMIC INTERESTS IN COAL BETWEEN RELATED PARTIES.

(a) IN GENERAL.—The last sentence of section 631(c) (relating to disposal of coal or domestic iron ore with a retained economic interest) is amended by inserting "or coal" after "iron ore" each place it appears.

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to dispositions after September 30, 1985.

(2) SPECIAL RULE FOR FIXED CONTRACTS.—

(A) IN GENERAL.—The amendment made by subsection (a) shall not apply to any disposition of an interest in coal by a person to a related person if such coal is subsequently sold before January 1, 1990, by either such person—

(i) to a person who is not a related person with respect to either such person, and

(ii) pursuant to a qualified fixed contract.

(B) ALLOCATION WHERE MORE THAN 1 CONTRACT.—If, for any taxable year, there is a disposition described in subparagraph (A) which is not specifically allocable to a qualified fixed contract or to a contract which is not a qualified fixed contract, such disposition shall be treated as first allocable to the qualified fixed contract.

(C) QUALIFIED FIXED CONTRACT DEFINED.—The term "qualified fixed contract" means any contract for the sale of coal which—

(i) was entered into before June 12, 1984,

(ii) is binding at all times thereafter, and

(iii) cannot be adjusted to reflect to any extent the increase in liabilities of the person disposing of the coal for tax under chapter 1 of the Internal Revenue Code of 1954 by reason of the amendment made by subsection (a).

(D) RELATED PERSON.—For purposes of this paragraph, the term "related person" means a person who bears a relationship to another person described in the last sentence of section 631(c).

SEC. 179. LIMITATION ON AMOUNT OF DEPRECIATION AND INVESTMENT TAX CREDIT FOR LUXURY AUTOMOBILES; LIMITATION WHERE CERTAIN PROPERTY USED FOR PERSONAL PURPOSES.

(a) IN GENERAL.—Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding after section 280E the following new section:

"SEC. 280F. LIMITATION ON INVESTMENT TAX CREDIT AND DEPRECIATION FOR LUXURY AUTOMOBILES; LIMITATION WHERE CERTAIN PROPERTY USED FOR PERSONAL PURPOSES.

"(a) LIMITATION ON AMOUNT OF INVESTMENT TAX CREDIT AND DEPRECIATION FOR LUXURY AUTOMOBILES.—

"(1) INVESTMENT TAX CREDIT.—The amount of the credit determined under section 46(a) for any passenger automobile shall not exceed $1,000.

"(2) DEPRECIATION.—

"(A) LIMITATION.—The amount of the recovery deduction for any taxable year for any passenger automobile shall not exceed—

"(i) $4,000 for the first taxable year in the recovery period, and

"(ii) $6,000 for each succeeding taxable year in the recovery period.

"(B) DISALLOWED DEDUCTIONS ALLOWED FOR YEARS AFTER RECOVERY PERIOD.—

"(i) IN GENERAL.—Except as provided in clause (ii), the unrecovered basis of any passenger automobile shall be treated as an expense for the 1st taxable year after the recovery period. Any excess of the unrecovered basis over the limitation of clause (ii) shall be treated as an expense in the succeeding taxable year.

"(ii) $6,000 LIMITATION.—The amount treated as an expense under clause (i) for any taxable year shall not exceed $6,000.

"(iii) PROPERTY MUST BE DEPRECIABLE.—No amount shall be allowable as a deduction by reason of this subparagraph with respect to any property for any taxable year unless a depreciation deduction would be allowable with respect to such property for such taxable year.

"(iv) AMOUNT TREATED AS RECOVERY DEDUCTION.—For purposes of this subtitle, any amount allowable as a deduction by reason of this subparagraph shall be treated as a recovery deduction allowable under section 168.

"(3) COORDINATION WITH REDUCTIONS IN AMOUNT ALLOWABLE BY REASON OF PERSONAL USE, ETC.—This subsection shall be applied before—

"(A) the application of subsection (b), and

"(B) the application of any other reduction in the amount of the credit determined under section 46(a) or any recovery deduction allowable under section 168 by reason of any use not qualifying the property for such credit or recovery deduction.

"(4) SPECIAL RULE WHERE ELECTION OF REDUCED CREDIT IN LIEU OF THE BASIS ADJUSTMENT.—In the case of any election under section 48(q)(4) with respect to any passenger automobile, the limitation of paragraph (1) applicable to such passenger automobile shall be ⅔ of the amount which would be so applicable but for this paragraph.

"(b) LIMITATION WHERE BUSINESS USE OF LISTED PROPERTY NOT GREATER THAN 50 PERCENT.—

"(1) INVESTMENT TAX CREDIT.—For purposes of this subtitle, any listed property shall not be treated as section 38 property for any taxable year unless such property is predominantly used in a qualified business use for such taxable year.

"(2) DEPRECIATION.—If any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under section 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under the straightline method over the earnings and profits life for such property.

"(3) RECAPTURE.—

"(A) WHERE BUSINESS USE PERCENTAGE DOES NOT EXCEED 50 PERCENT.—If—

"(i) property is predominantly used in a qualified business use in a taxable year in which it is placed in service, and

"(ii) such property is not predominantly used in a qualified business use for any subsequent taxable year,

then any excess depreciation shall be included in gross income for the taxable year referred to in clause (ii), and the recovery deduction for the taxable year referred to in clause (ii) and any subsequent taxable years shall be determined under the straightline method over the earnings and profits life.

"(B) EXCESS DEPRECIATION.—For purposes of subparagraph (A), the term 'excess depreciation' means the excess (if any) of—

"(i) the amount of the recovery deductions allowable with respect to the property for taxable years before the 1st taxable year in which the property was not predominantly used in a qualified business use, over

"(ii) the amount which would have been so allowable if the property had not been predominantly used in a qualified business use for the taxable year in which it was placed in service.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) PROPERTY PREDOMINANTLY USED IN QUALIFIED BUSINESS USE.—Property shall be treated as predominantly used in a qualified business use for any taxable year if the business use percentage for such taxable year exceeds 50 percent.

"(B) STRAIGHT-LINE METHOD OVER EARNINGS AND PROFITS LIFE.—The amount determined under the straightline method over the earnings and profits life' with respect to any property shall be the amount which would be determined with respect to such property under the principles of section 312(k)(3). If the recovery period applicable to any property under section 168 is longer than the recovery period applicable to such property under section 312(k)(3), such longer recovery period shall be used for purposes of the preceding sentence.

"(c) TREATMENT OF LEASES.—

"(1) LESSOR'S CREDITS AND DEDUCTIONS NOT AFFECTED.—This section shall not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing such property.

"(2) LESSEE'S DEDUCTIONS REDUCED.—For purposes of determining the amount allowable as a deduction under this chapter for rentals or other payments under a lease for a period of 30 days or more of listed property, only the allowable percentage of such payments shall be taken into account.

"(3) ALLOWABLE PERCENTAGE.—For purposes of pardgraph (2), the allowable percentage shall be determined under tables prescribed by the Secretary. Such tables shall be prescribed so that the reduction in the deduction under paragraph (2) is substantially equivalent to the applicable restrictions contained in subsections (a) and (b).

"(4) LEASE TERM.—In determining the term of any lease for purposes of paragraph (2), the rules of section 168(j)(6)(B) shall apply.

"(5) LESSEE RECAPTURE.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (b)(3) shall apply to any lessee to which paragraph (2) applies.

"(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) COORDINATION WITH SECTION 179.—Any deduction allowable under section 179 with respect to any listed property shall be subject to the limitations of subsections (a) and (b) in the same manner as if it were a recovery deduction allowable under section 168.

"(2) SUBSEQUENT DEPRECIATION DEDUCTIONS REDUCED FOR DEDUCTIONS ALLOCABLE TO PERSONAL USE.—Solely for purposes of determining the amount of the recovery deduction for subsequent taxable years, if less than 100 percent of the use of any listed property during any taxable year is not use described in section 168(c)(1) (defining recovery property), all of the use of such property during such taxable year shall be treated as use so described.

"(3) DEDUCTIONS OF EMPLOYEE.—

"(A) IN GENERAL.—Any employee use of listed property shall not be treated as use in a trade or business for purposes of determining the amount of any credit allowable under section 38 to the employee or the amount of any recovery deduction allowable to the employee unless such use is for the convenience of the employer and required as a condition of employment.

"(B) EMPLOYEE USE.—For purposes of subparagraph (A), the term 'employee use' means any use in connection with the performance of services as an employee.

"(4) LISTED PROPERTY.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'listed property' means—

"(i) any passenger automobile,

"(ii) any other property used as a means of transportation,

"(iii) any property of a type generally used for purposes of entertainment, recreation, or amusement,

"(iv) any computer or peripheral equipment (as defined in section 168(j)(5)(D)), and

"(v) any other property of a type specified by the Secretary by regulations.

"(B) EXCEPTION FOR CERTAIN COMPUTERS.—The term 'listed property' shall not include any computer or peripheral equipment (as so defined) used exclusively at a regular business establishment. For purposes of the preceding sentence, any portion of a dwelling unit shall be treated as a regular business establishment if (and only if) the requirements of section 280A(c)(1) are met with respect to such portion.

"(5) PASSENGER AUTOMOBILE.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'passenger automobile' means any 4-wheeled vehicle—

"(i) which is manufactured primarily for use on public streets, roads, and highways, and

"(ii) which is rated at 6,000 pounds gross vehicle weight or less.

"(B) EXCEPTION FOR CERTAIN VEHICLES.—The term 'passenger automobile' shall not include—

"(i) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

"(ii) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, and

"(iii) under regulations, any truck or van.

"(6) BUSINESS USE PERCENTAGE.—

"(A) IN GENERAL.—The term 'business use percentage' means the percentage of the use of any listed property during any taxable year which is a qualified business use.

"(B) QUALIFIED BUSINESS USE.—Except as provided in subparagraph (C), the term 'qualified business use' means any use in a trade or business of the taxpayer.

"(C) EXCEPTION FOR CERTAIN USE BY 5-PERCENT OWNERS AND RELATED PERSONS.—

"(i) IN GENERAL. The term 'qualified business use' shall not include—

"(I) LEASING PROPERTY TO ANY 5-PERCENT OWNER OR RELATED PERSON,

"(II) USE OF PROPERTY PROVIDED AS COMPENSATION FOR THE PERFORMANCE OF SERVICE BY A 5-PERCENT OWNER OR RELATED PERSON, OR

"(III) use of property provided as compensation for the performance of services by any person not described in subclause (II) unless an amount is included in the gross income of such person with respect to such use, and, where required, there was withholding under chapter 24.

"(ii) SPECIAL RULE FOR AIRCRAFT.—Clause (i) shall not apply with respect to any aircraft if at least 25 percent of the total use of the aircraft during the taxable year consists of qualified business use not described in clause (i).

"(D) DEFINITIONS.—For purposes of this paragraph—

"(i) 5-PERCENT OWNER.—The term '5-percent owner' means any person who is a 5-percent owner with respect to the taxpayer (as defined in section 416(i)(1)(B)(i)).

"(ii) RELATED PERSON.—The term 'related person' means any person related to the taxpayer (within the meaning of section 267(b)).

"(7) AUTOMOBILE PRICE INFLATION ADJUSTMENT.—

"(A) IN GENERAL.—In the case of any passenger automobile, subsection (a) shall be applied by increasing each dollar amount contained in such subsection by the automobile price inflation adjustment for the calendar year in which such automobile is placed in service. Any increase under the preceding sentence shall be rounded to the nearest multiple of $100 (or if the increase is a multiple of $50, such increase shall be increased to the next higher multiple of $100).

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"(B) AUTOMOBILE PRICE INFLATION ADJUSTMENT.—For purposes of this paragraph—

"(i) IN GENERAL.—The automobile price inflation adjustment for any calendar year is the percentage (if any) by which—

"(I) the CPI automobile component for October of the preceding calendar year, exceeds

"(II) the CPI automobile component for October of 1983.

In the case of calendar year 1984, the automobile price inflation adjustment shall be zero.

"(ii) CPI AUTOMOBILE COMPONENT.—The term 'CPI automobile component' means the automobile component of the Consumer Price Index for All Urban Consumers published by the Department of Labor.

"(8) UNRECOVERED BASIS.—For purposes of subsection (a)(2), the term 'unrecovered basis' means the excess (if any) of—

"(A) the unadjusted basis (as defined in section 168(d)(1)(A)) of the passenger automobile, over

"(B) the amount of the recovery deductions which would have been allowable for taxable years in the recovery period determined after the application of subsection (a) and as if all use during the recovery period were use described in section 168(c)(1).

"(9) ALL TAXPAYERS HOLDING INTERESTS IN PASSENGER AUTOMOBILE TREATED AS 1 TAXPAYER.—All taxpayers holding interests in any passenger automobile shall be treated as 1 taxpayer for purposes of applying subsection (a) to such automobile, and the limitations of subsection (a) shall be allocated among such taxpayers in proportion to their interests in such automobile.

"(10) SPECIAL RULE FOR PROPERTY ACQUIRED IN NONRECOGNITION TRANSACTIONS.—For purposes of subsection (a)(2), notwithstanding any regulations prescribed under section 168(f)(7), any property acquired in a nonrecognition transaction shall be treated as a single property originally placed in service in the taxable year in which it was placed in service after being so acquired.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations with respect to items properly included in, or excluded from, the adjusted basis of any listed property."

(b) COMPLIANCE PROVISIONS.—

(1) AMENDMENT OF SECTION 274(d).—Subsection (d) of section 274 (relating to substantiation requirements) is amended—

(A) by striking out "No deduction" and inserting in lieu thereof "No deduction or credit",

(B) by striking out "or" at the end of paragraph (2), by inserting "or" at the end of paragraph (3), and by inserting after paragraph (3) the following new paragraph:

"(4) with respect to any listed property (as defined in section 280F(d)(4)),",

(C) by striking out "adequate records or by sufficient evidence corroborating his own statement" and inserting in lieu thereof "adequate contemporaneous records", and

(D) by striking out "the facility" each place it appears following paragraph (4) (as added by subparagraph (B)) and inserting in lieu thereof "the facility or property".

(2) DUTIES OF RETURN PREPARERS.—Subsection (b) of section 6695 (relating to failure to sign return) is amended to read as follows:

"(b) FAILURE TO INFORM TAXPAYER OF CERTAIN RECORDKEEPING REQUIREMENTS OR TO SIGN RETURN.—Any person who is an income tax return preparer with respect to any return or claim for refund and who is required by regulations to sign such return or claim—

"(1) shall advise the taxpayer of the substantiation requirements of section 274(d) and obtain written confirmation from the taxpayer that such requirements were met with respect to any deduction or credit claimed on such return or claim for refund, and

"(2) shall sign such return or claim for refund.

Any person who fails to comply with the requirements of the preceding sentence with respect to any return or claim shall pay a penalty of $25 for such failure, unless it is shown that such failure is due to reasonable cause and not to willful neglect."

(3) UNDERPAYMENT ATTRIBUTABLE TO FAILURE TO MEET SUBSTANTIATION REQUIREMENTS TREATED AS DUE TO NEGLIGENCE.—Section 6653 (relating to failure to pay tax) is amended by adding at the end thereof the following new subsection:

"(h) SPECIAL RULE IN THE CASE OF UNDERPAYMENT ATTRIBUTABLE TO FAILURE TO MEET CERTAIN SUBSTANTIATION REQUIREMENTS.—

"(1) IN GENERAL.—Any portion of an underpayment attributable to a failure to comply with the requirements of section 274(d) shall be treated, for purposes of subsection (a), as due to negligence in the absence of clear and convincing evidence to the contrary.

"(2) PENALTY TO APPLY ONLY TO PORTION OF UNDERPAYMENT DUE TO FAILURE TO MEET SUBSTANTIATION REQUIREMENTS.—If any penalty is imposed under subsection (a) by reason of paragraph (1), the amount of the penalty imposed by paragraph (1) of subsection (a) shall be 5 percent of the portion of the underpayment which is attributable to the failure described in paragraph (1)."

(c) CLERICAL AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 is amended by adding after the item relating to section 280E the following new item:

"Sec. 280F. Limitation on investment tax credit and depreciation for luxury automobiles; limitation where certain property used for personal purposes."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—

(A) Except as provided in subparagraph (B), the amendments made by subsections (a) and (c) shall apply to—

(i) property placed in service after June 18, 1984, in taxable years ending after such date, and

(ii) property leased after June 18, 1984, in taxable years ending after such date.

(B) The amendments made by subsections (a) and (c) shall not apply to any property—

(i) acquired by the taxpayer pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter (or under construction on such date) but only if the property is placed in service before January 1, 1985 (January 1, 1987, in the case of 15-year real property), or

(ii) of which the taxpayer is the lessee but only if the lease is pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter and only if the taxpayer first uses such property under the lease before January 1, 1985 (January 1, 1987, in the case of 15-year real property).

(2) COMPLIANCE PROVISIONS.—The amendments made by subsection (b) shall apply to taxable years beginning after December 31, 1984.

TITLE II—LIFE INSURANCE PROVISIONS

SEC. 201. TABLE OF SECTIONS FOR PART I OF SUBCHAPTER L.

Under the amendment to part I of subchapter L made by section 211(a), the subparts and sections of such part I will be as follows:

PART I—LIFE INSURANCE COMPANIES

SUBPART A—TAX IMPOSED

Sec. 801. Tax imposed.

SUBPART B—LIFE INSURANCE GROSS INCOME

Sec. 803. Life insurance gross income.

SUBPART C—LIFE INSURANCE DEDUCTIONS

Sec. 804. Life insurance deductions.
Sec. 805. General deductions.
Sec. 806. Special deductions.
Sec. 807. Rules for certain reserves.
Sec. 808. Policyholder dividends deduction.
Sec. 809. Reduction in certain deductions of mutual life insurance companies.
Sec. 810. Operations loss deduction.

SUBPART D—ACCOUNTING, ALLOCATION, AND FOREIGN PROVISIONS

Sec. 811. Accounting provisions.
Sec. 812. Definition of company's share and policyholders' share.
Sec. 813. Foreign life insurance companies.
Sec. 814. Contiguous country branches of domestic life insurance companies.
Sec. 815. Distributions to shareholders from pre-1984 policyholders surplus account.

SUBPART E—DEFINITIONS AND SPECIAL RULES

Sec. 816. Life insurance company defined.
Sec. 817. Treatment of variable contracts.
Sec. 818. Other definitions and special rules.

Subtitle A—Taxation of Life Insurance Companies

PART I—AMENDMENT OF SUBCHAPTER L

SEC. 211. AMENDMENT OF SUBCHAPTER L.

(a) GENERAL RULE.—Part I of subchapter L of chapter 1 is amended to read as follows:

"PART I—LIFE INSURANCE COMPANIES

"Subpart A. Tax imposed.
"Subpart B. Life insurance gross income.
"Subpart C. Life insurance deductions.
"Subpart D. Accounting, allocation, and foreign provisions.
"Subpart E. Definitions and special rules.

"Subpart A—Tax Imposed

"Sec. 801. Tax imposed.

"SEC. 801. TAX IMPOSED.

"(a) TAX IMPOSED.—

"(1) IN GENERAL.—A tax is hereby imposed for each taxable year on the life insurance company taxable income of every life insurance company. Such tax shall consist of a tax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11.

"(2) ALTERNATIVE TAX IN CASE OF CAPITAL GAINS.—

"(A) IN GENERAL.—If a life insurance company has a net capital gain for the taxable year, then (in lieu of the tax imposed by paragraph (1)), there is hereby imposed a tax (if such tax is less than the tax imposed by paragraph (1)).

"(B) AMOUNT OF TAX.—The amount of the tax imposed by this paragraph shall be the sum of—

"(i) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income reduced by the amount of the net capital gain, and

"(ii) an amount determined as provided in section 1201(a) on such net capital gain.

"(C) NET CAPITAL GAIN NOT TAKEN INTO ACCOUNT IN DETERMINING SPECIAL LIFE INSURANCE COMPANY DEDUCTION AND SMALL LIFE INSURANCE COMPANY DEDUCTION.—For purposes of subparagraph (B)(i), the amounts allowable as deductions under paragraphs (2) and (3) of section 804 shall be determined by reducing the tentative LICTI by the amount of the net capital gain (determined without regard to

items attributable to noninsurance businesses).

"(b) LIFE INSURANCE COMPANY TAXABLE INCOME.—For purposes of this part, the term 'life insurance company taxable income' means—

"(1) life insurance gross income, reduced by

"(2) life insurance deductions.

"(c) TAXATION OF DISTRIBUTIONS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNT.—

"For provision taxing distributions to shareholders from pre-1984 policyholders surplus account, see section 815.

"Subpart B—Life Insurance Gross Income

"Sec. 803. Life insurance gross income.

"SEC. 803. LIFE INSURANCE GROSS INCOME.

"(a) IN GENERAL.—For purposes of this part, the term 'life insurance gross income' means the sum of the following amounts:

"(1) PREMIUMS.—

"(A) The gross amount of premiums and other consideration on insurance and annuity contracts, less

"(B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

"(2) DECREASES IN CERTAIN RESERVES.—Each net decrease in reserves which is required by section 807(a) to be taken into account under this paragraph.

"(3) OTHER AMOUNTS.—All amounts not includible under paragraph (1) or (2) which under this subtitle are includible in gross income.

"(b) SPECIAL RULES FOR PREMIUMS.—

"(1) CERTAIN ITEMS INCLUDED.—For purposes of subsection (a)(1)(A), the term 'gross amount of premiums and other consideration' includes—

"(A) advance premiums,

"(B) deposits,

"(C) fees,

"(D) assessments,

"(E) consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and

"(F) the amount of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies,

on insurance and annuity contracts.

"(2) POLICYHOLDER DIVIDENDS EXCLUDED FROM RETURN PREMIUMS.—For purposes of subsection (a)(1)(B)—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'return premiums' does not include any policyholder dividends.

"(B) EXCEPTION FOR INDEMNITY REINSURANCE.—Subparagraph (A) shall not apply to amounts of premiums or other consideration returned to another life insurance company in respect of indemnity reinsurance.

"Subpart C—Life Insurance Deductions

"Sec. 804. Life insurance deductions.

"Sec. 805. General deductions.

"Sec. 806. Special deductions.

"Sec. 807. Rules for certain reserves.

"Sec. 808. Policyholder dividends deduction.

"Sec. 809. Reduction in certain deductions of mutual life insurance companies.

"Sec. 810. Operations loss deduction.

"SEC. 804. LIFE INSURANCE DEDUCTIONS.

"For purposes of this part, the term 'life insurance deductions' means—

"(1) the general deductions provided in section 805,

"(2) the special life insurance company deduction determined under section 806(a), and

"(3) the small life insurance company deduction (if any) determined under section 806(b).

"SEC. 805. GENERAL DEDUCTIONS.

"(a) GENERAL RULE.—For purposes of this part, there shall be allowed the following deductions:

"(1) DEATH BENEFITS, ETC.—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts.

"(2) INCREASES IN CERTAIN RESERVES.—The net increase in reserves which is required by section 807(b) to be taken into account under this paragraph.

"(3) POLICYHOLDER DIVIDENDS.—The deduction for policyholder dividends (determined under section 808(c)).

"(4) DIVIDENDS RECEIVED BY COMPANY.—

"(A) IN GENERAL.—The deductions provided by sections 243, 244, and 245 (as modified by subparagraph (B))—

"(i) for 100 percent dividends received, and

"(ii) for the life insurance company's share of the dividends (other than 100 percent dividends) received.

"(B) APPLICATION OF SECTION 246(b).—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A), the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be 85 percent of the life insurance company taxable income, computed without regard to—

"(i) the special life insurance company deduction and the small life insurance company deduction,

"(ii) the operations loss deduction provided by section 810,

"(iii) the deductions allowed by sections 243(a)(1), 244(a), and 245, and

"(iv) any capital loss carryback to the taxable year under section 1212(a)(1),

but such limit shall not apply for any taxable year for which there is a loss from operations.

"(C) 100 PERCENT DIVIDEND.—For purposes of subparagraph (A), the term '100 percent dividend' means any dividend if the percentage used for purposes of determining the deduction allowable under section 243 or 244 is 100 percent. Such term does not include any dividend to the extent it is a distribution out of tax-exempt interest or out of dividends which are not 100 percent dividends (determined with the application of this sentence).

"(D) CERTAIN DIVIDENDS RECEIVED BY FOREIGN CORPORATIONS.—Subparagraph (A)(i) (and not subparagraph (A)(ii)) shall apply to any dividend received by a foreign corporation from a domestic corporation which would be a 100 percent dividend if section 1504(b)(3) did not apply for purposes of applying section 243(b)(5).

"(5) OPERATIONS LOSS DEDUCTION.—The operations loss deduction (determined under section 810).

"(6) ASSUMPTION BY ANOTHER PERSON OF LIABILITIES UNDER INSURANCE, ETC., CONTRACTS.—The consideration (other than consideration arising out of indemnity reinsurance) in respect of the assumption by another person of liabilities under insurance and annuity contracts.

"(7) REIMBURSABLE DIVIDENDS.—The amount of policyholder dividends which—

"(A) are paid or accrued by another insurance company in respect of policies the taxpayer has reinsured, and

"(B) are reimbursable by the taxpayer under the terms of the reinsurance contract.

"(8) OTHER DEDUCTIONS.—Subject to the modifications provided by subsection (b), all other deductions allowed under this subtitle for purposes of computing taxable income.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this part in respect of policyholder dividends.

"(b) MODIFICATIONS.—The modifications referred to in subsection (a)(8) are as follows:

"(1) INTEREST.—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 807(c).

"(2) BAD DEBTS.—Section 166(c) (relating to reserve for bad debts) shall not apply.

"(3) CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.—In applying section 170—

"(A) the limit on the total deductions under such section provided by section 170(b)(2) shall be 10 percent of the life insurance company taxable income computed without regard to—

"(i) the deduction provided by section 170,

"(ii) the deductions provided by paragraphs (3) and (4) of subsection (a),

"(iii) the special life insurance company deduction and the small life insurance company deduction,

"(iv) any operations loss carryback to the taxable year under section 810, and

"(v) any capital loss carryback to the taxable year under section 1212(a)(1), and

"(B) under regulations prescribed by the Secretary, a rule similar to the rule contained in section 170(d)(2)(B) (relating to special rule for net operating loss carryovers) shall be applied.

"(4) AMORTIZABLE BOND PREMIUM.—

"(A) IN GENERAL.—Section 171 shall not apply.

"(B) CROSS REFERENCE.—

"For rules relating to amortizable bond premium, see section 811(b).

"(5) NET OPERATING LOSS DEDUCTION.—Except as provided by section 844, the deduction for net operating losses provided in section 172 shall not be allowed.

"(6) DIVIDENDS RECEIVED DEDUCTION.—Except as provided in subsection (a)(4), the deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

"SEC. 806. SPECIAL DEDUCTIONS.

"(a) SPECIAL LIFE INSURANCE COMPANY DEDUCTION.—For purposes of section 804, the special life insurance company deduction for any taxable year is 20 percent of the excess of the tentative LICTI for such taxable year over the small life insurance company deduction (if any).

"(b) SMALL LIFE INSURANCE COMPANY DEDUCTION.—

"(1) IN GENERAL.—For purposes of section 804, the small life insurance company deduction for any taxable year is 60 percent of so much of the tentative LICTI for such taxable year as does not exceed $3,000,000.

"(2) PHASEOUT BETWEEN $3,000,000 AND $15,000,000.—The amount of the small life insurance company deduction determined under paragraph (1) for any taxable year shall be reduced (but not below zero) by 15 percent of so much of the tentative LICTI for such taxable year as exceeds $3,000,000.

"(3) SMALL LIFE INSURANCE COMPANY DEDUCTION NOT ALLOWABLE TO COMPANY WITH ASSETS OF $500,000,000 OR MORE.—

"(A) IN GENERAL.—The small life insurance company deduction shall not be allowed for any taxable year to any life insurance company which, at the close of such taxable year, has assets equal to or greater than $500,000,000.

"(B) ASSETS.—For purposes of this paragraph, the term 'assets' means all assets of the company.

"(C) VALUATION OF ASSETS.—For purposes of this paragraph, the amount attributable to—

"(i) real property and stock shall be the fair market value thereof, and

"(ii) any other asset shall be the adjusted basis of such asset for purposes of determining gain on sale or other disposition.

"(D) SPECIAL RULE FOR INTERESTS IN PARTNERSHIPS AND TRUSTS.—For purposes of this paragraph—

"(i) an interest in a partnership or trust shall not be treated as an asset of the company, but

"(ii) the company shall be treated as actually owning its proportionate share of the assets held by the partnership or trust (as the case may be).

"(c) TENTATIVE LICTI.—For purposes of this part—

"(1) IN GENERAL.—The term 'tentative LICTI' means life insurance company taxable income determined without regard to—

"(A) the special life insurance company deduction, and

"(B) the small life insurance company deduction.

"(2) EXCLUSION OF ITEMS ATTRIBUTABLE TO NONINSURANCE BUSINESSES.—The amount of the tentative LICTI for any taxable year shall be determined without regard to all items attributable to noninsurance businesses.

"(3) NONINSURANCE BUSINESS.—

"(A) IN GENERAL.—The term 'noninsurance business' means any activity which is not an insurance business.

"(B) CERTAIN ACTIVITIES TREATED AS INSURANCE BUSINESSES.—For purposes of subparagraph (A), any activity which is not an insurance business shall be treated as an insurance business if—

"(i) it is of a type traditionally carried on by life insurance companies for investment purposes, but only if the carrying on of such activity (other than in the case of real estate) does not constitute the active conduct of a trade or business, or

"(ii) it involves the performance of administrative services in connection with plans providing life insurance, pension, or accident and health benefits.

"(C) LIMITATION ON AMOUNT OF LOSS FROM NONINSURANCE BUSINESS WHICH MAY OFFSET INCOME FROM INSURANCE BUSINESS.—In computing the life insurance company taxable income of any life insurance company, any loss from a noninsurance business shall be limited under the principles of section 1503(c).

"(d) SPECIAL RULE FOR CONTROLLED GROUPS.—

"(1) SPECIAL LIFE INSURANCE COMPANY DEDUCTION AND SMALL LIFE INSURANCE COMPANY DEDUCTION DETERMINED ON CONTROLLED GROUP BASIS.—For purposes of subsections (a) and (b)—

"(A) all life insurance companies which are members of the same controlled group shall be treated as 1 life insurance company, and

"(B) any special life insurance company deduction and any small life insurance company deduction determined with respect to such group shall be allocated among the life insurance companies which are members of such group in proportion to their respective tentative LICTI's.

"(2) NONLIFE INSURANCE MEMBERS INCLUDED FOR ASSET TEST.—For purposes of subsection (b)(3), all members of the same controlled group (whether or not life insurance companies) shall be treated as 1 company.

"(3) CONTROLLED GROUP.—For purposes of this subsection, the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply.

"(4) ELECTION WITH RESPECT TO LOSS FROM OPERATIONS OF MEMBER OF GROUP.—

"(A) IN GENERAL.—Any life insurance company which is a member of a controlled group may elect to have its loss from operations for any taxable year not taken into account for purposes of determining the amount of the special life insurance company deduction for the life insurance companies which are members of such group and which do not file a consolidated return with such life insurance company for the taxable year.

"(B) LIMITATION ON AMOUNT OF LOSS WHICH MAY OFFSET NONLIFE INCOME.—In the case of that portion of any loss from operations for any taxable year of a life insurance company which (but for subparagraph (A)) would have reduced tentative LICTI of other life insurance companies for such taxable year—

"(i) only 80 percent of such portion may be used to offset nonlife income, and

"(ii) to the extent such portion is used to offset nonlife income, the loss shall be treated as used at a rate of $1 for each 80 cents of income so offset.

For purposes of the preceding sentence, any such portion shall be used before the remaining portion of the loss from the same year and shall be treated as first being offset against income which is not nonlife income.

"(C) NONLIFE INCOME.—

"(i) IN GENERAL.—The term 'nonlife income' means the portion of the life insurance company's taxable income for which the special life insurance company deduction was not allowable and any income of a corporation not subject to tax under this part.

"(ii) SPECIAL RULE FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1984.—In the case of a taxable year beginning before January 1, 1984, all life insurance company taxable income shall be treated as nonlife income.

"(5) ADJUSTMENTS TO PREVENT EXCESS DETRIMENT OR BENEFIT.—Under regulations prescribed by the Secretary, proper adjustments shall be made in the application of this subsection to prevent any excess detriment or benefit (whether from year-to-year or otherwise) arising from the application of this subsection.

"SEC. 807. RULES FOR CERTAIN RESERVES.

"(a) DECREASE TREATED AS GROSS INCOME.—If for any taxable year—

"(1) the opening balance for the items described in subsection (c), exceeds

"(2)(A) the closing balance for such items, reduced by

"(B) the sum of (i) the amount of the policyholders' share of tax-exempt interest, plus (ii) any excess described in section 809(a)(2) for the taxable year,

such excess shall be included in gross income under section 803(a)(2).

"(b) INCREASE TREATED AS DEDUCTION.—If for any taxable year—

"(1)(A) the closing balance for the items described in subsection (c), reduced by

"(B) the sum of (i) the amount of the policyholders' share of tax-exempt interest, plus (ii) any excess described in section 809(a)(2) for the taxable year, exceeds

"(2) the opening balance for such items,

such excess shall be taken into account as a deduction under section 805(a)(2).

"(c) ITEMS TAKEN INTO ACCOUNT.—The items referred to in subsections (a) and (b) are as follows:

"(1) The life insurance reserves (as defined in section 816(b)).

"(2) The unearned premiums and unpaid losses included in total reserves under section 816(c)(2).

"(3) The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.

"(4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.

"(5) Premiums received in advance, and liabilities for premium deposit funds.

"(6) Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of paragraph (3), the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit.

"(d) METHOD OF COMPUTING RESERVES FOR PURPOSES OF DETERMINING INCOME.—

"(1) IN GENERAL.—For purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of—

"(A) the net surrender value of such contract, or

"(B) the reserve determined under paragraph (2).

In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in section 809(b)(4)(B)).

"(2) AMOUNT OF RESERVE.—The amount of the reserve determined under this paragraph with respect to any contract shall be determined by using—

"(A) the tax reserve method applicable to such contract,

"(B) the prevailing State assumed interest rate, and

"(C) the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

"(3) TAX RESERVE METHOD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'tax reserve method' means—

"(i) LIFE INSURANCE CONTRACTS.—The CRVM in the case of a contract covered by the CRVM.

"(ii) ANNUITY CONTRACTS.—The CARVM in the case of a contract covered by the CARVM.

"(iii) NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—In the case of any noncancellable accident and health insurance contract, a 2-year full preliminary term method.

"(iv) OTHER CONTRACTS.—In the case of any contract not described in clause (i), (ii), or (iii)—

"(I) the reserve method prescribed by the National Association of Insurance Commissioners which covers such contract (as of the date of issuance), or

"(II) if no reserve method has been prescribed by the National Association of Insurance Commissioners which covers such contract, a reserve method which is consistent with the reserve method required under clause (i), (ii), or (iii) or under subclause (I) of this clause as of the date of the issuance of such contract (whichever is most appropriate).

"(B) DEFINITION OF CRVM AND CARVM.—For purposes of this paragraph—

"(i) CRVM.—The term 'CRVM' means the Commissioners' Reserve Valuation Method prescribed by the National Association of

Insurance Commissioners which is in effect on the date of the issuance of the contract.

"(ii) CARVM.—The term 'CARVM' means the Commissoners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract.

"(C) NO ADDITIONAL RESERVE DEDUCTION ALLOWED FOR DEFICIENCY RESERVES.—Nothing in any reserve method described under this paragraph shall permit any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit.

"(4) PREVAILING STATE ASSUMED INTEREST RATE.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'prevailing State assumed interest rate' means, with respect to any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance contracts or annuity contracts (as the case may be) under the insurance laws of at least 26 States. For purposes of the preceding sentence, the effect of the nonforfeiture laws of a State on interest rates for reserves shall not be taken into account.

"(B) WHEN RATE DETERMINED.—Except as provided in subparagraph (C), the prevailing State assumed rate with respect to any contract shall be determined as of the beginning of the calendar year in which the contract was issued.

"(C) ELECTION FOR NONANNUITY CONTRACTS.—In the case of a contract other than an annuity contract, the issuer may elect (at such time and in such manner as the Secretary shall by regulations prescribe) to determine the prevailing State assumed rate as of the beginning of the calendar year preceding the calendar year in which the contract was issued.

"(D) RATE FOR NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—If there is no prevailing State assumed interest rate applicable under subparagraph (A) to any noncancellable accident and health insurance contract when it is issued, the prevailing State assumed interest rate for such contract shall be the prevailing State assumed interest rate which would be determined under subparagraph (A) for a whole life insurance contract issued on the date on which the noncancellable accident and health insurance contract is issued.

"(5) PREVAILING COMMISSIONERS' STANDARD TABLES.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'prevailing commissioners' standard tables' means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.

"(B) INSURER MAY USE OLD TABLES FOR 3 YEARS WHEN TABLES CHANGE.—If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this subparagraph referred to as the 'year of change') is different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.

"(C) SPECIAL RULE FOR CONTRACTS FOR WHICH THERE ARE NO COMMISSIONERS' STANDARD TABLES.—If there are no commissioners' standard tables applicable to any contract when it is issued, the mortality and morbidity tables used for purposes of paragraph (2)(C) shall be determined under regulations prescribed by the Secretary.

"(D) SPECIAL RULE FOR CONTRACTS ISSUED BEFORE 1948.—If—

"(i) a contract was issued before 1948, and

"(ii) there were no commissioners' standard tables applicable to such contract when it was issued,

the mortality and morbidity tables used in computing statutory reserves for such contracts shall be used for purposes of paragraph (2)(C).

"(E) SPECIAL RULE WHERE MORE THAN 1 TABLE OR OPTION APPLICABLE.—If, with respect to any category of risks, there are 2 or more tables (or options under 1 or more tables) which meet the requirements of subparagraph (A) (or, where applicable, subparagraph (B) or (C)), the table (and option thereunder) which generally yields the lowest reserves shall be used for purposes of paragraph (2)(C).

"(e) SPECIAL RULES FOR COMPUTING RESERVES.—

"(1) NET SURRENDER VALUE.—For purposes of this section—

"(A) IN GENERAL.—The net surrender value of any contract shall be determined—

"(i) with regard to any penalty or charge which would be imposed on surrender, but

"(ii) without regard to any market value adjustment on surrender.

"(B) SPECIAL RULE FOR PENSION PLAN CONTRACTS.—In the case of a pension plan contract, the balance in the policyholder's fund shall be treated as the net surrender value of such contract. For purposes of the preceding sentence, such balance shall be determined with regard to any penalty or forfeiture which would be imposed on surrender but without regard to any market value adjustment.

"(2) ISSUANCE DATE IN CASE OF GROUP CONTRACTS.—For purposes of this section, in the case of a group contract, the date on which such contract is issued shall be the date as of which the master plan is issued (or, with respect to a benefit guaranteed to a participant after such date, the date as of which such benefit is guaranteed).

"(3) SUPPLEMENTAL BENEFITS.—

"(A) QUALIFIED SUPPLEMENTAL BENEFITS TREATED SEPARATELY.—For purposes of this part, the amount of the life insurance reserve for any qualified supplemental benefit—

"(i) shall be computed separately as though such benefit were under a separate contract, and

"(ii) shall, except to the extent otherwise provided in regulations, be the reserve taken into account for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(B) SUPPLEMENTAL BENEFITS WHICH ARE NOT QUALIFIED SUPPLEMENTAL BENEFITS.—In the case of any supplemental benefit described in subparagraph (D) which is not a qualified supplemental benefit, the amount of the reserve determined under paragraph (2) of subsection (d) shall, except to the extent otherwise provided in regulations, be the reserve taken into account for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(C) QUALIFIED SUPPLEMENTAL BENEFIT.—For purposes of this paragraph, the term 'qualified supplemental benefit' means any supplemental benefit described in subparagraph (D) if—

"(i) there is a separately identified premium or charge for such benefit, and

"(ii) any net surrender value under the contract attributable to any other benefit is not available to fund such benefit.

"(D) SUPPLEMENTAL BENEFITS.—For purposes of this paragraph, the supplemental benefits described in this subparagraph are any—

"(i) guaranteed insurability,

"(ii) accidental death or disability benefit,

"(iii) convertibility,

"(iv) disability waiver benefit, or

"(v) other benefit prescribed by regulations,

which is supplemental to a contract for which there is a reserve described in subsection (c).

"(4) CERTAIN CONTRACTS ISSUED BY FOREIGN BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES.—

"(A) IN GENERAL.—In the case of any qualified foreign contract, the amount of the reserve shall be not less than the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of the foreign country referred to in subparagraph (B) (but not to exceed the net level reserves for such contract).

"(B) QUALIFIED FOREIGN CONTRACT.—For purposes of subparagraph (A), the term 'qualified foreign contract' means any contract issued by a foreign life insurance branch (which has its principal place of business in a foreign country) of a domestic life insurance company if—

"(i) such contract is issued on the life or health of a resident of such country,

"(ii) such domestic life insurance company was required by such foreign country (as of the time it began operations in such country) to operate in such country through a branch, and

"(iii) such foreign country is not contiguous to the United States.

"(5) TREATMENT OF SUBSTANDARD RISKS.—

"(A) SEPARATE COMPUTATION.—Except to the extent provided in regulations, the amount of the life insurance reserve for any qualified substandard risk shall be computed separately under subsection (d)(1) from any other reserve under the contract.

"(B) QUALIFIED SUBSTANDARD RISK.—For purposes of subparagraph (A), the term 'qualified substandard risk' means any substandard risk if—

"(i) the insurance company maintains a separate reserve for such risk,

"(ii) there is a separately identified premium or charge for such risk,

"(iii) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and

"(iv) the net surrender value under the contract is not regularly used to pay premium charges for such risk.

"(C) LIMITATION ON AMOUNT OF LIFE INSURANCE RESERVE.—The amount of the life insurance reserve determined for any qualified substandard risk shall in no event exceed the sum of the separately identified premiums charged for such risk plus interest less mortality charges for such risk.

"(D) LIMITATION ON AMOUNT OF CONTRACTS TO WHICH PARAGRAPH APPLIES.—The aggregate amount of insurance in force under contracts to which this paragraph applies shall not exceed 10 percent of the insurance in force (other than term insurance) under life insurance contracts of the company.

"(6) SPECIAL RULES FOR CONTRACTS ISSUED BEFORE JANUARY 1, 1989, UNDER EXISTING PLANS OF INSURANCE, WITH TERM INSURANCE OR ANNUITY BENEFITS.—For purposes of this part—

"(A) IN GENERAL.—In the case of a life insurance contract issued before January 1, 1989, under an existing plan of insurance, the life insurance reserve for any benefit to which this paragraph applies shall be computed separately under subsection (d)(1) from any other reserve under the contract.

"(B) BENEFITS TO WHICH THIS PARAGRAPH APPLIES.—This paragraph applies to any term insurance or annuity benefit with respect to

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which the requirements of clauses (i) and (ii) of paragraph (3)(C) are met.

"(C) EXISTING PLAN OF INSURANCE.—For purposes of this paragraph, the term 'existing plan of insurance' means, with respect to any contract, any plan of insurance which was filed by the company using such contract in one or more States before January 1, 1984, and is on file in the appropriate State for such contract.

"(f) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—

"(1) 10-YEAR SPREAD.—

"(A) IN GENERAL.—For purposes of this part, if the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

"(i) the amount of the item at the close of the taxable year, computed on the new basis, and

"(ii) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

"(B) METHOD.—The method provided in this subparagraph is as follows:

"(i) if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2); or

"(ii) if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

"(2) TERMINATION AS LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this subsection shall be taken into account for the preceding taxable year.

"SEC. 808. POLICYHOLDER DIVIDENDS DEDUCTION.

"(a) POLICYHOLDER DIVIDEND DEFINED.—For purposes of this part, the term 'policyholder dividend' means any dividend or similar distribution to policyholders in their capacity as such.

"(b) CERTAIN AMOUNTS INCLUDED.—For purposes of this part, the term 'policyholder dividend' includes—

"(1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management,

"(2) excess interest,

"(3) premium adjustments, and

"(4) experience-rated refunds.

"(c) AMOUNT OF DEDUCTION.—

"(1) IN GENERAL.—Except as limited by paragraph (2), the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year.

"(2) REDUCTION IN CASE OF MUTUAL COMPANIES.—In the case of a mutual life insurance company, the deduction for policyholder dividends for any taxable year shall be reduced by the amount determined under section 809.

"(d) DEFINITIONS.—For purposes of this section—

"(1) EXCESS INTEREST.—The term 'excess interest' means any amount in the nature of interest—

"(A) paid or credited to a policyholder in his capacity as such, and

"(B) determined at a rate in excess of the prevailing State assumed interest rate for such contract.

"(2) PREMIUM ADJUSTMENT.—The term 'premium adjustment' means any reduction in the premium under an insurance or annuity contract which (but for the reduction) would have been required to be paid under the contract.

"(3) EXPERIENCE-RATED REFUND.—The term 'experience-rated refund' means any refund or credit based on the experience of the contract or group involved.

"(e) TREATMENT OF POLICYHOLDER DIVIDENDS.—For purposes of this part, any policyholder dividend which—

"(1) increases the cash surrender value of the contract or other benefits payable under the contract, or

"(2) reduces the premium otherwise required to be paid,

shall be treated as paid to the policyholder and returned by the policyholder to the company as a premium.

"SEC. 809. REDUCTION IN CERTAIN DEDUCTIONS OF MUTUAL LIFE INSURANCE COMPANIES.

"(a) GENERAL RULE.—

"(1) POLICYHOLDER DIVIDENDS.—In the case of any mutual life insurance company, the amount of the deduction allowed under section 808 shall be reduced (but not below zero) by the differential earnings amount.

"(2) REDUCTION IN RESERVE DEDUCTION IN CERTAIN CASES.—In the case of any mutual life insurance company, if the differential earnings amount exceeds the amount allowable as a deduction under section 808 for the taxable year (determined without regard to this section), such excess shall be taken into account under subsections (a) and (b) of section 807.

"(3) DIFFERENTIAL EARNINGS AMOUNT.—For purposes of this section, the term 'differential earnings amount' means, with respect to any taxable year, an amount equal to the product of—

"(A) the life insurance company's average equity base for the taxable year, multiplied by

"(B) the differential earnings rate for such taxable year.

"(b) AVERAGE EQUITY BASE.—For purposes of this section—

"(1) IN GENERAL.—The term 'average equity base' means, with respect to any taxable year, the average of—

"(A) the equity base determined as of the close of the taxable year, and

"(B) the equity base determined as of the close of the preceding taxable year.

"(2) EQUITY BASE.—The term 'equity base' means an amount determined in the manner prescribed by regulations equal to—

"(A) the surplus and capital,

"(B) adjusted as provided in paragraphs (3), (4), (5), and (6) of this subsection.

"(3) INCREASE FOR NONADMITTED FINANCIAL ASSETS.—

"(A) IN GENERAL.—The amount of the surplus and capital shall be increased by the amount of the nonadmitted financial assets.

"(B) NONADMITTED FINANCIAL ASSETS.—For purposes of subparagraph (A), the term 'nonadmitted financial asset' means any nonadmitted asset of the company which is—

"(i) a bond,

"(ii) stock,

"(iii) real estate,

"(iv) a mortgage loan on real estate, or

"(v) any other invested asset.

"(4) INCREASE WHERE STATUTORY RESERVES EXCEED TAX RESERVES.—

"(A) IN GENERAL.—If—

"(i) the aggregate amount of statutory reserves, exceeds

"(ii) the aggregate amount of tax reserves,

the amount of the surplus and capital shall be increased by the amount of such excess.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) STATUTORY RESERVES.—The term 'statutory reserves' means the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term shall not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under section 811(c).

"(ii) TAX RESERVES.—The term 'tax reserves' means the aggregate of the items described in section 807(c) as determined for purposes of section 807.

"(5) INCREASE BY AMOUNT OF CERTAIN OTHER RESERVES.—The amount of the surplus and capital shall be increased by the sum of—

"(A) the amount of any mandatory securities valuation reserve,

"(B) the amount of any deficiency reserve, and

"(C) the amount of any voluntary reserve or similar liability not described in subparagraph (A) or (B).

"(6) ADJUSTMENT FOR NEXT YEAR'S POLICYHOLDER DIVIDENDS.—The amount of the surplus and capital shall be increased by 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

"(c) DIFFERENTIAL EARNINGS RATE.—

"(1) IN GENERAL.—For purposes of this section, the differential earnings rate for any taxable year is the excess of—

"(A) the imputed earnings rate for the taxable year, over

"(B) the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

"(2) TRANSITIONAL RULE.—The differential earnings rate—

"(A) for any taxable year beginning in 1984, or

"(B) for purposes of computing the amount of underpayment under section 6655 (including the application of section 6655(d)(3)) for any taxable year beginning in 1985,

shall be equal to 7.8 percent.

"(d) IMPUTED EARNINGS RATE.—

"(1) IN GENERAL.—For purposes of this section, the imputed earnings rate for any taxable year is—

"(A) 16.5 percent in the case of taxable years beginning in 1984, and

"(B) in the case of taxable years beginning after 1984, an amount which bears the same ratio to 16.5 percent as the current stock earnings rate for the taxable year bears to the base period stock earnings rate.

"(2) CURRENT STOCK EARNINGS RATE.—For purposes of this subsection, the term 'current stock earnings rate' means, with respect to any taxable year, the average of the stock earnings rates determined under paragraph (4) for the 3 calendar years preceding the calendar year in which the taxable year begins.

"(3) BASE PERIOD STOCK EARNINGS RATE.—For purposes of this subsection, the base period stock earnings rate is the average of the stock earnings rates determined under paragraph (4) for calendar years 1981, 1982, and 1983.

"(4) STOCK EARNINGS RATE.—

"(A) IN GENERAL.—For purposes of this subsection, the stock earnings rate for any calendar year is the numerical average of the earnings rates of the 50 largest stock companies.

"(B) EARNINGS RATE.—For purposes of subparagraph (A), the earnings rate of any stock company is the percentage (determined by the Secretary) which—

"(i) the statement gain or loss from operations for the calendar year of such company, is of

"(ii) such company's average equity base for such year.

"(C) 50 LARGEST STOCK COMPANIES.—For purposes of this paragraph, the term '50 largest stock companies' means a group (as determined by the Secretary) of stock life insurance companies which consists of the 50 largest stock life insurance companies which are subject to tax under this part. The Secretary may by regulations provide for exclusion from the group determined under the preceding sentence of any stock life insurance company if (i) the equity of such company is not great enough for such company to be 1 of the 50 largest stock life insurance companies if the determination were made on the basis of equity, and (ii) by reason of the small equity base of such company, it has an earnings rate which would seriously distort the stock earnings rate.

"(D) TREATMENT OF AFFILIATED GROUPS.—For purposes of this paragraph, all stock life insurance companies which are members of the same affiliated group shall be treated as one stock life insurance company.

"(e) AVERAGE MUTUAL EARNINGS RATE.—For purposes of this section, the average mutual earnings rate for any calendar year is the percentage (determined by the Secretary) which—

"(1) the aggregate statement gain or loss from operations for such year of mutual life insurance companies, is of

"(2) their aggregate average equity bases for such year.

"(f) RECOMPUTATION IN SUBSEQUENT YEAR.—

"(1) INCLUSION IN INCOME WHERE RECOMPUTED AMOUNT GREATER.—In the case of any mutual life insurance company, if—

"(A) the recomputed differential earnings amount for any taxable year, exceeds

"(B) the differential earnings amount determined under this section for such taxable year,

such excess shall be included in life insurance gross income for the succeeding taxable year.

"(2) DEDUCTION WHERE RECOMPUTED AMOUNT SMALLER.—In the case of any mutual life insurance company, if—

"(A) the differential earnings amount determined under this section for any taxable year, exceeds

"(B) the recomputed differential earnings amount for such taxable year,

such excess shall be allowed as a life insurance deduction for the succeeding taxable year.

"(3) RECOMPUTED DIFFERENTIAL EARNINGS AMOUNT.—For purposes of this subsection, the term 'recomputed differential earnings amount' means, with respect to any taxable year, the amount which would be the differential earnings amount for such taxable year if the average mutual earnings rate taken into account under subsection (c)(2) were the average mutual earnings rate for the calendar year in which the taxable year begins.

"(4) SPECIAL RULE WHERE COMPANY CEASES TO BE MUTUAL LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22), if—

"(A) a life insurance company is a mutual life insurance company for any taxable year, but

"(B) such life insurance company is not a mutual life insurance company for the succeeding taxable year,

any adjustment under paragraph (1) or (2) by reason of the recomputed differential earnings amount for the first of such taxable years shall be taken into account for the first of such taxable years.

"(g) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) STATEMENT GAIN OR LOSS FROM OPERATIONS.—The term 'statement gain or loss from operations' means the net gain or loss from operations required to be set forth in the annual statement—

"(A) determined with regard to policyholder dividends (as defined in section 808) but without regard to Federal income taxes,

"(B) determined on the basis of the tax reserves rather than statutory reserves, and

"(C) properly adjusted for realized capital gains and losses and other relevant items.

"(2) OTHER TERMS.—Except as otherwise provided in this section, the terms used in this section shall have the same respective meanings as when used in the annual statement.

"(3) DETERMINATIONS BASED ON AMOUNT SET FORTH IN ANNUAL STATEMENT.—Except as otherwise provided in this section or in regulations, all determinations under this section shall be made on the basis of the amounts required to be set forth on the annual statement.

"(4) ANNUAL STATEMENT.—The term 'annual statement' means the annual statement for life insurance companies approved by the National Association of Insurance Commissioners.

"(5) REDUCTION IN EQUITY BASE FOR PORTION OF EQUITY ALLOCABLE TO LIFE INSURANCE BUSINESS IN NONCONTIGUOUS WESTERN HEMISPHERE COUNTRIES.—The equity base of any mutual life insurance company shall be reduced by an amount equal to the portion of the equity base attributable to the life insurance business multiplied by a fraction—

"(A) the numerator of which is the portion of the tax reserves which is allocable to life insurance contracts issued on the life of residents of countries in the Western Hemisphere which are not contiguous to the United States, and

"(B) the denominator of which is the amount of the tax reserves allocable to life insurance contracts.

The preceding sentence shall not apply unless the fraction determined under the preceding sentence exceeds 1/10.

"(6) SPECIAL RULE FOR CERTAIN CONTRACTS ISSUED BEFORE JANUARY 1, 1985.—In determining the amount of tax reserves of a mutual insurance company for purposes of subsection (b)(4), section 811(d) shall not apply with respect to any life insurance contract issued before January 1, 1985, under a plan of life insurance in existence on July 1, 1983.

"(h) TREATMENT OF STOCK COMPANIES OWNED BY MUTUAL LIFE INSURANCE COMPANIES.—

"(1) TREATMENT AS MUTUAL LIFE INSURANCE COMPANIES FOR PURPOSES OF DETERMINING STOCK EARNINGS RATES AND MUTUAL EARNINGS RATES.—Solely for purposes of subsections (d) and (e), a stock life insurance company shall be treated as a mutual life insurance company if stock possessing—

"(A) at least 80 percent of the total combined voting power of all classes of stock of such stock life insurance company entitled to vote, or

"(B) at least 80 percent of the total value of shares of all classes of stock of such stock life insurance company,

is owned at any time during the calendar year directly (or through the application of section 318) by one or more mutual life insurance companies.

"(2) TREATMENT OF AFFILIATED GROUP WHICH INCLUDES MUTUAL PARENT AND STOCK SUBSIDIARY.—In the case of an affiliated group of corporations which includes a common parent which is a mutual life insurance company and one or more stock life insurance companies, for purposes of determining the average equity base of such common parent (and the statement gain or loss from operations)—

"(A) stock in such stock life insurance companies held by such common parent (and dividends on such stock) shall not be taken into account, and

"(B) such common parent and such stock life insurance companies shall be treated as though they were one mutual life insurance company.

"(3) ADJUSTMENT WHERE STOCK COMPANY NOT MEMBER OF AFFILIATED GROUP.—In the case of any stock life insurance company which is described in paragraph (1) but is not a member of an affiliated group described in paragraph (2), under regulations, proper adjustments shall be made in the average equity bases (and statement gains or losses from operations) of mutual life insurance companies owning stock in such company as may be necessary or appropriate to carry out the purposes of this section.

"(i) TRANSITIONAL RULE FOR CERTAIN HIGH SURPLUS MUTUAL LIFE INSURANCE COMPANIES.—

"(1) IN GENERAL.—For purposes of subsection (a)(3), the average equity base of a high surplus mutual life insurance company for any taxable year shall not include the applicable percentage of the excess equity base of such company for such taxable year.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) EXCESS EQUITY BASE.—The term 'excess equity base' means the excess of—

"(i) the average equity base of the company for the taxable year, over

"(ii) the amount which would be its average equity base if its equity percentage equaled the following percentage:

For taxable years beginning	The percentage is:
1984	14.5
1985 or 1986	14
1987 or 1988	13.5

In no case shall the excess equity base for any taxable year be greater than the excess equity base for the company's first taxable year beginning in 1984.

"(B) APPLICABLE PERCENTAGE.—The term 'applicable percentage' means the percentage determined in accordance with the following table:

"For taxable years beginning in:	The applicable percentage is:
1984	100
1985	80
1986	60
1987	40
1988	20
1989 or thereafter	0

"(C) HIGH SURPLUS MUTUAL LIFE INSURANCE COMPANY.—The term 'high surplus mutual life insurance company' means any mutual life insurance company if, for the taxable year beginning in 1984, its equity percentage exceeded 14.5 percent.

"(D) EQUITY PERCENTAGE.—The term 'equity percentage' means, with respect to any mutual life insurance company, the percentage which—

"(i) the average equity base of such company (determined under this section without regard to this subsection) for a taxable year bears to

"(ii) the average of—

"(I) the assets of such company as of the close of the preceding taxable year, and

"(II) the assets of such company as of the close of the taxable year.

For purposes of the preceding sentence, the assets of a company shall include all assets taken into account under this section in determining its equity base (after applying the principles of subsection (h)).

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"SEC. 810. OPERATIONS LOSS DEDUCTION.

"(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of—

"(1) the operations loss carryovers to such year, plus

"(2) the operations loss carrybacks to such year.

For purposes of this part, the term 'operations loss deduction' means the deduction allowed by this subsection.

"(b) OPERATIONS LOSS CARRYBACKS AND CARRYOVERS.—

"(1) YEARS TO WHICH LOSS MAY BE CARRIED.—The loss from operations for any taxable year (hereinafter in this section referred to as the 'loss year') shall be—

"(A) an operations loss carryback to each of the 3 taxable years preceding the loss year,

"(B) an operations loss carryover to each of the 15 taxable years following the loss year, and

"(C) if the life insurance company is a new company for the loss year, an operations loss carryover to each of the 3 taxable years following the 15 taxable years described in subparagraph (B).

"(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.

"(3) ELECTION FOR OPERATIONS LOSS CARRYBACKS.—In the case of a loss from operations for any taxable year, the taxpayer may elect to relinquish the entire carryback period for such loss. Such election shall be made by the due date (including extensions of time) for filing the return for the taxable year of the loss from operations for which the election is to be in effect, and, once made for any taxable year, such election shall be irrevocable for that taxable year.

"(c) COMPUTATION OF LOSS FROM OPERATIONS.—For purposes of this section—

"(1) IN GENERAL.—The term 'loss from operations' means the excess of the life insurance deductions for any taxable year over the life insurance gross income for such taxable year.

"(2) MODIFICATIONS.—For purposes of paragraph (1)—

"(A) the operations loss deduction shall not be allowed, and

"(B) the deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) as modified by section 805(a)(4).

"(d) OFFSET DEFINED.—

"(1) IN GENERAL.—For purposes of subsection (b)(2), the term 'offset' means, with respect to any taxable year, an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income (computed without regard to paragraphs (2) and (3) of section 804) for such year to zero.

"(2) OPERATIONS LOSS DEDUCTION.—For purposes of paragraph (1), the operations loss deduction for any taxable year shall be computed without regard to the loss from operations for the loss year or for any taxable year thereafter.

"(e) NEW COMPANY DEFINED.—For purposes of this part, a life insurance company is a new company for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor, if section 381(c)(22) applies) was authorized to do business as an insurance company.

"(f) APPLICATION OF SUBTITLES A AND F IN RESPECT OF OPERATION LOSSES.—Except as provided in section 805(b)(5), subtitles A and F shall apply in respect of operation loss carrybacks, operation loss carryovers, and the operations loss deduction under this part, in the same manner and to the same extent as such subtitles apply in respect of net operating loss carrybacks, net operating loss carryovers, and the net operating loss deduction.

"(g) TRANSITIONAL RULE.—For purposes of this section and section 812 (as in effect before the enactment of the Life Insurance Tax Act of 1984), this section shall be treated as a continuation of such section 812.

"Subpart D—Accounting, Allocation, and Foreign Provisions

"Sec. 811. Accounting provisions.
"Sec. 812. Definition of company's share and policyholders' share.
"Sec. 813. Foreign life insurance companies.
"Sec. 814. Contiguous country branches of domestic life insurance companies.
"Sec. 815. Distributions to shareholders from pre-1984 policyholders surplus account.

"SEC. 811. ACCOUNTING PROVISIONS.

"(a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

"(1) under an accrual method of accounting, or

"(2) to the extent permitted under regulations prescribed by the Secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(b) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—

"(1) IN GENERAL.—The appropriate items of income, deductions, and adjustments under this part shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

"(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

"(B) in all other cases, in accordance with regulations prescribed by the Secretary.

"(2) SPECIAL RULES.—

"(A) AMORTIZATION OF BOND PREMIUM.—In the case of any bond (as defined in section 171(d)), the amount of bond premium, and the amortizable bond premium for the taxable year, shall be determined under section 171(b) as if the election set forth in section 171(c) had been made.

"(B) CONVERTIBLE EVIDENCE OF INDEBTEDNESS.—In no case shall the amount of premium on a convertible evidence of indebtedness include any amount attributable to the conversion features of the evidence of indebtedness.

"(3) EXCEPTION.—No accrual of discount shall be required under paragraph (1) on any bond (as defined in section 171(d)), except in the case of discount which is—

"(A) interest to which section 103 applies, or

"(B) original issue discount (as defined in section 1232(b)).

"(c) NO DOUBLE COUNTING.—Nothing in this part shall permit—

"(1) a reserve to be established for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in life insurance gross income,

"(2) the same item to be counted more than once for reserve purposes, or

"(3) any item to be deducted (either directly or as an increase in reserves) more than once.

"(d) METHOD OF COMPUTING RESERVES ON CONTRACT WHERE INTEREST IS GUARANTEED BEYOND END OF TAXABLE YEAR.—For purposes of this part (other than section 816), amounts in the nature of interest to be paid or credited under any contract for any period which is computed at a rate which—

"(1) exceeds the prevailing State assumed interest rate for the contract for such period, and

"(2) is guaranteed beyond the end of the taxable year on which the reserves are being computed,

shall be taken into account in computing the reserves with respect to such contract as if such interest were guaranteed only up to the end of the taxable year.

"(e) SHORT TAXABLE YEARS.—If any return of a corporation made under this part is for a period of less than the entire calendar year (referred to in this subsection as 'short period'), then section 443 shall not apply in respect to such period, but life insurance company taxable income shall be determined, under regulations prescribed by the Secretary, on an annual basis by a ratable daily projection of the appropriate figures for the short period.

"SEC. 812. DEFINITION OF COMPANY'S SHARE AND POLICYHOLDERS' SHARE.

"(a) GENERAL RULE.—

"(1) COMPANY'S SHARE.—For purposes of section 805(a)(4), the term 'company's share' means, with respect to any taxable year, the percentage obtained by dividing—

"(A) the company's share of the net investment income for the taxable year, by

"(B) the net investment income for the taxable year.

"(2) POLICYHOLDERS' SHARE.—For purposes of section 807, the term 'policyholders' share' means, with respect to any taxable year, the excess of 100 percent over the percentage determined under paragraph (1).

"(b) COMPANY'S SHARE OF NET INVESTMENT INCOME.—

"(1) IN GENERAL.—For purposes of this section, the company's share of net investment income is the excess (if any) of—

"(A) the net investment income for the taxable year, over

"(B) the sum of—

"(i) the policy interest, for the taxable year, plus

"(ii) the gross investment income's proportionate share of policyholder dividends for the taxable year.

"(2) POLICY INTEREST.—For purposes of this subsection, the term 'policy interest' means—

"(A) required interest (at the prevailing State assumed rate) on reserves under section 807(c) (other than paragraph (2) thereof),

"(B) the deductible portion of excess interest, and

"(C) the deductible portion of any amount (whether or not a policyholder dividend),

and not taken into account under subparagraph (A) or (B), credited to—

"(i) a policyholder's fund under a pension plan contract for employees (other than retired employees), or

"(ii) a deferred annuity contract before the annuity starting date.

"(3) GROSS INVESTMENT INCOME'S PROPORTIONATE SHARE OF POLICYHOLDER DIVIDENDS.—For purposes of paragraph (1), the gross investment income's proportionate share of policyholder dividends is—

"(A) the deduction for policyholders' dividends determined under sections 808 and 809 for the taxable year, but not including—

"(i) the deductible portion of excess interest,

"(ii) the deductible portion of policyholder dividends on contracts referred to in clauses (i) and (ii) of paragraph (2)(C), and

"(iii) the deductible portion of the premium and mortality charge adjustments with respect to contracts paying excess interest for such year,

multiplied by

"(B) the fraction—

"(i) the numerator of which is gross investment income for the taxable year (reduced by the policy interest for such year), and

"(ii) the denominator of which is life insurance gross income (including tax-exempt interest) reduced by the excess (if any) of the closing balance for the items described in section 807(c) over the opening balance for such items for the taxable year.

"(c) NET INVESTMENT INCOME.—For purposes of this section, the term 'net investment income' means 90 percent of gross investment income.

"(d) GROSS INVESTMENT INCOME.—For purposes of this section, the term 'gross investment income' means the sum of the following:

"(1) INTEREST, ETC.—The gross amount of income from—

"(A) interest (including tax-exempt interest), dividends, rents, and royalties,

"(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

"(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

"(2) SHORT-TERM CAPITAL GAIN.—The amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

"(3) TRADE OR BUSINESS INCOME.—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

"(e) DIVIDENDS FROM CERTAIN SUBSIDIARIES NOT INCLUDED IN GROSS INVESTMENT INCOME.—For purposes of this section, the term 'gross investment income' shall not include any dividend received by the life insurance company which is a 100-percent dividend (as defined in section 805(a)(4)(C)). Such term also shall not include any dividend described in section 805(a)(4)(D) (relating to certain dividends in the case of foreign corporations).

"(f) NO DOUBLE COUNTING.—Under regulations, proper adjustments shall be made in the application of this section to prevent an item from being counted more than once.

"SEC. 813. FOREIGN LIFE INSURANCE COMPANIES.

"(a) ADJUSTMENT WHERE SURPLUS HELD IN THE UNITED STATES IS LESS THAN SPECIFIED MINIMUM.—

"(1) IN GENERAL.—In the case of any foreign company taxable under this part, if—

"(A) the required surplus determined under paragraph (2), exceeds

"(B) the surplus held in the United States, then its income effectively connected with the conduct of an insurance business within the United States shall be increased by an amount determined by multiplying such excess by such company's current investment yield.

"(2) REQUIRED SURPLUS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'required surplus' means the amount determined by multiplying the taxpayer's total insurance liabilities on United States business by a percentage for the taxable year determined and proclaimed by the Secretary under subparagraph (B).

"(B) DETERMINATION OF PERCENTAGE.—The percentage determined and proclaimed by the Secretary under this subparagraph shall be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary considers representative. Such percentage shall be computed on the basis of a ratio the numerator of which is the excess of the assets over the total insurance liabilities, and the denominator of which is the total insurance liabilities.

"(3) CURRENT INVESTMENT YIELD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'current investment yield' means the percent obtained by dividing—

"(i) the net investment income on assets held in the United States, by

"(ii) the mean of the assets held in the United States during the taxable year.

"(B) DETERMINATIONS BASED ON AMOUNT SET FORTH IN THE ANNUAL STATEMENT.—Except as otherwise provided in regulations, determinations under subparagraph (A) shall be made on the basis of the amounts required to be set forth on the annual statement approved by the National Association of Insurance Commissioners.

"(4) OTHER DEFINITIONS.—For purposes of this subsection—

"(A) SURPLUS HELD IN THE UNITED STATES.—The surplus held in the United States is the excess of the assets (determined under section 806(b)(3)(C)) held in the United States over the total insurance liabilities on United States business.

"(B) TOTAL INSURANCE LIABILITIES.—For purposes of this subsection, the term 'total insurance liabilities' means the sum of the total reserves (as defined in section 816(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of section 807(c).

"(5) REDUCTION OF SECTION 881 TAXES.—In the case of any foreign company taxable under this part, there shall be determined—

"(A) the amount which would be subject to taxes under section 881 if the amount taxable under such section were determined without regard to sections 103 and 894, and

"(B) the amount of the increase provided by paragraph (1).

The tax under section 881 (determined without regard to this paragraph) shall be reduced (but not below zero) by an amount which is the same proportion of such tax as the amount referred to in subparagraph (B) is of the amount referred to in subparagraph (A); but such reduction in taxes shall not exceed the increase in taxes under this part by reason of the increase provided by paragraph (1).

"(b) ADJUSTMENT TO LIMITATION ON DEDUCTION FOR POLICYHOLDER DIVIDENDS IN THE CASE OF FOREIGN MUTUAL LIFE INSURANCE COMPANIES.—For purposes of section 809, the equity base of any foreign mutual life insurance company as of the close of any taxable year shall be increased by the amount of any excess determined under paragraph (1) of subsection (a) with respect to such taxable year.

"(c) CROSS REFERENCE.—

"For taxation of foreign corporations carrying on life insurance business within the United States, see section 842.

"SEC. 814. CONTIGUOUS COUNTRY BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES.

"(a) EXCLUSION OF ITEMS.—In the case of a domestic mutual insurance company which—

"(1) is a life insurance company,

"(2) has a contiguous country life insurance branch, and

"(3) makes the election provided by subsection (g) with respect to such branch,

there shall be excluded from each item involved in the determination of life insurance company taxable income the items separately accounted for in accordance with subsection (c).

"(b) CONTIGUOUS COUNTRY LIFE INSURANCE BRANCH.—For purposes of this section, the term contiguous country life insurance branch means a branch which—

"(1) issues insurance contracts insuring risks in connection with the lives or health of residents of a country which is contiguous to the United States,

"(2) has its principal place of business in such contiguous country, and

"(3) would constitute a mutual life insurance company if such branch were a separate domestic insurance company.

For purposes of this section, the term 'insurance contract' means any life, health, accident, or annuity contract or reinsurance contract or any contract relating thereto.

"(c) SEPARATE ACCOUNTING REQUIRED.—Any taxpayer which makes the election provided by subsection (g) shall establish and maintain a separate account for the various income, exclusion, deduction, asset, reserve, liability, and surplus items properly attributable to the contracts described in subsection (b). Such separate accounting shall be made—

"(1) in accordance with the method regularly employed by such company, if such method clearly reflects income derived from, and the other items attributable to, the contracts described in subsection (b), and

"(2) in all other cases, in accordance with regulations prescribed by the Secretary.

"(d) RECOGNITION OF GAIN ON ASSETS IN BRANCH ACCOUNT.—If the aggregate fair market value of all the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account established pursuant to subsection (c) exceeds the aggregate adjusted basis of such assets for purposes of determining gain, then the domestic life insurance company shall be treated as having sold all such assets on the first day of the first taxable year for which the election is in effect at their fair market value on such first day. Notwithstanding any other provision of this chapter, the net gain shall be recognized to the domestic life insurance company on the deemed sale described in the preceding sentence.

"(e) TRANSACTIONS BETWEEN CONTIGUOUS COUNTRY BRANCH AND DOMESTIC LIFE INSURANCE COMPANY.—

"(1) REIMBURSEMENT FOR HOME OFFICE SERVICES, ETC.—Any payment, transfer, reimbursement, credit, or allowance which is made from a separate account established pursuant to subsection (c) to one or more

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other accounts of a domestic life insurance company as reimbursement for costs incurred for or with respect to the insurance (or reinsurance) of risks accounted for in such separate account shall be taken into account by the domestic life insurance company in the same manner as if such payment, transfer, reimbursement, credit, or allowance had been received from a separate person.

"(2) REPATRIATION OF INCOME.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any amount directly or indirectly transferred or credited from a branch account established pursuant to subsection (c) to one or more other accounts of such company shall, unless such transfer or credit is a reimbursement to which paragraph (1) applies, be added to the income of the domestic life insurance company.

"(B) LIMITATION.—The addition provided by subparagraph (A) for the taxable year with respect to any contiguous country life insurance branch shall not exceed the amount by which—

"(i) the aggregate decrease in the tentative LICTI of the domestic life insurance company for the taxable year and for all prior taxable years resulting solely from the application of subsection (a) of this section with respect to such branch, exceeds

"(ii) the amount of additions to tentative LICTI pursuant to subparagraph (A) with respect to such contiguous country branch for all prior taxable years.

"(C) TRANSITIONAL RULE.—For purposes of this paragraph, in the case of a prior taxable year beginning before January 1, 1984, the term 'tentative LICTI' means life insurance company taxable income determined under this part (as in effect for such year) without regard to this paragraph.

"(f) OTHER RULES.—

"(1) TREATMENT OF FOREIGN TAXES.—

"(A) IN GENERAL.—No income, war profits, or excess profits taxes paid or accrued to any foreign country or possession of the United States which is attributable to income excluded under subsection (a) shall be taken into account for purposes of subpart A of part III of subchapter N (relating to foreign tax credit) or allowable as a deduction.

"(B) TREATMENT OF REPATRIATED AMOUNTS.—For purposes of sections 78 and 902, where any amount is added to the life insurance company taxable income of the domestic life insurance company by reason of subsection (e)(2), the contiguous country life insurance branch shall be treated as a foreign corporation. Any amount so added shall be treated as a dividend paid by a foreign corporation, and the taxes paid to any foreign country or possession of the United States with respect to such amount shall be deemed to have been paid by such branch.

"(2) UNITED STATES SOURCE INCOME ALLOCABLE TO CONTIGUOUS COUNTRY BRANCH.—For purposes of sections 881, 882, and 1442, each contiguous country life insurance branch shall be treated as a foreign corporation. Such sections shall be applied to each such branch in the same manner as if such sections contained the provisions of any treaty to which the United States and the contiguous country are parties, to the same extent such provisions would apply if such branch were incorporated in such contiguous country.

"(g) ELECTION.—A taxpayer may make the election provided by this subsection with respect to any contiguous country for any taxable year. An election made under this subsection for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary. The election provided by this subsection shall be made not later than the time prescribed by law for filing the return for the taxable year (including extensions thereof) with respect to which such election is made, and such election and any approved revocation thereof shall be made in the manner provided by the Secretary.

"(h) SPECIAL RULE FOR DOMESTIC STOCK LIFE INSURANCE COMPANIES.—At the election of a domestic stock life insurance company which has a contiguous country life insurance branch described in subsection (b) (without regard to the mutual requirement in subsection (b)(3)), the assets of such branch may be transferred to a foreign corporation organized under the laws of the contiguous country without the application of section 367 or 1491. Subsection (a) shall apply to the stock of such foreign corporation as if such domestic company were a mutual company and as if the stock were an item described in subsection (c). Subsection (e)(2) shall apply to amounts transferred or credited to such domestic company as if such domestic company and such foreign corporation constituted one domestic mutual life insurance company. The insurance contracts which may be transferred pursuant to this subsection shall include only those which are similar to the types of insurance contracts issued by a mutual life insurance company. Notwithstanding the first sentence of this subsection, if the aggregate fair market value of the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account exceeds the aggregate adjusted basis of such assets for purposes of determining gain, the domestic life insurance company shall be deemed to have sold all such assets on the first day of the taxable year for which the election under this subsection applies and the net gain shall be recognized to the domestic life insurance company on the deemed sale, but not in excess of the proportion of such net gain which equals the proportion which the aggregate fair market value of such assets which are transferred pursuant to this subsection is of the aggregate fair market value of all such assets.

"SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNT.

"(a) GENERAL RULE.—In the case of a stock life insurance company which has an existing policyholders surplus account, the tax imposed by section 801 for any taxable year shall be the amount which would be imposed by such section for such year on the sum of—

"(1) life insurance company taxable income for such year (but not less than zero), plus

"(2) the amount of direct and indirect distributions during such year to shareholders from such account.

"(b) ORDERING RULE.—For purposes of this section, any distribution to shareholders shall be treated as made—

"(1) first out of the shareholders surplus account, to the extent thereof,

"(2) then out of the policyholders surplus account, to the extent thereof, and

"(3) finally, out of other accounts.

"(c) SHAREHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company which has an existing policyholders surplus account shall continue its shareholders surplus account for purposes of this part.

"(2) ADDITIONS TO ACCOUNT.—The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1983, shall be the excess of—

"(A) the sum of—

"(i) the life insurance company's taxable income (but not below zero),

"(ii) the special deductions provided by section 806, and

"(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 805(a)(4)) and the amount of interest excluded from gross income under section 103, over

"(B) the taxes imposed for the taxable year by section 801 (determined without regard to this section).

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

"(d) POLICYHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company which has an existing policyholders surplus account shall continue such account.

"(2) NO ADDITIONS TO ACCOUNT.—No amount shall be added to the policyholders surplus account for any taxable year beginning after December 31, 1983.

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of—

"(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

"(B) the amount by which the tax imposed for the taxable year by section 801 is increased by reason of this section.

"(e) EXISTING POLICYHOLDERS SURPLUS ACCOUNT.—For purposes of this section, the term 'existing policyholders surplus account' means any policyholders surplus account which has a balance as of the close of December 31, 1983.

"(f) OTHER RULES APPLICABLE TO POLICYHOLDERS SURPLUS ACCOUNT CONTINUED.—Except to the extent inconsistent with the provisions of this part, the provisions of subsections (d), (e), (f), and (g) of section 815 (and of sections 6501(c)(6), 6501(k), 6511(d)(6), 6601(d)(3), and 6611(f)(4)) as in effect before the enactment of the Life Insurance Tax Act of 1984 are hereby made applicable in respect of any policyholders surplus account for which there was a balance as of December 31, 1983.

"SUBPART E—DEFINITIONS AND SPECIAL RULES

"Sec. 816. Life insurance company defined.

"Sec. 817. Treatment of variable contracts.

"Sec. 818. Other definitions and special rules.

"SEC. 816. LIFE INSURANCE COMPANY DEFINED.

"(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if—

"(1) its life insurance reserves (as defined in subsection (b)), plus

"(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)). For purposes of the preceding sentence, the term 'insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

"(b) LIFE INSURANCE RESERVES DEFINED.—

"(1) IN GENERAL.—For purposes of this part, the term 'life insurance reserves' means amounts—

"(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

"(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

"(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

"(A) in the case of policies covering life, accident, and health insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

"(B) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

"(3) ASSESSMENT COMPANIES.—In the case of an assessment life insurance company or association, the term 'life insurance reserves' includes—

"(A) sums actually deposited by such company or association with State officers pursuant to law as guaranty or reserve funds, and

"(B) any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

"(4) AMOUNT OF RESERVES.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

"(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term 'total reserves' means—

"(1) life insurance reserves,

"(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

"(3) all other insurance reserves required by law.

"(d) ADJUSTMENTS IN RESERVES FOR POLICY LOANS.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, the life insurance reserves, and the total reserves, shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained.

"(e) GUARANTEED RENEWABLE CONTRACTS.—For purposes of this part, guaranteed renewable life, accident, and health insurance shall be treated in the same manner as noncancellable life, accident, and health insurance.

"(f) AMOUNTS NOT INVOLVING LIFE, ACCIDENT, OR HEALTH CONTINGENCIES.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in reserves described in paragraph (1) or (3) of subsection (c).

"(g) BURIAL AND FUNERAL BENEFIT INSURANCE COMPANIES.—A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this part but shall be taxable under section 821 or section 831.

"SEC. 817. TREATMENT OF VARIABLE CONTRACTS.

"(a) INCREASES AND DECREASES IN RESERVES.—For purposes of subsections (a) and (b) of section 807, the sum of the items described in section 807(c) taken into account as of the close of the taxable year with respect to any variable contract shall, under regulations prescribed by the Secretary, be adjusted—

"(1) by subtracting therefrom an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with subsection (c) by reason of appreciation in value of assets (whether or not the assets have been disposed of), and

"(2) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets (whether or not the assets have been disposed of).

The deduction allowable for items described in paragraphs (1) and (6) of section 805(a) with respect to variable contracts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments under the preceding sentence.

"(b) ADJUSTMENT TO BASIS OF ASSETS HELD IN SEGREGATED ASSET ACCOUNT.—In the case of variable contracts, the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be—

"(1) increased by the amount of any appreciation in value, and

"(2) decreased by the amount of any depreciation in value,

to the extent such appreciation and depreciation are from time to time reflected in the increases and decreases in reserves or other items referred to in subsection (a) with respect to such contracts.

"(c) SEPARATE ACCOUNTING.—For purposes of this part (other than section 809), a life insurance company which issues variable contracts shall separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts. For such items as are not accounted for directly, separate accounting shall be made—

"(1) in accordance with the method regularly employed by such company, if such method is reasonable, and

"(2) in all other cases, in accordance with regulations prescribed by the Secretary.

"(d) VARIABLE CONTRACT DEFINED.—For purposes of this part, the term 'variable contract' means a contract—

"(1) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

"(2) which—

"(A) provides for the payment of annuities, or

"(B) is a life insurance contract, and

"(3) under which—

"(A) in the case of an annuity contract, the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account, or

"(B) in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account.

If a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of paragraph (3) after such cessation.

"(e) PENSION PLAN CONTRACTS TREATED AS PAYING ANNUITY.—A pension plan contract which is not a life, accident, or health, property, casualty, or liability insurance contract shall be treated as a contract which provides for the payments of annuities for purposes of subsection (d).

"(f) OTHER SPECIAL RULES.—

"(1) LIFE INSURANCE RESERVES.—For purposes of subsection (b)(1)(A) of section 816, the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest.

"(2) ADDITIONAL SEPARATE COMPUTATIONS.—Under regulations prescribed by the Secretary, such additional separate computations shall be made, with respect to the items separately accounted for in accordance with subsection (c), as may be necessary to carry out the purposes of this section and this part.

"(g) VARIABLE ANNUITY CONTRACTS TREATED AS ANNUITY CONTRACTS.—For purposes of this part, the term 'annuity contract' includes a contract which provides for the payment of a variable annuity computed on the basis of—

"(1) recognized mortality tables, and

"(2)(A) the investment experience of a segregated asset account, or

"(B) the company-wide investment experience of the company.

Paragraph (2)(B) shall not apply to any company which issues contracts which are not variable contracts.

"(h) TREATMENT OF CERTAIN NONDIVERSIFIED CONTRACTS.—

"(1) IN GENERAL.—For purposes of subchapter L, section 72 (relating to annuities), and section 7702(a) (relating to definition of life insurance contract), a variable contract (other than a pension plan contract) which is otherwise described in this section and which is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified. For purposes of the preceding sentence, beneficial interests in a regulated investment company or in a trust shall not be treated as 1 investment if all of the beneficial interests in such company or trust are held by 1 or more segregated asset accounts of 1 or more insurance companies.

"(2) SAFE HARBOR FOR DIVERSIFICATION.—A segregated asset account shall be treated as meeting the requirements of paragraph (1) for any quarter of a taxable year if as of the close of such quarter—

"(A) it meets the requirements of section 851(b)(4), and

"(B) no more than 55 percent of the value of the total assets of the account are assets described in section 851(b)(4)(A)(i).

"(3) SPECIAL RULE FOR VARIABLE LIFE INSURANCE CONTRACTS INVESTING IN UNITED STATES OBLIGATIONS.—In the case of a segregated asset account with respect to variable life insurance contracts, paragraph (1) shall not apply in the case of securities issued by the United States Treasury which are owned by a regulated investment company or by a trust all the beneficial interests in which are held by 1 or more segregated asset accounts of the company issuing the contract.

"(4) INDEPENDENT INVESTMENT ADVISORS PERMITTED.—Nothing in this subsection shall be construed as prohibiting the use of independent investment advisors.

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"SEC. 818. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) PENSION PLAN CONTRACTS.—For purposes of this part, the term 'pension plan contract' means any contract—

"(1) entered into with trusts which (as of the time the contracts were entered into) were deemed to be trusts described in section 401(a) and exempt from tax under section 501(a), (or trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws);

"(2) entered into under plans which (as of the time the contracts were entered into) were deemed to be plans described in section 403(a), or plans meeting the requirements of paragraphs (3), (4), (5), and (6) of section 165(a) of the Internal Revenue Code of 1939;

"(3) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of paragraphs (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), (19), (20), and (22) of section 401(a);

"(4) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) (or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws), or purchased to provide retirement annuities for employees described in section 403(b)(1)(A)(ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing;

"(5) entered into with trusts which (at the time the contracts were entered into) were individual retirement accounts described in section 408(a) or under contracts entered into with individual retirement annuities described in section 408(b); or

"(6) purchased by—

"(A) a governmental plan (within the meaning of section 414(d)), or

"(B) the Government of the United States, the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, for use in satisfying an obligation of such government, political subdivision, or agency or instrumentality to provide a benefit under a plan described in subparagraph (A).

"(b) TREATMENT OF CAPITAL GAINS AND LOSSES, ETC.—In the case of a life insurance company—

"(1) in applying section 1231(a), the term 'property used in the trade or business' shall be treated as including only—

"(A) property used in carrying on an insurance business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in carrying on an insurance business, held for more than 1 year, which is not described in section 1231(b)(1) (A), (B), or (C), and

"(B) property described in section 1231(b)(2), and

"(2) in applying section 1221(2), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

"(c) GAIN ON PROPERTY HELD ON DECEMBER 31, 1958 AND CERTAIN SUBSTITUTED PROPERTY ACQUIRED AFTER 1958.—

"(1) PROPERTY HELD ON DECEMBER 31, 1958.—In the case of property held by the taxpayer on December 31, 1958, if—

"(A) the fair market value of such property on such date exceeds the adjusted basis for determining gain as of such date, and

"(B) the taxpayer has been a life insurance company at all times on and after December 31, 1958,

the gain on the sale or other disposition of such property shall be treated as an amount (not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date.

"(2) CERTAIN PROPERTY ACQUIRED AFTER DECEMBER 31, 1958.—In the case of property acquired after December 31, 1958, and having a substituted basis (within the meaning of section 1016(b))—

"(A) for purposes of paragraph (1), such property shall be deemed held continuously by the taxpayer since the beginning of the holding period thereof, determined with reference to section 1223,

"(B) the fair market value and adjusted basis referred to in paragraph (1) shall be that of that property for which the holding period taken into account includes December 31, 1958,

"(C) paragraph (1) shall apply only if the property or properties the holding periods of which are taken into account were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account,

"(D) the difference between the fair market value and adjusted basis referred to in paragraph (1) shall be reduced (to not less than zero) by the excess of (i) the gain that would have been recognized but for this subsection on all prior sales or dispositions after December 31, 1958, of properties referred to in subparagraph (C), over (ii) the gain which was recognized on such sales or other dispositions, and

"(E) the basis of such property shall be determined as if the gain which would have been recognized but for this subsection were recognized gain.

"(3) PROPERTY DEFINED.—For purposes of paragraphs (1) and (2), the term 'property' does not include insurance and annuity contracts and property described in paragraph (1) of section 1221.

"(d) INSURANCE OR ANNUITY CONTRACT INCLUDES CONTRACTS SUPPLEMENTARY THERETO.—For purposes of this part, the term 'insurance or annuity contract' includes any contract supplementary thereto.

"(e) SPECIAL RULE FOR CONSOLIDATED RETURNS.—If an election under section 1504(c)(2) is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

"(f) ALLOCATION OF CERTAIN ITEMS FOR PURPOSES OF FOREIGN TAX CREDIT, ETC.—

"(1) IN GENERAL.—Under regulations, in applying sections 861, 862, and 863 to a life insurance company, the deduction for policyholder dividends (determined under section 808(c)), reserve adjustments under subsections (a) and (b) of section 807, and death benefits and other amounts described in section 805(a)(1) shall be treated as items which cannot definitely be allocated to an item or class of gross income.

"(2) ELECTION OF ALTERNATIVE ALLOCATION.—

"(A) IN GENERAL.—On or before September 15, 1985, any life insurance company may elect to treat items described in paragraph (1) as properly apportioned or allocated among items of gross income to the extent (and in the manner) prescribed in regulations.

"(B) ELECTION IRREVOCABLE.—Any election under subparagraph (A), once made, may be revoked only with the consent of the Secretary."

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subclause (IV) of section 72(e)(5)(D)(i) is amended by striking out "section 805(d)(3)" and inserting in lieu thereof "section 818(a)(3)".

(2) Subsection (a) of section 80 (relating to restoration of value of certain securities) is amended by striking out "802" and inserting in lieu thereof "801".

(3)(A) Subparagraph (C) of section 243(b)(3) (relating to effect of election) is amended by striking out clause (iii), by adding "and" at the end of clause (ii), and by redesignating clause (iv) as clause (iii).

(B) Paragraph (6) of section 243(b) (relating to special rules for insurance companies) is amended by striking out "section 802" and inserting in lieu thereof "section 801".

(4) Subsection (d) of section 381 (relating to carryover in certain corporate acquisitions) is amended by striking out "section 812(f)" and inserting in lieu thereof "section 810".

(5) Paragraph (24) of section 401(a) (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by striking out "section 805(d)(6)" and inserting in lieu thereof "section 818(a)(6)".

(6)(A) Paragraph (1) of section 453B(e) (relating to life insurance companies) is amended by striking out "section 801(a)" and inserting in lieu thereof "section 816(a)".

(B) Paragraph (2) of section 453B(e) is amended to read as follows:

"(2) SPECIAL RULE WHERE LIFE INSURANCE COMPANY ELECTS TO TREAT INCOME AS NOT RELATED TO INSURANCE BUSINESS.—Paragraph (1) shall not apply to any transfer or deemed transfer of an installment obligation if the life insurance company elects (at such time and in such manner as the Secretary may by regulations prescribe) to determine its life insurance company taxable income—

"(A) by returning the income on such installment obligation under the installment method prescribed in section 453, and

"(B) as if such income were an item attributable to a noninsurance business (as defined in section 806(c)(3))."

(7) Paragraph (5) of section 542(b) (relating to certain dividend income received from a nonincludible life insurance company) is amended by striking out "section 802" and inserting in lieu thereof "section 801".

(8) Subsection (b) of section 594 (relating to alternative tax for mutual savings banks conducting life insurance business) is amended by striking out "section 801" and inserting in lieu thereof "section 816".

(9) Paragraph (4) of section 832(b) (defining premiums earned) is amended by striking out "section 801(b)" and inserting in lieu thereof "section 816(b) but determined as provided in section 807" and by striking out "section 801" and inserting in lieu thereof "section 816".

(10) Section 841 (relating to credit for foreign taxes) is amended—

(A) by striking out "section 802," each place it appears and inserting in lieu thereof "section 801,", and

(B) by striking out "section 802(b)" and inserting in lieu thereof "section 801(b)".

(11)(A) Subsection (a) of section 844 (relating to special loss carryover rules) is amended—

(i) by striking out "section 812," and inserting in lieu thereof "section 810 (or the corresponding provisions of prior law),", and

(ii) by striking out "section 812(a)" and inserting in lieu thereof "section 810(a)".

(B) Subsection (b) of section 844 is amended—

(i) by striking out "section 812(a)" and inserting in lieu thereof "section 810(a)", and

(ii) by striking out "section 812(b)(1)(C)" in paragraph (2) and inserting in lieu thereof "section 810(b)(1)(C)".

(12) Section 891 (relating to doubling of rates of tax on citizens and corporations of certain foreign countries) is amended by striking out "802" and inserting in lieu thereof "801".

(13)(A) Subsection (b) of section 953 (relating to income from insurance of United States risks) is amended by striking out paragraph (1) and by redesignating paragraphs (2), (3), (4), and (5) as paragraphs (1), (2), (3), and (4), respectively.

(B) Paragraph (2) of section 953(b), as redesignated by subparagraph (A), is amended to read as follows:

"(2) The following provisions of subchapter L shall not apply:

"(A) The special life insurance company deduction and the small life insurance company deduction.

"(B) Section 805(a)(5) (relating to operations loss deduction).

"(C) Section 832(c)(5) (relating to certain capital losses)."

(C) Paragraph (3) of section 953(b), as redesignated by subparagraph (A), is amended by—

(i) striking out "section 809(c)(1)" and inserting in lieu thereof "section 803(a)(1)", and

(ii) by striking out "section 809(c)(2)" and inserting in lieu thereof "section 803(a)(2)", and

(iii) by striking out "section 809(d)(2)" and inserting in lieu thereof "section 805(a)(2)".

(D) Paragraph (2) of section 953(a) is amended by striking out ", (2), and (3)" and inserting in lieu thereof "and (2)".

(E) Paragraph (4) of section 953(b), as redesignated by subparagraph (A), is amended by striking out "paragraph (4)" and inserting in lieu thereof "paragraph (3)".

(14) Paragraph (17) of section 1016(a) is amended by striking out "section 818(b)" each place it appears and inserting in lieu thereof "section 811(b)".

(15) Paragraph (1) of section 1035(b) (defining endowment contract) is amended by striking out "section 801" and inserting in lieu thereof "section 816".

(16) Paragraph (1) of section 1201(b) (relating to cross references) is amended by striking out "section 802(a)(2)" and inserting in lieu thereof "section 801(a)(2)".

(17) Subparagraph (B) of section 1232A(c)(4) (relating to original issue discount) is amended by striking out "section 818(b)" and inserting in lieu thereof "section 811(b)".

(18)(A) Paragraph (1) of section 1351(a) (relating to treatment of recoveries of foreign expropriation losses) is amended by striking out "802" each place it appears and inserting in lieu thereof "801".

(B) Paragraph (2) of section 1351(c) (relating to amount of recovery) is amended by striking out "section 810(c)" and inserting in lieu thereof "section 807(c)".

(C) Paragraph (3) of section 1351(i) (relating to adjustments for succeeding years) is amended by striking out "section 812" and inserting in lieu thereof "section 810".

(19)(A) Subsection (c) of section 1503 (relating to special rules for application of certain losses against income of insurance companies taxed under section 802) is amended by striking out "section 802" each place it appears and inserting in lieu thereof "section 801".

(B) Paragraph (1) of section 1503(c) is amended by striking out the third sentence.

(C) The subsection heading of section 1503(c) is amended by striking out "SECTION 802" and inserting in lieu thereof "SECTION 801".

(20) Subsections (b)(2), (c)(1), and (c)(2)(A) of section 1504 (defining affiliated group) are each amended by striking out "section 802" and inserting in lieu thereof "section 801".

(21)(A) Subsection (a) of section 1561 (relating to limitations on certain multiple tax benefits in the case of certain controlled corporations) is amended—

(i) by striking out paragraphs (3) and (4), by adding "and" at the end of paragraph (1), and by striking out the comma at the end of paragraph (2) and inserting in lieu thereof a period, and

(ii) by striking out "paragraphs (2), (3), and (4)" in the last sentence and inserting in lieu thereof "paragraph (2)".

(B) Subsection (b) of section 1561 is amended—

(i) by striking out paragraphs (3) and (4) and by adding "and" at the end of paragraph (1), and

(ii) by striking out ", (2), (3), or (4)" and inserting in lieu thereof "or (2)".

(22) Subsections (a)(4) and (b)(2)(D) of section 1563 (defining controlled group of corporations) are each amended by striking out "section 802" and inserting in lieu thereof "section 801".

(23) Paragraph (2) of section 4371 (relating to imposition of tax on policies issued by foreign insurers) is amended by striking out "section 819" and inserting in lieu thereof "section 813".

(24)(A) Subsection (c) of section 6501 (relating to limitations on assessment and collection) is amended by striking out paragraph (6) and by redesignating paragraph (7) as paragraph (6).

(B) Subsection (k) of section 6501 (relating to reductions of policyholders' surplus account of life insurance companies) is hereby repealed.

(25) Subsection (d) of section 6511 (relating to limitations on credit or refund) is amended by striking out paragraph (6) and by redesignating paragraph (7) as paragraph (6).

(26) Subsection (d) of section 6601 (relating to interest on underpayments, etc.) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(27) Subsection (f) of section 6611 (relating to interest on overpayments) is amended by striking out paragraph (4).

SEC. 212. CERTAIN REINSURANCE AGREEMENTS.

(a) IN GENERAL.—Part IV of subchapter L of chapter 1 (relating to provisions of general application) is amended by adding at the end thereof the following new section:

"SEC. 845. CERTAIN REINSURANCE AGREEMENTS.

"(a) ALLOCATION IN CASE OF REINSURANCE AGREEMENT INVOLVING TAX AVOIDANCE OR EVASION.—In the case of 2 or more related persons (within the meaning of section 482) who are parties to a reinsurance agreement (or where one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons), the Secretary may—

"(1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement,

"(2) recharacterize any such items, or

"(3) make any other adjustment,

if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

"(b) REINSURANCE CONTRACT HAVING SIGNIFICANT TAX AVOIDANCE EFFECT.—If the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to such party to eliminate such tax avoidance effect (including treating such contract with respect to such party as terminated on December 31 of each year and reinstated on January 1 of the next year)."

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following new item:

"Sec. 845. Certain reinsurance agreements."

PART II—EFFECTIVE DATE; TRANSITIONAL RULES

Subpart A—Effective Date

SEC. 215. EFFECTIVE DATE.

The amendments made by this subtitle shall apply to taxable years beginning after December 31, 1983.

Subpart B—Transitional Rules

SEC. 216. RESERVES COMPUTED ON NEW BASIS; FRESH START.

(a) RECOMPUTATION OF RESERVES.—

(1) IN GENERAL.—As of the beginning of the first taxable year beginning after December 31, 1983, for purposes of subchapter L of the Internal Revenue Code of 1954 (other than section 816 thereof), the reserve for any contract shall be recomputed as if the amendments made by this subtitle had applied to such contract when it was issued.

(2) PREMIUMS EARNED.—For the first taxable year beginning after December 31, 1983, in determining "premiums earned on insurance contracts during the taxable year" as provided in section 832(b)(4) of the Internal Revenue Code of 1954, life insurance reserves which are included in unearned premiums on outstanding business at the end of the preceding taxable year shall be determined as provided in section 807 of the Internal Revenue Code of 1954, as amended by this subtitle, as though section 807 was applicable to such reserves in such preceding taxable year.

(3) ISSUANCE DATE FOR GROUP CONTRACTS.—For purposes of this subsection, the issuance date of any group contract shall be determined under section 807(e)(2) of the Internal Revenue Code of 1954 (as added by this subtitle), except that if such issuance date cannot be determined, the issuance date shall be determined on the basis by the Secretary of the Treasury or his delegate for purposes of this subsection.

(b) FRESH START.—

(1) IN GENERAL.—Except as provided in paragraph (2), in the case of any insurance company, any change in the method of accounting (and any change in the method of computing reserves) between such company's first taxable year beginning after December 31, 1983, and the preceding taxable year which is required solely by the amendments made by this subtitle shall be treated as not being a change in the method of accounting (or change in the method of computing reserves) for purposes of the Internal Revenue Code of 1954.

(2) TREATMENT OF ADJUSTMENTS FROM YEARS BEFORE 1984.—

(A) ADJUSTMENTS ATTRIBUTABLE TO DECREASES IN RESERVES.—No adjustment under section 810(d) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) attributable to any decrease in reserves as a result of a change in a taxable year beginning before 1984 shall be taken into account in any taxable year beginning after 1983.

(B) ADJUSTMENTS ATTRIBUTABLE TO INCREASES IN RESERVES.—

(I) IN GENERAL.—Any adjustment under section 810(d) of the Internal Revenue Code of 1954 (as so in effect) attributable to an increase in reserves as a result of a change in a taxable year beginning before 1984 shall be taken into account in taxable years beginning after 1983 to the extent that—

(I) the amount of the adjustments which would be taken into account under such section in taxable years beginning after 1983 without regard to this subparagraph, exceeds

(II) the amount of any fresh start adjustment attributable to contracts for which there was such an increase in reserves as a result of such change.

(ii) FRESH START ADJUSTMENT.—For purposes of clause (i), the fresh start adjustment with respect to any contract is the excess (if any) of—

(I) the reserve attributable to such contract as of the close of the taxpayer's last taxable year beginning before January 1, 1984, over

(II) the reserve for such contract as of the beginning of the taxpayer's first taxable year beginning after 1983 as recomputed under subsection (a) of this section.

(C) RELATED INCOME INCLUSIONS NOT TAKEN INTO ACCOUNT TO THE EXTENT DEDUCTION DISALLOWED UNDER SUBPARAGRAPH (b).—No premium shall be included in income to the extent such premium is directly related to an increase in a reserve for which a deduction is disallowed by subparagraph (B).

(3) REINSURANCE TRANSACTIONS, AND RESERVE STRENGTHENING, AFTER SEPTEMBER 27, 1983.—

(A) IN GENERAL.—Paragraph (1) shall not apply (and section 807(f) of the Internal Revenue Code of 1954 as amended by this subtitle shall apply)—

(i) to any reserve transferred pursuant to—

(I) a reinsurance agreement entered into after September 27, 1983, and before January 1, 1984, or

(II) a modification of a reinsurance agreement made after September 27, 1983, and before January 1, 1984, and

(ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Clause (ii) shall not apply to the computation of reserves on any contact issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

(B) TREATMENT OF RESERVE ATTRIBUTABLE TO SECTION 818(C) ELECTION.—In the case of any reserve described in subparagraph (A), for purposes of section 807(f) of the Internal Revenue Code of 1954, any change in the treatment of any contract to which an election under section 818(c) of such Code (as in effect on the day before the date of the enactment of this Act) applied shall be treated as a change in the basis for determining the amount of any reserve.

(C) 10-YEAR SPREAD INAPPLICABLE WHERE NO 10-YEAR SPREAD UNDER PRIOR LAW.—In the case of any item to which section 807(f) of such Code applies by reason of subparagraph (A) or (B), such item shall be taken into account for the first taxable year beginning after December 31, 1983 (in lieu of over the 10-year period otherwise provided in such section) unless the item was required to have been taken into account over a period of 10 taxable years under section 810(d) of such Code (as in effect on the day before the date of the enactment of this Act).

(D) DISALLOWANCE OF SPECIAL LIFE INSURANCE COMPANY DEDUCTION AND SMALL LIFE INSURANCE COMPANY DEDUCTION.—Any amount included in income under section 807(f) of such Code by reason of subparagraph (A) or (B) (and any income attributable to expenses transferred in connection with the transfer of reserves described in subparagraph (A)) shall not be taken into account for purposes of determining the amount of special life insurance company deduction and the small life insurance company deduction.

(E) DISALLOWANCE OF DEDUCTIONS UNDER SECTION 809(d).—No deduction shall be allowed under paragraph (5) or (6) of section 809(d) of such Code (as in effect before the amendments made by this subtitle) with respect to any amount described in either such paragraph which is transferred in connection with the transfer of reserves described in subparagraph (A).

(4) ELECTIONS UNDER SECTION 818(C) AFTER SEPTEMBER 27, 1983, NOT TO TAKE EFFECT.—

(A) IN GENERAL.—Except as provided in subparagraph (B), any election after September 27, 1983, under section 818(c) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) shall not take effect.

(B) EXCEPTION FOR CERTAIN CONTRACTS ISSUED UNDER PLAN OF INSURANCE FIRST FILED AFTER MARCH 1, 1982, AND BEFORE SEPTEMBER 28, 1983.—Subparagraph (A) shall not apply to any election under such section 818(c) if more than 95 percent of the reserves computed in accordance with such election are attributable to risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

(5) RECAPTURE OF REINSURANCE AFTER DECEMBER 31, 1983.—If (A) insurance or annuity contracts in force on December 31, 1983, are subject to a conventional coinsurance agreement entered into after December 31, 1981, and before January 1, 1984, and (B) such contracts are recaptured by the reinsured in any taxable year beginning after December 31, 1983, then—

(i) if the amount of the reserves with respect to the recaptured contracts, computed at the date of recapture, that the reinsurer would have taken into account under section 810(c) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) exceeds the amount of the reserves with respect to the recaptured contracts, computed at the date of recapture, taken into account by the reinsurer under section 807(c) of the Internal Revenue Code of 1954 (as amended by this subtitle), such excess (but not greater than the amount of such excess if computed on January 1, 1984) shall be taken into account by the reinsurer under the method described in section 807(f)(1)(B)(ii) of the Internal Revenue Code of 1954 (as amended by this subtitle) commencing with the taxable year of recapture, and

(ii) the amount, if any, taken into account by the reinsurer under clause (i) for purposes of part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 shall be taken into account by the reinsured under the method described in section 807(f)(1)(B)(i) of the Internal Revenue Code of 1954 (as amended by this subtitle) commencing with the taxable year of recapture.

The excess described in clause (i) shall be reduced by any portion of such excess to which section 807(f) of the Internal Revenue Code of 1954 applies by reason of paragraph (3) of this subsection. For purposes of this paragraph, the term "reinsurer" refers to the taxpayer that held reserves with respect to the recaptured contracts as of the end of the taxable year preceding the first taxable year beginning after December 31, 1983, and the term "reinsured" refers to the taxpayer to which such reserves are ultimately transferred upon termination.

(c) ELECTION NOT TO HAVE RESERVES RECOMPUTED.—

(1) IN GENERAL.—If a qualified life insurance company makes an election under this paragraph—

(A) subsection (a) shall not apply to such company, and

(B) as of the beginning of the first taxable year beginning after December 31, 1983, and thereafter, the reserve for any contract issued before the first day of such taxable year by such company shall be the statutory reserve for such contract (within the meaning of section 809(b)(4)(B)(i) of the Internal Revenue Code of 1954).

(2) ELECTION WITH RESPECT TO CONTRACTS ISSUED AFTER 1983 AND BEFORE 1989.—

(A) IN GENERAL.—If—

(i) a qualified life insurance company makes an election under paragraph (1), and

(ii) the tentative LICTI (within the meaning of section 806(c) of such Code) of such company for its first taxable year beginning after December 31, 1983, does not exceed $3,000,000,

such company may elect under this paragraph to have the reserve for any contract issued on or after the first day of such first taxable year and before January 1, 1989, be equal to the statutory reserve for such contract, adjusted as provided in subparagraph (B).

(B) ADJUSTMENT TO RESERVES.—If this paragraph applies to any contract, the statutory reserves for such contract shall be adjusted as provided under section 805(c)(1) of such Code (as in effect for taxable years beginning in 1982 and 1983), except that section 805(c)(1)(B)(ii) of such Code (as so in effect) shall be applied by substituting—

(i) the prevailing State assumed interest rate (within the meaning of section 807(c)(4) of such Code), for

(ii) the adjusted reserves rate.

(3) QUALIFIED LIFE INSURANCE COMPANY.—For purposes of this subsection, the term "qualified life insurance company" means any life insurance company which, as of December 31, 1983, had assets of less than $100,000,000 (determined in the same manner as under section 806(b)(3) of such Code).

(4) SPECIAL RULES FOR CONTROLLED GROUPS.—For purposes of applying the dollar limitations of paragraphs (2) and (3), rules similar to the rules of section 806(d) of such Code shall apply.

(5) ELECTIONS.—Any election under paragraph (1) or (2)—

(A) shall be made at such time and in such manner as the Secretary of the Treasury may prescribe, and

(B) once made, shall be irrevocable.

SEC. 217. OTHER SPECIAL RULES.

(a) NEW SECTION 814 TREATED AS CONTINUATION OF SECTION 819A.—For purposes of section 814 of the Internal Revenue Code of 1954 (relating to contiguous country branches of domestic life insurance companies)—

(1) any election under section 819A of such Code (as in effect on the day before the date of the enactment of this Act) shall be treated as an election under such section 814, and

(2) any reference to a provision of such section 814 shall be treated as including a reference to the corresponding provision of such section 819A.

(b) TREATMENT OF ELECTIONS UNDER SECTION 453B(e)(2).—If an election is made under section 453B(e)(2) before January 1, 1984, with respect to any installment obligation, any income from such obligation shall be treated as attributable to a noninsurance business (as defined in section 806(c)(3) of the Internal Revenue Code of 1954).

(c) DETERMINATION OF TENTATIVE LICTI WHERE CORPORATION MADE CERTAIN ACQUISITIONS IN 1980, 1981, 1982, AND 1983.—If—

(1) a corporation domiciled or having its principal place of business in Alabama, Arkansas, Oklahoma, or Texas acquired the assets of 1 or more insurance companies after 1979 and before April 1, 1983, and

(2) the bases of such assets in the hands of the corporation were determined under section 334(b)(2) of the Internal Revenue Code of 1954 or such corporation made an election under section 338 of such Code with respect to such assets,

then the tentative LICTI of the corporation holding such assets for taxable years beginning after December 31, 1983, shall, for purposes of determining the amount of the special deductions under section 806 of such Code, be increased by the deduction allowable under chapter 1 of such Code for the amortization of the cost of insurance contracts acquired in such asset acquisition (and any portion of any operations loss deduction attributable to such amortization).

(d) EFFECTIVE DATE FOR NEW SECTION 845.—

(1) Subsection (a) of section 845 of the Internal Revenue Code of 1954 (as added by this title) shall apply with respect to any risk reinsured on or after September 27, 1983.

(2) Subsection (d) of section 845 of such Code (as so added) shall apply with respect to risks reinsured after December 31, 1984.

(e) TREATMENT OF CERTAIN COMPANIES OPERATING BOTH AS STOCK AND MUTUAL COMPANY.—If, during the 10-year period ending on December 31, 1983, a company has, as authorized by the law of the State in which the company is domiciled, been operating as a mutual life insurance company with shareholders, such company shall be treated as a stock life insurance company.

(f) TREATMENT OF CERTAIN ASSESSMENT LIFE INSURANCE COMPANIES.—

(1) MORTALITY AND MORBIDITY TABLES.—In the case of a contract issued by an assessment life insurance company, the mortality and morbidity tables used in computing statutory reserves for such contract shall be used for purposes of paragraph (2)(C) of section 807(d) of the Internal Revenue Code of 1954 (as amended by this subtitle) if such tables were—

(A) in use since 1965, and

(B) developed on the basis of the experience of assessment life insurance companies in the State in which such assessment life insurance company is domiciled.

(2) TREATMENT OF CERTAIN MUTUAL ASSESSMENT LIFE INSURANCE COMPANIES.—In the case of any contract issued by a mutual assessment life insurance company which—

(A) has been in existence since 1965, and

(B) operates under chapter 13 or 14 of the Texas Insurance Code,

for purposes of part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954, the amount of the life insurance reserves for such contract shall be equal to the amount taken into account with respect to such contract in determining statutory reserves.

(3) STATUTORY RESERVES.—For purposes of this subsection, the term "statutory reserves" has the meaning given to such term by section 809(b)(4)(B) of such Code.

(g) TREATMENT OF REINSURANCE AGREEMENTS REQUIRED BY NAIC.—Effective for taxable years beginning after December 31, 1981, and before January 1, 1984, subsections (c)(1)(F) and (d)(12) of section 809 of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) shall not apply to dividends to policyholders reimbursed to the taxpayer by a reinsurer in respect of accident and health policies reinsured under a reinsurance agreement entered into before June 30, 1955, pursuant to the direction of the National Association of Insurance Commissioners and approved by the State insurance commissioner of the taxpayer's State of domicile. For purposes of subchapter L of chapter 1 of such Code (as in effect on the day before the date of the enactment of this Act) any such dividends shall be treated as dividends of the reinsurer and not the taxpayer.

(h) DETERMINATION OF ASSETS OF CONTROLLED GROUP FOR PURPOSES OF SMALL LIFE INSURANCE COMPANY DEDUCTION FOR 1984.—

(1) IN GENERAL.—For purposes of applying paragraph (2) of section 806(d) of the Internal Revenue Code of 1954 (relating to non-life insurance members included for asset test) for the first taxable year beginning after December 31, 1983, the members of the controlled group referred to in such paragraph shall be treated as including only those members of such group which are described in paragraph (2) of this subsection if—

(A) an election under section 1504(c)(2) of such Code is not in effect for the controlled group for such taxable year,

(B) during such taxable year, the controlled group does not include a member which is taxable under part I of subchapter L of chapter 1 of such Code and which became a member of such group after September 27, 1983, and

(C) the sum of the contributions to capital received by members of the controlled group which are taxable under such part I during such taxable year from the members of the controlled group which are not taxable under such part does not exceed the aggregate dividends paid during such taxable year by the members of such group which are taxable under such part I.

(2) MEMBERS OF GROUP TAKEN INTO ACCOUNT.—For purposes of paragraph (1), the members of the controlled group which are described in this paragraph are—

(A) any financial institution to which section 585 or 593 of such Code applies,

(B) any lending or finance business (as defined by section 542(d)),

(C) any insurance company subject to tax imposed by subchapter L of chapter 1 of such Code, and

(D) any securities broker.

(i) SPECIAL ELECTION TO TREAT INDIVIDUAL NONCANCELLABLE ACCIDENT AND HEALTH CONTRACTS AS CANCELLABLE.—

(1) IN GENERAL.—A mutual life insurance company may elect to treat all individual noncancellable (or guaranteed renewable) accident and health insurance contracts as though they were cancellable for purposes of section 816 of subchapter L of chapter 1 of the Internal Revenue Code of 1954.

(2) EFFECT OF ELECTION ON SUBSIDIARIES OF ELECTING PARENT.—

(A) TREATED AS MUTUAL LIFE INSURANCE COMPANY.—Any stock life insurance company which is a member of an affiliated group which has a common parent which made an election under paragraph (1), for purposes of part I of subchapter L of the Internal Revenue Code of 1954, such stock life insurance company shall be treated as though it were a mutual life insurance company.

(B) INCOME OF ELECTING PARENT TAKEN INTO ACCOUNT IN DETERMINING SMALL LIFE INSURANCE COMPANY DEDUCTION OF ANY SUBSIDIARY.—For purposes of determining the amount of the small life insurance company deduction of any controlled group which includes a mutual company which made an election under paragraph (1), the taxable income of such electing company shall be taken into account under section 806(b)(2) of the Internal Revenue Code of 1954 (relating to phase-out of small life insurance company deduction).

(3) ELECTION.—An election under paragraph (1) shall apply to the company's first taxable year beginning after December 31, 1983, and all taxable years thereafter.

(4) TIME AND MANNER.—An election under paragraph (1) shall be made—

(A) on the return of the taxpayer for its first taxable year beginning after December 31, 1983, and

(B) in such manner as the Secretary of the Treasury or his delegate may prescribe.

(j) REDUCTION IN EQUITY BASE FOR MUTUAL SUCCESSOR OF FRATERNAL BENEFIT SOCIETY.—In the case of any mutual life insurance company which—

(1) is the successor to a fraternal benefit society, and

(2) which assumed the surplus of such fraternal benefit society in 1950 or in March of 1961,

for purposes of section 809 of the Internal Revenue Code of 1954 (as amended by this subtitle), the equity base of such mutual life insurance company shall be reduced by the amount of the surplus so assumed plus earnings thereon, (i) for taxable years before 1984, at a 7 percent interest rate, and (ii) for taxable years 1984 and following, at the average mutual earnings rate for such year.

(k) SPECIAL RULE FOR CERTAIN DEBT-FINANCED ACQUISITION OF STOCK.—If—

(1) a life insurance company owns the stock of another corporation through a partnership of which it is a partner,

(2) the stock of the corporation was acquired on January 14, 1981, and

(3) such stock was acquired by debt financing,

then, for purposes of determining the special deductions under section 806 of the Internal Revenue Code of 1954 (as amended by this subtitle), the amount of tentative LICTI of such life insurance company shall be computed without taking into account any income, gain, loss, or deduction attributable to the ownership of such stock.

(l) TREATMENT OF LOSSES FROM CERTAIN GUARANTEED INTEREST CONTRACTS.—

(1) IN GENERAL.—For purposes of determining the amount of the special deductions under section 806 of the Internal Revenue Code of 1954 (as amended by this subtitle), for any taxable year beginning before January 1, 1988, the amount of tentative LICTI of any qualified life insurance company shall be computed without taking into account any income, gain, loss, or deduction attributable to a qualified GIC.

(2) QUALIFIED LIFE INSURANCE COMPANY.—For purposes of this subsection, the term "qualified life insurance company" means any life insurance company if—

(A) the accrual of discount less amortization of premium for bonds and short-term investments (as shown in the first footnote to Exhibit 3 of its 1983 annual statement for life insurance companies approved by the National Association of Insurance Commissioners (but excluding separate accounts) filed in its state of domicile) exceeds $72,000,000 but does not exceed $73,000,000, and

(B) such life insurance company makes an election under this subsection on its return for its first taxable year beginning after December 31, 1983.

(3) QUALIFIED GIC.—The term "qualified GIC" means any group contract—

(A) which is issued before January 1, 1984,

(B) which specifies the contract maturity or renewal date,

(C) under which funds deposited by the contract holder plus interest guaranteed at the inception of the contract for the term of the contract and net of any specified expenses are paid as directed by the contract holder, and

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(D) which is a pension plan contract (as defined in section 818(a) of the Internal Revenue Code of 1954).

(4) SCOPE OF ELECTION.—An election under this subsection shall apply to all qualified GIC's of a qualified life insurance company. Any such election, once made, shall be irrevocable.

(5) INCOME ON UNDERLYING ASSETS TAKEN INTO ACCOUNT.—In determining the amount of any income attributable to a qualified GIC, income on any asset attributable to such contract (as determined in the manner provided by the Secretary of the Treasury or his delegate) shall be taken into account.

(6) LIMITATION ON TAX BENEFIT.—The amount of any reduction in tax for any taxable year by reason of this subsection for any qualified life insurance company (or controlled group within the meaning of section 806(d)(3) of the Internal Revenue Code of 1954) shall not exceed the applicable amount set forth in the following table:

In the case of taxable years beginning in:	The reduction may not exceed:
1984	$4,500,000
1985	$4,500,000
1986	$3,000,000
1987	$2,000,000

(m) SPECIAL RULE FOR CERTAIN INTERESTS IN OIL AND GAS PROPERTIES.—

(1) IN GENERAL.—For purposes of section 806 of the Internal Revenue Code of 1954, the ownership by a qualified life insurance company of any undivided interest in operating mineral interests with respect to any oil or gas properties held on December 31, 1983, shall be treated as an insurance business.

(2) QUALIFIED LIFE INSURANCE COMPANY.—For purposes of paragraph (1), the term "qualified life insurance company" means a mutual life insurance company which—

(A) was originally incorporated in March of 1857, and

(B) has a cost to such company (as of December 31, 1983) in the operating mineral interests described in paragraph (1) in excess of $250,000,000.

SEC. 218. UNDERPAYMENTS OF ESTIMATED TAX FOR 1984.

No addition to the tax shall be made under section 6655 of the Internal Revenue Code of 1954 (relating to failure by corporation to pay estimated tax) with respect to any underpayment of an installment required to be paid before the date of the enactment of this Act to the extent—

(1) such underpayment was created or increased by any provision of this subtitle, and

(2) such underpayment is paid in full on or before the last date prescribed for payment of the first installment of estimated tax required to be paid after the date of the enactment of this Act.

SEC. 219. CLARIFICATION OF APPLICATION OF SECTION 6001.

Nothing in any provision of law shall be construed to prevent the Secretary of the Treasury or his delegate from exercising his authority under section 6001 of the Internal Revenue Code of 1954 to require (from time to time) life insurance companies to provide such data with respect to taxable years beginning before January 1, 1984, as may be necessary to carry out the provisions of section 809 of such Code (as added by this title).

Subtitle B—Taxation of Life Insurance Products

SEC. 221. DEFINITION OF LIFE INSURANCE CONTRACT.

(a) GENERAL RULE.—Chapter 79 (relating to definitions) is amended by adding at the end thereof the following new section:

"SEC. 7702. LIFE INSURANCE CONTRACT DEFINED.

"(a) GENERAL RULE.—For purposes of this title, the term 'life insurance contract' means any contract which is a life insurance contract under the applicable law, but only if such contract—

"(1) meets the cash value accumulation test of subsection (b), or

"(2)(A) meets the guideline premium requirements of subsection (c), and

"(B) falls within the cash value corridor of subsection (d).

"(b) CASH VALUE ACCUMULATION TEST FOR SUBSECTION (a)(1).—

"(1) IN GENERAL.—A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

"(2) RULES FOR APPLYING PARAGRAPH (1).—Determinations under paragraph (1) shall be made—

"(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract,

"(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3), and

"(C) by taking into account under subparagraphs (A) and (C) of subsection (e)(1) only current and future death benefits and qualified additional benefits.

"(c) GUIDELINE PREMIUM REQUIREMENTS.—For purposes of this section—

"(1) IN GENERAL.—A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

"(2) GUIDELINE PREMIUM LIMITATION.—The term 'guideline premium limitation' means, as of any date, the greater of—

"(A) the guideline single premium, or

"(B) the sum of the guideline level premiums to such date.

"(3) GUIDELINE SINGLE PREMIUM.—

"(A) IN GENERAL.—The term 'guideline single premium' means the premium at issue with respect to future benefits under the contract.

"(B) BASIS ON WHICH DETERMINATION IS MADE.—The determination under subparagraph (A) shall be based on—

"(i) the mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract),

"(ii) any charges (not taken into account under clause (i)) specified in the contract (the amount of any charge not so specified shall be treated as zero), and

"(iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

"(C) WHEN DETERMINATION MADE.—Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

"(4) GUIDELINE LEVEL PREMIUM.—The term 'guideline level premium' means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting '4 percent' for '6 percent'.

"(d) CASH VALUE CORRIDOR FOR PURPOSES OF SUBSECTION (a)(2)(B).—For purposes of this section—

"(1) IN GENERAL.—A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

"(2) APPLICABLE PERCENTAGE.—

In the case of an insured with an attained age as of the beginning of the contract year of: More than	But not more than:	The applicable percentage shall decrease by a ratable portion for each full year: From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100.

"(e) COMPUTATIONAL RULES.—

"(1) IN GENERAL.—For purposes of this section—

"(A) the death benefit (and any qualified additional benefit) shall be deemed not to increase,

"(B) the maturity date, including the date on which any benefit described in subparagraph (C) is payable, shall be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100, and

"(C) the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date described in subparagraph (B)) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

"(2) LIMITED INCREASES IN DEATH BENEFIT PERMITTED.—Notwithstanding paragraph (1)(A)—

"(A) for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract, and

"(B) for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the contract will meet such test at all times assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium.

"(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PREMIUMS PAID.—

"(A) IN GENERAL.—The term 'premiums paid' means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any other amounts received with respect to the contract which are specified in regulations.

"(B) TREATMENT OF CERTAIN PREMIUMS RETURNED TO POLICYHOLDER.—If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such year.

"(C) INTEREST RETURNED INCLUDIBLE IN GROSS INCOME.—Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

"(2) CASH VALUES.—

"(A) CASH SURRENDER VALUE.—The cash surrender value of any contract shall be its

cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

"(B) NET SURRENDER VALUE.—The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

"(3) DEATH BENEFIT.—The term 'death benefit' means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

"(4) FUTURE BENEFITS.—The term 'future benefits' means death benefits and endowment benefits.

"(5) QUALIFIED ADDITIONAL BENEFITS.—

"(A) IN GENERAL.—The term 'qualified additional benefits' means any—

"(i) guaranteed insurability,

"(ii) accidental death or disability benefit,

"(iii) family term coverage,

"(iv) disability waiver benefit, or

"(v) other benefit prescribed under regulations.

"(B) TREATMENT OF QUALIFIED ADDITIONAL BENEFITS.—For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

"(C) TREATMENT OF OTHER ADDITIONAL BENEFITS.—In the case of any additional benefit which is not a qualified additional benefit—

"(i) such benefit shall not be treated as a future benefit, and

"(ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

"(6) PREMIUM PAYMENTS NOT DISQUALIFYING CONTRACT.—The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

"(7) ADJUSTMENTS.—

"(A) IN GENERAL.—In the event of a change in the future benefits or any qualified additional benefit (or in any other terms) under the contract which was not reflected in any previous determination made under this section, under regulations prescribed by the Secretary, there shall be proper adjustments in future determinations made under this section.

"(B) CERTAIN CHANGES TREATED AS EXCHANGE.—In the case of any change which reduces the future benefits under the contract, such change shall be treated as an exchange of the contract for another contract.

"(8) CORRECTION OF ERRORS.—If the taxpayer establishes to the satisfaction of the Secretary that—

"(A) the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and

"(B) reasonable steps are being taken to remedy the error,

the Secretary may waive the failure to satisfy such requirements.

"(9) SPECIAL RULE FOR VARIABLE LIFE INSURANCE CONTRACTS.—In the case of any contract which is a variable contract (as defined in section 817), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.

"(g) TREATMENT OF CONTRACTS WHICH DO NOT MEET SUBSECTION (a) TEST.—

"(1) INCOME INCLUSION.—

"(A) IN GENERAL.—If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

"(B) INCOME ON THE CONTRACT.—For purposes of this paragraph, the term 'income on the contract' means, with respect to any taxable year of the policyholder, the excess of—

"(i) the sum of—

"(I) the increase in the net surrender value of the contract during the taxable year, and

"(II) the cost of life insurance protection provided under the contract during the taxable year, over

"(ii) the amount of premiums paid under the contract during the taxable year reduced by any policyholder dividends received during such taxable year.

"(C) CONTRACTS WHICH CEASE TO MEET DEFINITION.—If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

"(D) COST OF LIFE INSURANCE PROTECTION.—For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of—

"(i) the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or

"(ii) the mortality charge (if any) stated in the contract.

"(2) TREATMENT OF AMOUNT PAID ON DEATH OF INSURED.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.

"(3) CONTRACT CONTINUES TO BE TREATED AS INSURANCE CONTRACT.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

"(h) ENDOWMENT CONTRACTS RECEIVE SAME TREATMENT.—

"(1) IN GENERAL.—References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.

"(2) DEFINITION OF ENDOWMENT CONTRACT.—For purposes of this title (other than paragraph (1)), the term 'endowment contract' means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

"(i) TRANSITIONAL RULE FOR CERTAIN 20-PAY CONTRACTS.—

"(1) IN GENERAL.—In the case of a qualified 20-pay contract, this section shall be applied by substituting '3 percent' for '4 percent' in subsection (b)(2).

"(2) QUALIFIED 20-PAY CONTRACT.—For purposes of paragraph (1), the term 'qualified 20-pay contract' means any contract which—

"(A) requires at least 20 nondecreasing annual premium payments, and

"(B) is issued pursuant to an existing plan of insurance.

"(3) EXISTING PLAN OF INSURANCE.—For purposes of this subsection, the term 'existing plan of insurance' means, with respect to any contract, any plan of insurance which was filed by the company issuing such contract in 1 or more States before September 28, 1983, and is on file in the appropriate State for such contract.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.".

(b) 1-YEAR EXTENSION OF FLEXIBLE PREMIUM CONTRACT PROVISIONS.—

(1) IN GENERAL.—Paragraph (1) of section 266(c) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by striking out "January 1, 1984" and inserting in lieu thereof "January 1, 1985".

(2) TECHNICAL AMENDMENTS.—

(A) Paragraph (1) of section 101(f) is amended by striking out "flexible premium life insurance contract" and inserting in lieu thereof "flexible premium life insurance contract issued before January 1, 1985".

(B) The subsection heading of subsection (f) of section 101 is amended by striking out "FLEXIBLE PREMIUM CONTRACTS" and inserting in lieu thereof "FLEXIBLE PREMIUM CONTRACTS ISSUED BEFORE JANUARY 1, 1985".

(c) CLERICAL AMENDMENT.—The table of sections for chapter 79 is amended by adding at the end thereof the following new item:

"Sec. 7702. Life insurance contract defined.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to contracts issued after December 31, 1984, in taxable years ending after such date.

(2) SPECIAL RULE FOR CERTAIN CONTRACTS ISSUED AFTER JUNE 30, 1984.—

(A) GENERAL RULE.—Except as otherwise provided in this paragraph, the amendments made by this section shall apply also to any contract issued after June 30, 1984, which provides an increasing death benefit and has premium funding more rapid that 10-year level premium payments.

(B) EXCEPTION FOR CERTAIN CONTRACTS.—Subparagraph (A) shall not apply to any contract if—

(i) such contract (whether or not a flexible premium contract) would meet the requirements of section 101(f) of the Internal Revenue Code of 1954,

(ii) such contract is not a flexible premium life insurance contract (within the meaning of section 101(f) of such Code) and would meet the requirements of section 7702 of such Code determined by—

(I) substituting "3 percent" for "4 percent" in section 7702(b)(2) of such Code, and

(II) treating subparagraph (B) of section 7702(e)(1) of such Code as if it read as follows: "the maturity date shall be the latest maturity date permitted under the contract, but not less than 20 years after the date of issue or (if earlier) age 95", or

(iii) under such contract—

(I) the premiums (including any policy fees) will be adjusted from time-to-time to reflect the level amount necessary (but not less than zero) at the time of such adjustment to provide a level death benefit assuming interest crediting and an annual effective interest rate of not less than 3 percent, or

(II) at the option of the insured, in lieu of an adjustment under subclause (I) there will be a comparable adjustment in the amount of the death benefit.

(C) CERTAIN CONTRACTS ISSUED BEFORE OCTOBER 1, 1984.—

(i) IN GENERAL.—Subparagraph (A) shall be applied by substituting "September 30, 1984" for "June 30, 1984" in clause (i) thereof in the case of a contract—

(I) which would meet the requirements of section 7702 of such Code if "3 percent" were substituted for "4 percent" in section 7702(b)(2) of such Code, and the rate or rates guaranteed on issuance of the contract were determined without regard to any mortality charges, and

(II) the cash surrender value of which does not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

(ii) DEFINITIONS.—For purposes of clause (i)—

(I) IN GENERAL.—Except as provided in subclause (II), terms used in clause (i) shall have the same meanings as when used in section 7702 of such Code.

(II) NET SINGLE PREMIUM.—The term "net single premium" shall be determined by substituting "3 percent" for "4 percent" in section 7702(b)(2) of such Code, by using the 1958 standard ordinary mortality and morbidity tables of the National Association of Insurance Commissioners, and by assuming a level death benefit.

(3) TRANSITIONAL RULE FOR CERTAIN EXISTING PLANS OF INSURANCE.—A plan of insurance on file in 1 or more States before September 28, 1983, shall be treated for purposes of section 7702(i)(3) of such Code as a plan of insurance on file in 1 or more States before September 28, 1983, without regard to whether such plan of insurance is modified after September 28, 1983, to permit the crediting of excess interest or similar amounts annually and not monthly under contracts issued pursuant to such plan of insurance.

(4) EXTENSION OF FLEXIBLE PREMIUM CONTRACT PROVISIONS.—The amendments made by subsection (b) shall take effect on January 1, 1984.

(5) SPECIAL RULE FOR MASTER CONTRACT.—For purposes of this subsection, in the case of a master contract, the date taken into account with respect to any insured shall be the first date on which such insured is covered under such contract.

SEC. 222. TREATMENT OF CERTAIN ANNUITY CONTRACTS.

(a) PENALTY ON PREMATURE DISTRIBUTIONS.—Paragraph (1) of section 72(q) (relating to 5-percent penalty for premature distributions from annuity contracts) is amended to read as follows:

"(1) IMPOSITION OF PENALTY.—If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 5 percent of the portion of such amount which is includible in gross income."

(b) REQUIRED DISTRIBUTIONS WHERE HOLDER DIES BEFORE ENTIRE INTEREST IS DISTRIBUTED.—Section 72 (relating to annuities; certain proceeds of endowment and life insurance contracts) is amended by redesignating subsection (s) and subsection (t) and by inserting after subsection (r) the following new subsection:

"(s) REQUIRED DISTRIBUTIONS WHERE HOLDER DIES BEFORE ENTIRE INTEREST IS DISTRIBUTED.—

"(1) IN GENERAL.—A contract shall not be treated as an annuity contract for purposes of this title unless it provides that—

"(A) if the holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

"(B) if the holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

"(2) EXCEPTION FOR CERTAIN AMOUNTS PAYABLE OVER LIFE OF BENEFICIARY.—If—

"(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

"(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

"(C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,

then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

"(3) SPECIAL RULE WHERE SURVIVING SPOUSE BENEFICIARY.—If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

"(4) DESIGNATED BENEFICIARY.—For purposes of this subsection, the term 'designated beneficiary' means any individual designated a beneficiary by the holder of the contract."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to contracts issued after the day which is 6 months after the date of the enactment of this Act in taxable years ending after such date.

(2) TRANSITIONAL RULES FOR CONTRACTS ISSUED BEFORE EFFECTIVE DATE.—In the case of any contract (other than a single premium contract) which is issued on or before the day which is 6 months after the date of the enactment of this Act, for purposes of section 72(q)(1)(A) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act), any investment in such contract which is made during any calendar year shall be treated as having been made on January 1 of such calendar year.

SEC. 223. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES.

(a) SECTION 79 EXTENDED TO FORMER EMPLOYEES.—

(1) Section 79 (relating to group-term insurance purchased for employees) is amended by adding at the end thereof the following new subsection:

"(e) EMPLOYEE INCLUDES FORMER EMPLOYEE.—For purposes of this section, the term 'employee' includes a former employee."

(2) Paragraph (1) of section 79(b) is amended to read as follows:

"(1) the cost of group-term life insurance on the life of an individual which is provided under a policy carried directly or indirectly by an employer after such individual has terminated his employment with such employer and is disabled (within the meaning of section 72(m)(7)),".

(b) AMOUNT OF INCLUSION IN CASE OF DISCRIMINATORY PLANS.—Paragraph (1) of section 79(d) (relating to nondiscrimination requirements) is amended to read as follows:

"(1) IN GENERAL.—In the case of a discriminatory group-term life insurance plan—

"(A) subsection (a)(1) shall not apply with respect to any key employee, and

"(B) the cost of group-term life insurance on the life of any key employee shall be determined without regard to subsection (c),"

(c) CLARIFICATION OF COORDINATION WITH SECTION 83.—Subsection (e) of section 83 (relating to application of section) is amended by striking out "or" at the end of paragraph (3), by striking out the period at the end of paragraph (4) and inserting in lieu thereof ", or", and by adding at the end thereof the following new paragraph:

"(5) the cost of group-term life insurance to which section 79 applies.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1983.

(2) INCLUSION OF FORMER EMPLOYEES IN THE CASE OF EXISTING GROUP-TERM INSURANCE PLANS.—

(A) IN GENERAL.—The amendments made by subsection (a) shall not apply—

(i) to any group-term life insurance plan of the employer in existence on January 1, 1984, or

(ii) to any group-term life insurance plan of the employer (or a successor employer) which is a comparable successor to a plan described in clause (i),

but only with respect to an individual who attained age 55 on or before January 1, 1984 and either was employed by such employer at any time during 1983 or retired from employment with such employer on or before January 1, 1984.

(B) SPECIAL RULE IN THE CASE OF DISCRIMINATORY GROUP-TERM LIFE INSURANCE PLAN.—In the case of any plan which, after December 31, 1986, is a discriminatory group-term life insurance plan (as defined in section 79(d) of the Internal Revenue Code of 1954), subparagraph (A) shall not apply in the case of any individual retiring under such plan after December 31, 1986.

(C) BENEFITS TO CERTAIN RETIRED INDIVIDUALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DETERMINING WHETHER PLAN IS DISCRIMINATORY.—For purposes of determining whether after December 31, 1986, a plan described in subparagraph (A) meets the requirements of section 79(d) of the Internal Revenue Code of 1954 with respect to group-term life insurance for former employees, coverage provided to employees who retired on or before December 31, 1986, shall not be taken into account.

SEC. 224. TREATMENT OF CERTAIN EXCHANGES OF INSURANCE POLICIES.

(a) GENERAL RULE.—Paragraph (1) of section 1035(b) (defining endowment contract) is amended by striking out "a life insurance company as defined in section 801" and inserting in lieu thereof "an insurance company subject to tax under subchapter L".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to all exchanges whether before, on, or after the date of the enactment of this Act.

Subtitle C—Studies

SEC. 231. STUDIES.

(a) REVENUE REPORTS.—Not later than July 1, 1985, and July 1 of each calendar year thereafter, the Secretary of the Treasury shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on—

(1) the aggregate amount of revenue received under part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 for the most recent taxable years for which data are available,

(2) a comparison between the amount of such revenue and the amount anticipated by reason of changes made by the Tax Equity and Fiscal Responsibility Act of 1982 or the Life Insurance Tax Act of 1984, and

(3) the reasons for any difference between such aggregate revenues and anticipated revenues.

(b) REPORT WITH RESPECT TO SEGMENT BALANCE, ETC.—

(1) IN GENERAL.—The Secretary of the Treasury (in consultation with the Joint Committee on Taxation, the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate) shall conduct a full and complete study of the operation of part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 during 1984, 1985, and 1986. Such study shall also include an analysis of life insurance products and the taxation thereof. Such study shall also include an analysis of whether part I of such subchapter L operates as a disincentive to growing companies.

(2) ITEMS TO BE INCLUDED.—The study conducted under paragraph (1) shall include—

(A) an analysis of the portion of the taxes paid by mutual life insurance companies and stock life insurance companies, and

(B) any other data considered relevant by either stock life insurance companies or mutual life insurance companies in determining appropriate segment balance, such as the respective amounts of the following items held by each segment of the industry—

(i) equity,

(ii) life insurance reserves,

(iii) other types of reserves,

(iv) dividends paid to policyholders and shareholders,

(v) pension business,

(vi) total assets, and

(vii) gross receipts.

Such report shall also include an analysis of the extent to which taxes paid by stockholders of life insurance companies shall be included in analyzing segment balance.

(3) REPORTS.—

(A) INTERIM REPORTS.—The Secretary of the Treasury shall submit interim reports on the study conducted under this subsection to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate not later than July 1, 1986, 1987, and 1988.

(B) FINAL REPORT.—Not later than January 1, 1989, the Secretary of the Treasury shall submit a final report on the study conducted under this subsection to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

(c) AUTHORITY TO REQUIRE DATA.—The Secretary of the Treasury shall have authority to require reporting of such data with respect to life insurance companies and their products as may be necessary to carry out the purposes of this section.

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

SEC. 301. LIMITATIONS ON DEDUCTION FOR CONTRIBUTIONS TO PRIVATE FOUNDATIONS.

(a) INCREASE IN PERCENTAGE LIMITATION FOR INDIVIDUALS.—

(1) IN GENERAL.—Clause (i) of section 170(b)(1)(B) (relating to percentage limitations for individuals) is amended by striking out "20 percent" and inserting in lieu thereof "30 percent".

(2) CARRYOVER OF EXCESS CONTRIBUTIONS.—Subparagraph (B) of section 170(b)(1) is amended by adding at the end thereof the following new sentence:

"If the aggregate of such contributions exceeds the limitation of the preceding sentence, such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution (to which subparagraph (A) does not apply) in each of the 5 succeeding taxable years in order of time."

(b) DEDUCTION ALLOWED FOR FULL FAIR MARKET VALUE OF CERTAIN STOCK CONTRIBUTED TO PRIVATE FOUNDATIONS.—Subsection (e) of section 170 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR CONTRIBUTIONS OF STOCK FOR WHICH MARKET QUOTATIONS ARE READILY AVAILABLE.—

"(A) IN GENERAL.—Subparagraph (B)(ii) of paragraph (1) shall not apply to any contribution of qualified appreciated stock.

"(B) QUALIFIED APPRECIATED STOCK.—Except as provided in subparagraph (C), for purposes of this paragraph, the term 'qualified appreciated stock' means any stock of a corporation—

"(i) for which (as of the date of the contribution) market quotations are readily available on an established securities market, and

"(ii) which is capital gain property (as defined in subsection (b)(1)(C)(iv)).

"(C) DONOR MAY NOT CONTRIBUTE MORE THAN 10 PERCENT OF STOCK OF CORPORATION.—

"(i) IN GENERAL.—In the case of any donor, the term 'qualified appreciated stock' shall not include any stock of a corporation contributed by the donor in a contribution to which paragraph (1)(B)(ii) applies (determined without regard to this paragraph) to the extent that the amount of the stock so contributed (when increased by the aggregate amount of all prior such contributions by the donor of stock in such corporation) exceeds 10 percent (in value) of all of the outstanding stock of such corporation.

"(ii) SPECIAL RULE.—For purposes of clause (i), an individual shall be treated as making all contributions made by any member of his family (as defined in section 267(c)(4)).

"(D) TERMINATION.—This paragraph shall not apply to contributions made after December 31, 1994."

(c) 20-PERCENT LIMITATION RETAINED FOR CONTRIBUTIONS OF CAPITAL GAIN PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 170(b) (relating to percentage limitations for individuals) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL LIMITATION WITH RESPECT TO CONTRIBUTIONS OF CAPITAL GAIN PROPERTY TO ORGANIZATIONS NOT DESCRIBED IN SUBPARAGRAPH (A).—

"(i) IN GENERAL.—In the case of charitable contributions (other than charitable contributions to which subparagraph (A) applies) of capital gain property, the total amount of such contributions of such property taken into account under subsection (a) for any taxable year shall not exceed the lesser of—

"(I) 20 percent of the taxpayer's contribution base for the taxable year, or

"(II) the excess of 30 percent of the taxpayer's contribution base for the taxable year over the amount of the contributions of capital gain property to which subparagraph (C) applies.

For purposes of this subsection, contributions of capital gain property to which this subparagraph applies shall be taken into account after all other charitable contributions.

"(ii) CARRYOVER.—If the aggregate amount of contributions described in clause (i) exceeds the limitation of clause (i), such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution of capital gain property to which clause (i) applies in each of the 5 succeeding taxable years in order of time."

(2) TECHNICAL AMENDMENTS.—

(A) Clause (vii) of section 170(b)(1)(A) is amended by striking out "subparagraph (D)" and inserting in lieu thereof "subparagraph (E)".

(B) The subparagraph heading and clause (i) of subparagraph (C) of section 170(b)(1) are amended to read as follows:

"(C) SPECIAL LIMITATION WITH RESPECT TO CONTRIBUTIONS DESCRIBED IN SUBPARAGRAPH (A) OF CERTAIN CAPITAL GAIN PROPERTY.—

"(i) In the case of charitable contributions described in subparagraph (A) of capital gain property to which subsection (e)(1)(B) does not apply, the total amount of contributions of such property which may be taken into account under subsection (a) for any taxable year shall not exceed 30 percent of the taxpayer's contribution base for such year. For purposes of this subsection, contributions of capital gain property to which this subparagraph applies shall be taken into account after all other charitable contributions (other than charitable contributions to which subparagraph (D) applies)."

(C) Subparagraph (B) of section 170(e)(1) is amended by striking out "subsection (b)(1)(D)" and inserting in lieu thereof "subsection (b)(1)(E)".

(d) EFFECTIVE DATES.—

(1) SUBSECTIONS (a) AND (c).—The amendments made by subsections (a) and (c) shall apply to contributions made in taxable years ending after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to contributions made after the date of the enactment of this Act in taxable years ending after such date.

SEC. 302. EXEMPTION FOR CERTAIN OPERATING FOUNDATIONS FROM EXCISE TAX ON INVESTMENT INCOME.

(a) GENERAL RULE.—Section 4940 (relating to excise tax based on investment income) is amended by adding at the end thereof the following new subsection:

"(d) EXEMPTION FOR CERTAIN OPERATING FOUNDATIONS.—

"(1) IN GENERAL.—No tax shall be imposed by this section on any private foundation which is an exempt operating foundation for the taxable year.

"(2) EXEMPT OPERATING FOUNDATION.—For purposes of this subsection, the term 'exempt operating foundation' means, with respect to any taxable year, any private foundation if—

"(A) such foundation is an operating foundation (as defined in section 4942(j)(3)),

"(B) such foundation has been publicly supported for at least 10 taxable years,

"(C) at all times during the taxable year, the governing body of such foundation—

"(i) consists of individuals at least 75 percent of whom are not disqualified individuals, and

"(ii) is broadly representative of the general public, and

"(D) at no time during the taxable year does such foundation have an officer who is a disqualified individual.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) PUBLICLY SUPPORTED.—A private foundation is publicly supported for a taxable year if it meets the requirements of section 170(b)(1)(A)(vi) or 509(a)(2) for such taxable year.

"(B) DISQUALIFIED INDIVIDUAL.—The term 'disqualified individual' means, with respect to any private foundation, an individual who is—

"(i) a substantial contributor to the foundation,

"(ii) an owner of more than 20 percent of—

"(I) the total combined voting power of a corporation,

"(II) the profits interest of a partnership, or

"(III) the beneficial interest of a trust or unincorporated enterprise,

which is a substantial contributor to the foundation, or

"(iii) a member of the family of any individual described in clause (i) or (ii).

"(C) SUBSTANTIAL CONTRIBUTOR.—The term 'substantial contributor' means a person who is described in section 507(d)(2).

"(D) FAMILY.—The term 'family' has the meaning given to such term by section 4946(d).

"(E) CONSTRUCTIVE OWNERSHIP.—The rules of paragraphs (3) and (4) of section 4946(a) shall apply for purposes of subparagraph (B)(ii)."

(b) REQUIREMENT OF EXPENDITURE RESPONSIBILITY NOT TO APPLY TO CERTAIN OPERATING FOUNDATIONS.—Paragraph (4) of section 4945(d) (defining taxable expenditure) is amended to read as follows:

"(4) as a grant to an organization unless—

"(A) such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation (as defined in section 4940(d)(2)), or

"(B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h), or".

(c) EFFECTIVE DATE.—

(1) FOR SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

(2) FOR SUBSECTION (b).—The amendment made by subsection (b) shall apply to grants made after December 31, 1984, in taxable years ending after such date.

(3) CERTAIN EXISTING FOUNDATIONS.—A foundation which was an operating foundation (as defined in section 4942(j)(3) of the Internal Revenue Code of 1954) as of January 1, 1983, shall be treated as meeting the requirements of section 4940(d)(2)(B) of such Code (as added by subsection (a)).

SEC. 303. REDUCTION IN EXCISE TAX ON INVESTMENT INCOME WHERE PRIVATE FOUNDATION MEETS CERTAIN DISTRIBUTION REQUIREMENTS.

(a) GENERAL RULE.—Section 4940 (relating to excise tax based on investment income) is amended by adding at the end thereof the following new subsection:

"(e) REDUCTION IN TAX WHERE PRIVATE FOUNDATION MEETS CERTAIN DISTRIBUTION REQUIREMENTS.—

"(1) IN GENERAL.—In the case of any private foundation which meets the requirements of paragraph (2) for any taxable year, subsection (a) shall be applied with respect to such taxable year by substituting '1 percent' for '2 percent'.

"(2) REQUIREMENTS.—A private foundation meets the requirements of this paragraph for any taxable year if—

"(A) the amount of the qualifying distributions made by the private foundation during such taxable year equals or exceeds the sum of—

"(i) an amount equal to the assets of such foundation for such taxable year multiplied by the average percentage payout for the base period, plus

"(ii) 1 percent of the net investment income of such foundation for such taxable year, and

"(B) the average percentage payout for the base period equals or exceeds 5 percent.

In the case of an operating foundation (as defined in section 4942(j)(3)), subparagraph (B) shall be applied by substituting '3½ percent' for '5 percent'.

"(3) AVERAGE PERCENTAGE PAYOUT FOR BASE PERIOD.—For purposes of this subsection—

"(A) IN GENERAL.—The average percentage payout for the base period is the average of the percentage payouts for taxable years in the base period.

"(B) PERCENTAGE PAYOUT.—The term 'percentage payout' means, with respect to any taxable year, the percentage determined by dividing—

"(i) the amount of the qualifying distributions made by the private foundation during the taxable year, by

"(ii) the assets of the private foundation for the taxable year.

"(C) SPECIAL RULE WHERE TAX REDUCED UNDER THIS SUBSECTION.—For purposes of this paragraph, if the amount of the tax imposed by this section for any taxable year in the base period is reduced by reason of this subsection, the amount of the qualifying distributions made by the private foundation during such year shall be reduced by the amount of such reduction in tax.

"(4) BASE PERIOD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'base period' means, with respect to any taxable year, the 5 taxable years preceding such taxable year.

"(B) NEW PRIVATE FOUNDATIONS, ETC.—If an organization has not been a private foundation throughout the base period referred to in subparagraph (A), the base period shall consist of the taxable years during which such foundation has been in existence.

"(5) OTHER DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFYING DISTRIBUTION.—The term 'qualifying distribution' has the meaning given such term by section 4942(g).

"(B) ASSETS.—The assets of a private foundation for any taxable year shall be treated as equal to the excess determined under section 4942(e)(1).

"(6) TREATMENT OF SUCCESSOR ORGANIZATIONS, ETC.—In the case of—

"(A) a private foundation which is a successor to another private foundation, this subsection shall be applied with respect to such successor by taking into account the experience of such other foundation, and

"(B) a merger, reorganization, or division of a private foundation, this subsection shall be applied under regulations prescribed by the Secretary."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 304. AMENDMENT TO TAXES ON FAILURE TO DISTRIBUTE INCOME.

(a) LIMIT ON AMOUNT OF CERTAIN ADMINISTRATIVE EXPENSES TAKEN INTO ACCOUNT AS QUALIFYING DISTRIBUTIONS.—

(1) Subsection (g) of section 4942 (defining qualified distributions) is amended by adding at the end thereof the following new paragraph:

"(4) LIMITATION ON ADMINISTRATIVE EXPENSES ALLOCABLE TO MAKING OF CONTRIBUTIONS, GIFTS, AND GRANTS.—

"(A) IN GENERAL.—The amount of the grant administrative expenses paid during any taxable year which may be taken into account as qualifying distributions shall not exceed the excess (if any) of—

"(i) .65 percent of the sum of the net assets of the private foundation for such taxable year and the immediately preceding 2 taxable years, over

"(ii) the aggregate amount of grant administrative expenses paid during the 2 preceding taxable years which were taken into account as qualifying distributions.

"(B) GRANT ADMINISTRATIVE EXPENSES.—For purposes of this paragraph, the term 'grant administrative expenses' means any administrative expenses which are allocable to the making of qualified grants.

"(C) QUALIFIED GRANTS.—For purposes of this paragraph, the term 'qualified grant' means any contribution, gift, or grant which is a qualifying distribution.

"(D) NET ASSET.—For purposes of this paragraph, the term 'net assets' means, with respect to any taxable year, the excess determined under subsection (e)(1) for such taxable year.

"(E) TRANSITIONAL RULE.—In the case of any preceding taxable year which begins before January 1, 1985, the amount of the grant administrative expenses taken into account under subparagraph (A)(ii) shall not exceed .65 percent of the net assets of the private foundation for such taxable year.

"(F) TERMINATION.—This paragraph shall not apply to taxable years beginning after December 31, 1990."

(2) Subparagraph (A) of section 4942(g)(1) (defining qualifying distribution) is amended by striking out "including administrative expenses" and inserting in lieu thereof "including that portion of reasonable and necessary administrative expenses".

(b) REQUIRED DISTRIBUTION INCREASED BY AMOUNT OF CERTAIN REPAYMENTS, ETC.—Paragraph (1) of section 4942(d) (defining distributable amount) is amended to read as follows:

"(1) the sum of the minimum investment return plus the amounts described in subsection (f)(2)(C), reduced by".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 305. ABATEMENT OF FIRST TIER TAXES IN CERTAIN CASES.

(a) GENERAL RULE.—Subchapter C of chapter 42 (relating to abatement of second tier taxes) is amended by redesignating section 4962 as section 4963 and by inserting after section 4961 the following new section:

"SEC. 4962. ABATEMENT OF PRIVATE FOUNDATION FIRST TIER TAXES IN CERTAIN CASES.

"(a) GENERAL RULE.—If it is established to the satisfaction of the Secretary that—

"(1) a taxable event was due to reasonable cause and not to willful neglect, and

"(2) such event was corrected within the correction period for such event,

then any private foundation first tier tax imposed with respect to such event (including interest) shall not be assessed and, if assessed, the assessment shall be abated and, if collected, shall be credited or refunded as an overpayment.

"(b) PRIVATE FOUNDATION FIRST TIER TAX.—For purposes of this section, the term 'private foundation first tier tax' means any first tier tax imposed by subchapter A of chapter 42, except that such term shall not include the tax imposed by section 4941(a) (relating to initial tax on self-dealing)."

(b) CONFORMING AMENDMENTS.—

(1) The heading of subchapter C of chapter 42 is amended to read as follows:

"Subchapter C—Abatement of First and Second Tier Taxes in Certain Cases".

(2) The table of sections for subchapter C of chapter 42 is amended by striking out the item relating to section 4962 and inserting in lieu thereof the following:

"Sec. 4962. Abatement of private foundation first tier taxes in certain cases.
"Sec. 4963. Definitions."

(3) The table of subchapters for chapter 42 is amended by striking out the item relating to subchapter C and inserting in lieu thereof the following:

"SUBCHAPTER C. Abatement of first and second tier taxes in certain cases."

(4) Sections 4942(g)(2)(C), 6213(e), and 6503(g) are each amended by striking out "section 4962(e)" and inserting in lieu thereof "section 4963(e)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable events occurring after December 31, 1984.

SEC. 306. MISCELLANEOUS AMENDMENTS.

(a) DEFINITION OF FAMILY MEMBER.—Subsection (d) of section 4946 (defining members of family) is amended to read as follows:

"(d) MEMBERS OF FAMILY.—For purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren."

(b) REQUIREMENT THAT ANNUAL NOTICE INCLUDE TELEPHONE NUMBER OF THE PRIVATE FOUNDATION.—Subsection (d) of section 6104 (relating to public inspection of private foundations' annual returns) is amended by striking out "shall state the address of the private foundation's principal office" and inserting in lieu thereof "shall state the address and the telephone number of the private foundation's principal office".

(c) EFFECTIVE DATES.—The amendments made by this subsection shall take effect on January 1, 1985.

SEC. 307. 5-YEAR EXTENSION OF REQUIREMENT TO DISPOSE OF CERTAIN EXCESS HOLDINGS ATTRIBUTABLE TO LARGE GIFTS AND BEQUESTS.

(a) GENERAL RULE.—Subsection (c) of section 4943 (relating to taxes on excess business holdings) is amended by adding at the end thereof the following new paragraph:

"(7) 5-YEAR EXTENSION OF PERIOD TO DISPOSE OF CERTAIN LARGE GIFTS AND BEQUESTS.—The Secretary may extend for an additional 5-year period the period under paragraph (6) for disposing of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if—

"(A) the foundation establishes that—

"(i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and

"(ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of such holdings,

"(B) before the close of the initial 5-year period—

"(i) the private foundation submits to the Secretary a plan for disposing of all of the excess business holdings involved in the extension, and

"(ii) the private foundation submits the plan described in clause (i) to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings involved and submits to the Secretary any response received by the private foundation from the Attorney General (or other appropriate State official) to such plan during such 5-year period, and

"(C) the Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to business holdings with respect to which the 5-year period described in section 4943(c)(6) of the Internal Revenue Code of 1954 ends on or after November 1, 1983.

(2) TRANSITIONAL RULE.—Any plan submitted to the Secretary of the Treasury or his delegate on or before the 60th day after the date of the enactment of this Act shall be treated as submitted before the close of the initial 5-year period referred to in section 4943(c)(7)(B) of the Internal Revenue Code of 1954 (as added by subsection (a)).

SEC. 308. DECREASES ATTRIBUTABLE TO STOCK ISSUANCES NOT TO REDUCE PERMITTED PERCENTAGE OF HOLDINGS WHERE DECREASE IS 2 PERCENT OR LESS.

(a) GENERAL RULE.—The second sentence of clause (ii) of section 4943(c)(4)(A) (relating to present holdings) is amended to read as follows:

"For purposes of the preceding sentence, any decrease in percentage holdings attributable to issuances of stock (or to issuances of stock coupled with redemptions of stock) shall be disregarded so long as—

"(I) the net percentage decrease disregarded under this sentence does not exceed 2 percent, and

"(II) the number of shares held by the foundation is not affected by any such issuance or redemption."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to increases and decreases occurring after the date of the enactment of this Act.

SEC. 309. AGGREGATION OF STOCK HOLDINGS OF PRIVATE FOUNDATION AND DISQUALIFIED PERSONS IN APPLYING 95 PERCENT OWNERSHIP TEST.

(a) GENERAL RULE.—Clause (i) of section 4943(c)(4)(B) (relating to present holdings) is amended by striking out "the private foundation has" and inserting in lieu thereof "the private foundation and all disqualified persons have".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if included in the amendment made by section 101(b) of the Tax Reform Act of 1969.

SEC. 310. 5-YEAR PERIOD TO DISPOSE OF EXCESS HOLDINGS RESULTING FROM CERTAIN ACQUISITIONS BY DISQUALIFIED PERSONS.

(a) GENERAL RULE.—Paragraph (6) of section 4943(c) (relating to 5-year period to dispose of gifts, bequests, etc.) is amended by adding at the end thereof the following new sentence:

"In any case where an acquisition by a disqualified person would result in a substitution under clause (i) or (ii) of subparagraph (D) of paragraph (4), the preceding sentence shall be applied with respect to such acquisition as if it did not contain the phrase 'or by a disqualified person' in the material preceding subparagraph (A)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to acquisitions after the date of the enactment of this Act.

SEC. 311. THE CONDUCTING OF CERTAIN GAMES OF CHANCE NOT TREATED AS UNRELATED TRADE OR BUSINESS.

(a) GENERAL RULE.—For purposes of section 513 of the Internal Revenue Code of 1954 (defining unrelated trade or business), the term "unrelated trade or business" does not include any trade or business which consists of conducting any game of chance if—

(1) such game of chance is conducted by a nonprofit organization,

(2) the conducting of such game by such organization does not violate any State or local law, and

(3) as of October 5, 1983—

(A) there was a State law in effect which permitted the conducting of such game of chance by such nonprofit organization, but

(B) the conducting of such game of chance by organizations which were not nonprofit organizations would have violated such law.

(b) EFFECTIVE DATE.—Subsection (a) shall apply to games of chance conducted after June 30, 1981, in taxable years ending after such date.

SEC. 312. TAX ON SELF-DEALING NOT TO APPLY TO CERTAIN STOCK PURCHASES.

(a) GENERAL RULE.—Section 4941 of the Internal Revenue Code of 1954 (relating to taxes on self-dealing) shall not apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if—

(1) consideration for such purchase equaled or exceeded the fair market value of such stock,

(2) the purchaser of such stock did not make any contribution to such foundation at any time during the 5-year period ending on the date of such purchase,

(3) the aggregate contributions to such foundation by the purchaser before such date were less than $10,000 and less than 2 percent of the total contributions received by the foundation as of such date, and

(4) such purchase was pursuant to the settlement of litigation involving the purchaser.

(b) STATUTE OF LIMITATIONS.—If credit or refund of any overpayment of tax resulting from subsection (a) is prevented at any time before the close of the 1-year period beginning on the date of the enactment of this Act by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed before the close of such 1-year period.

SEC. 313. PERSON CEASES TO BE SUBSTANTIAL CONTRIBUTOR AFTER 10 YEARS WITH NO CONNECTION TO FOUNDATION.

(a) GENERAL RULE.—Paragraph (2) of section 507(d) (defining substantial contributor) is amended by adding at the end thereof the following new subparagraph:

"(C) PERSON CEASES TO BE SUBSTANTIAL CONTRIBUTOR IN CERTAIN CASES.—

"(i) IN GENERAL.—A person shall cease to be treated as a substantial contributor with respect to any private foundation as of the close of any taxable year of such foundation if—

"(I) during the 10-year period ending at the close of such taxable year such person (and all related persons) have not made any contribution to such private foundation,

"(II) at no time during such 10-year period was such person (or any related person) a foundation manager of such private foundation, and

"(III) the aggregate contributions made by such person (and related persons) are determined by the Secretary to be insignificant when compared to the aggregate amount of contributions to such foundation by one other person.

For purposes of subclause (III), appreciation on contributions while held by the foundation shall be taken into account.

"(ii) RELATED PERSON.—For purposes of clause (i), the term 'related person' means, with respect to any person, any other person who would be a disqualified person (within the meaning of section 4946) by reason of his relationship to such person. In the case of a contributor which is a corporation, the term also includes any officer or director of such corporation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 314. TECHNICAL AMENDMENTS.

(a) AMENDMENTS OF INTERNAL REVENUE CODE OF 1954.—

(1) Subparagraph (B) of section 4942(a)(2) (relating to taxes on failure to distribute income) is amended by striking out "subsection (j)(4)" and inserting in lieu thereof "subsection (j)(2)".

(2) Paragraph (1) of section 4942(f) (defining adjusted net income) is amended by striking out "subsection (d)" and inserting in lieu thereof "subsection (j)".

(3) Paragraph (3) of section 6501(n) (relating to special rule for chapter 42 and simi-

lar taxes) is amended by striking out "section 4942(g)(2)(B)(i)(II)" and inserting in lieu thereof "section 4942(g)(2)(B)(ii)".

(4) The amendments made by this subsection shall take effect on the date of the enactment of this Act.

(b) AMENDMENT OF 1969 TAX REFORM ACT.—

(1) Subparagraph (A) of section 101(l)(4) of the Tax Reform Act of 1969 is amended by striking out "by substituting '51 percent' for '50 percent'" and inserting in lieu thereof "as if it did not contain the phrase ', but in no event shall the percentage so substituted be more than 50 percent'".

(2) The amendment made by paragraph (1) shall apply as if included in section 101(l)(4) of the Tax Reform Act of 1969.

(c) EXCEPTION TO DEFINITION OF DISQUALIFIED PERSONS.—

(1) Subsection (d) of section 4943 (relating to definitions and special rules with respect to taxes on excess business holdings) is amended by adding at the end thereof the following new paragraph:

"(4) DISQUALIFIED PERSON.—The term 'disqualified person' (as defined in section 4946(a)) does not include a plan described in section 4975(e)(7) with respect to the holdings of a private foundation described in paragraph (4) and (5) of subsection (c).".

(2) The amendment made by paragraph (1) shall apply with respect to taxable years beginning after the date of the enactment of this Act.

TITLE IV—TAX SIMPLIFICATION

Subtitle A—Revision and Simplification of Estimated Income Tax for Individuals

SEC. 411. REVISION OF PENALTY FOR FAILURE TO PAY ESTIMATED INCOME TAX.

Section 6654 (relating to addition to the tax for failure by individual to pay estimated income tax) is amended to read as follows:

"SEC. 6654. FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX.

"(a) ADDITION TO THE TAX.—Except as otherwise provided in this section, in the case of any underpayment of estimated tax by an individual, there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined by applying—

"(1) the applicable annual rate established under section 6621,

"(2) to the amount of the underpayment,

"(3) for the period of the underpayment.

"(b) AMOUNT OF UNDERPAYMENT; PERIOD OF UNDERPAYMENT.—For purposes of subsection (a)—

"(1) AMOUNT.—The amount of the underpayment shall be the excess of—

"(A) the required installment, over

"(B) the amount (if any) of the installment paid on or before the due date for the installment.

"(2) PERIOD OF UNDERPAYMENT.—The period of the underpayment shall run from the due date for the installment to whichever of the following dates is the earlier—

"(A) the 15th day of the 4th month following the close of the taxable year, or

"(B) with respect to any portion of the underpayment, the date on which such portion is paid.

"(3) ORDER OF CREDITING PAYMENTS.—For purposes of paragraph (2)(B), a payment of estimated tax shall be credited against unpaid required installments in the order in which such installments are required to be paid.

"(c) NUMBER OF REQUIRED INSTALLMENTS; DUE DATES.—For purposes of this section—

"(1) PAYABLE IN 4 INSTALLMENTS.—There shall be 4 required installments for each taxable year.

"(2) TIME FOR PAYMENT OF INSTALLMENTS.—

"In the case of the following required installments:	The due date is:
1st	April 15
2nd	June 15
3rd	September 15
4th	January 15 of the following taxable year.

"(d) AMOUNT OF REQUIRED INSTALLMENTS.—For purposes of this section—

"(1) AMOUNT.—

"(A) IN GENERAL.—Except as provided in paragraph (2), the amount of any required installment shall be 25 percent of the required annual payment.

"(B) REQUIRED ANNUAL PAYMENT.—For purposes of subparagraph (A), the term 'required annual payment' means the lesser of—

"(i) 80 percent of the tax shown on the return for the taxable year (or, if no return is filed, 80 percent of the tax for such year), or

"(ii) 100 percent of the tax shown on the return of the individual for the preceding taxable year.

Clause (ii) shall not apply if the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year.

"(2) LOWER REQUIRED INSTALLMENT WHERE ANNUALIZED INCOME INSTALLMENT IS LESS THAN AMOUNT DETERMINED UNDER PARAGRAPH (1).—

"(A) IN GENERAL.—In the case of any required installment, if the individual establishes that the annualized income installment is less than the amount determined under paragraph (1)—

"(i) the amount of such required installment shall be the annualized income installment, and

"(ii) any reduction in a required installment resulting from the application of this subparagraph shall be recaptured by increasing the amount of the next required installment determined under paragraph (1) by the amount of such reduction (and by increasing subsequent required installments to the extent that the reduction has not previously been recaptured under this clause).

"(B) DETERMINATION OF ANNUALIZED INCOME INSTALLMENT.—In the case of any required installment, the annualized income installment is the excess (if any) of—

"(i) an amount equal to the applicable percentage of the tax for the taxable year computed by placing on an annualized basis the taxable income, alternative minimum taxable income, and adjusted self-employment income for months in the taxable year ending before the due date for the installment, over

"(ii) the aggregate amount of any prior required installments for the taxable year.

"(C) SPECIAL RULES.—For purposes of this paragraph—

"(i) ANNUALIZATION.—The taxable income, alternative minimum taxable income, and adjusted self-employment income shall be placed on an annualized basis under regulations prescribed by the Secretary.

"(ii) APPLICABLE PERCENTAGE.—

"In the case of the following required installments	The applicable percentage is:
1st	20
2nd	40
3rd	60
4th	80.

"(iii) ADJUSTED SELF-EMPLOYMENT INCOME.—The term 'adjusted self-employment income' means self-employment income (as defined in section 1402(b)); except that section 1402(b) shall be applied by placing wages (within the meaning of section 1402(b)) for months in the taxable year ending before the due date for the installment on an annualized basis consistent with clause (i).

"(e) EXCEPTIONS.—

"(1) WHERE TAX IS SMALL AMOUNT.—No addition to tax shall be imposed under subsection (a) for any taxable year if the tax shown on the return for such taxable year (or, if no return is filed, the tax), reduced by the credit allowable under section 31, is less than $500.

"(2) WHERE NO TAX LIABILITY FOR PRECEDING TAXABLE YEAR.—No addition to tax shall be imposed under subsection (a) for any taxable year if—

"(A) the preceding taxable year was a taxable year of 12 months,

"(B) the individual did not have any liability for tax for the preceding taxable year, and

"(C) the individual was a citizen or resident of the United States throughout the preceding taxable year.

"(3) WAIVER IN CERTAIN CASES.—

"(A) IN GENERAL.—No addition to tax shall be imposed under subsection (a) with respect to any underpayment to the extent the Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.

"(B) NEWLY RETIRED OR DISABLED INDIVIDUALS.—No addition to tax shall be imposed under subsection (a) with respect to any underpayment if the Secretary determines that—

"(i) the taxpayer—

"(I) retired after having attained age 62, or

"(II) became disabled,

in the taxable year for which estimated payments were required to be made or in the taxable year preceding such taxable year, and

"(ii) such underpayment was due to reasonable cause and not to willful neglect.

"(f) TAX COMPUTED AFTER APPLICATION OF CREDITS AGAINST TAX.—For purposes of this section, the term 'tax' means—

"(1) the tax imposed by chapter 1, plus

"(2) the tax imposed by chapter 2, minus

"(3) the sum of—

"(A) the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages), plus

"(B) to the extent allowed under regulations prescribed by the Secretary, any overpayment of the tax imposed by section 4986 (determined without regard to section 4995(a)(4)(B)).

"(g) APPLICATION OF SECTION IN CASE OF TAX WITHHELD ON WAGES.—

"(1) IN GENERAL.—For purposes of applying this section, the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

"(2) SEPARATE APPLICATION.—The taxpayer may apply paragraph (1) separately with respect to—

"(A) wage withholding, and

"(B) all other amounts withheld for which credit is allowed under section 31.

"(h) SPECIAL RULE WHERE RETURN FILED ON OR BEFORE JANUARY 31.—If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on

the return as payable, then no addition to tax shall be imposed under subsection (a) with respect to any underpayment of the 4th required installment for the taxable year.

"(i) SPECIAL RULES FOR FARMERS AND FISHERMEN.—For purposes of this section—

"(1) IN GENERAL.—If an individual is a farmer or fisherman for any taxable year—

"(A) there shall be only 1 required installment for the taxable year,

"(B) the due date for such installment shall be January 15 of the following taxable year,

"(C) the amount of such installment shall be equal to the required annual payment (determined under subsection (d)(1)(B) by substituting '66⅔ percent' for '80 percent', and

"(D) subsection (h) shall be applied—

"(i) by substituting 'March 1' for 'January 31', and

"(ii) by treating the required installment described in subparagraph (A) of this paragraph as the 4th required installment.

"(2) FARMER OR FISHERMAN DEFINED.—An individual is a farmer or fisherman for any taxable year if—

"(A) the individual's gross income from farming or fishing (including oyster farming) for the taxable year is at least 66⅔ percent of the total gross income from all sources for the taxable year, or

"(B) such individual's gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least 66⅔ percent of the total gross income from all sources shown on such return.

"(j) FISCAL YEARS AND SHORT YEARS.—

"(1) FISCAL YEARS.—In applying this section to a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

"(2) SHORT TAXABLE YEAR.—This section shall be applied to taxable years of less than 12 months in accordance with regulations prescribed by the Secretary.

"(k) ESTATES AND TRUSTS.—This section shall not apply to any estate or trust.

"(l) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

SEC. 412. REPEAL OF REQUIREMENT OF DECLARATIONS, ETC.

(a) GENERAL RULE.—The following provisions are hereby repealed:

(1) Section 6015 (relating to declaration of estimated income tax by individuals).

(2) Section 6073 (relating to time for filing declarations of estimated income tax by individuals).

(3) Section 6153 (relating to installment payments of estimated income tax by individuals).

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (g) of section 871 is amended by striking out paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(2) Subsection (b) of section 1403 is amended by striking out paragraph (3).

(3) Paragraph (2) of section 6012(b) is amended by striking out "or section 6015(a)".

(4) Paragraph (1) of section 6020(b) is amended by striking out "(other than a declaration of estimated tax required under section 6015)".

(5) Paragraph (1) of section 6201(b) is amended to read as follows:

"(1) ESTIMATED INCOME TAX.—No unpaid amount of estimated income tax required to be paid under section 6154 or 6654 shall be assessed."

(6) Paragraph (5) of section 6362(e) is amended by striking out "and section 6015 and other provisions relating to declarations of estimated income" and inserting in lieu thereof "and provisions relating to estimated income tax".

(7) Subsection (h) of section 6601 is amended to read as follows:

"(h) EXCEPTION AS TO ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(8) Subsection (d) of section 6651 is amended to read as follows:

"(d) EXCEPTION FOR ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(9) Section 7203 is amended by striking out "(other than a return required under the authority of section 6015)".

(10) Subsection (a) of section 7216 is amended—

(A) by striking out "or declarations or amended declarations of estimated tax under section 6015,", and

(B) by striking out "return or declaration" each place it appears and inserting in lieu thereof "return".

(11) Paragraph (34) of section 7701(a) is hereby repealed.

(c) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart B of part II of subchapter A of chapter 61 is amended by striking out the item relating to section 6015.

(2) The table of sections for part V of subchapter A of chapter 61 is amended by striking out the item relating to section 6073.

(3) The table of sections for subchapter A of chapter 62 is amended by striking out the item relating to section 6153.

SEC. 413. CREDITING OF INCOME TAX OVERPAYMENT AGAINST ESTIMATED TAX LIABILITY.

The application of the Internal Revenue Code of 1954 with respect to the crediting of a prior year overpayment of income tax against the estimated tax shall be determined—

(1) without regard to Revenue Ruling 83-111 (and without regard to any other regulation, ruling, or decision reaching the same result as, or a result similar to, the result set forth in such Revenue Ruling); and

(2) with full regard to the rules (including Revenue Ruling 77-475) before Revenue Ruling 83-111.

SEC. 414. EFFECTIVE DATES.

(a) SECTIONS 411 AND 412.—

(1) IN GENERAL.—The amendments made by sections 411 and 412 shall apply with respect to taxable years beginning after December 31, 1984.

(2) WAIVER AUTHORITY.—The provisions of paragraph (3) of section 6654(e) of the Internal Revenue Code of 1954 (as amended by section 411) shall also apply with respect to underpayments for taxable years beginning in 1984.

(b) SECTION 413.—The provisions of section 413 shall take effect on January 1, 1984.

Subtitle B—Domestic Relations

SEC. 421. TREATMENT OF TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE.—Part III of subchapter O of chapter 1 (relating to common nontaxable exchanges) is amended by adding at the end thereof the following new section:

"SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

"(a) GENERAL RULE.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

"(1) a spouse, or

"(2) a former spouse, but only if the transfer is incident to the divorce.

"(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

"(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

"(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

"(c) INCIDENT TO DIVORCE.—For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

"(1) occurs within 1 year after the date on which the marriage ceases, or

"(2) is related to the cessation of the marriage.

"(d) SPECIAL RULE WHERE SPOUSE IS NONRESIDENT ALIEN.—Paragraph (1) of subsection (a) shall not apply if the spouse of the individual making the transfer is a nonresident alien."

(b) TECHNICAL AMENDMENTS.—

(1) REPEAL OF SECTION 72(k).—Subsection (k) of section 72 (relating to payments in discharge of alimony) is hereby repealed.

(2) REPEAL OF SECTION 101(e).—Subsection (e) of section 101 (relating to alimony, etc., payments) is hereby repealed.

(3) COORDINATION WITH SECTION 453B.—Section 453B (relating to gain or loss on disposition of installment obligations) is amended by adding at the end thereof the following new subsection:

"(g) TRANSFERS BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in subsection (a) of section 1041—

"(1) subsection (a) of this section shall not apply, and

"(2) the same tax treatment with respect to the transferred installment obligation shall apply to the transferee as would have applied to the transferor."

(4) TERM INTERESTS.—Paragraph (1) of section 1001(e) (relating to certain term interest) is amended by striking out "section 1014 or 1015" and inserting in lieu thereof "section 1014, 1015, or 1041".

(5) COORDINATION WITH SECTION 1015.—Section 1015 (relating to basis of property acquired by gifts and transfers in trust) is amended by adding at the end thereof the following new subsection:

"(e) GIFTS BETWEEN SPOUSES.—In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b)(2) and not this section."

(6) COORDINATION WITH SECTION 1239.—

(A) Subsection (b) of section 1239, as amended by this Act, is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(B) Subparagraph (C) of section 453(h)(1) (relating to special rule where obligor and shareholder are related persons) is amended by striking out "the obligor of any installment obligation and the shareholder are related persons" and inserting in lieu thereof "the obligor of any installment obligation and the shareholder are married to each other or are related persons".

(C) The subsection heading for section 453(g) is amended by striking out "SPOUSE OR".

(7) COORDINATION WITH SECTION 47.—Section 47 (relating to certain dispositions, etc., of section 38 property) is amended by adding at the end thereof the following new subsection:

"(e) TRANSFERS BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in subsection (a) of section 1041—

"(1) subsection (a) of this section shall not apply, and

"(2) the same tax treatment under this section with respect to the transferred property shall apply to the transferee as would have applied to the transferor."

(c) CLERICAL AMENDMENT.—The table of sections for such part III is amended by adding at the end thereof the following:

"Sec. 1041. Transfers of property between spouses or incident to divorce."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

(2) ELECTION TO HAVE AMENDMENTS APPLY TO TRANSFERS AFTER 1983.—If both spouses or former spouses make an election under this paragraph, the amendments made by this section shall apply to all transfers made by such spouses (or former spouses) after December 31, 1983.

(3) EXCEPTION FOR TRANSFERS PURSUANT TO EXISTING DECREES.—Except in the case of an election under paragraph (2), the amendments made by this section shall not apply to transfers under any instrument in effect on or before the date of the enactment of this Act unless both spouses (or former spouses) elect to have such amendments apply to transfers under such instrument.

(4) ELECTION.—Any election under paragraph (2) or (3) shall be made in such manner, at such time, and subject to such conditions, as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 422. TAX TREATMENT OF ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) GENERAL RULE.—Section 71 (relating to alimony and separate maintenance payments) is amended to read as follows:

"SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

"(a) GENERAL RULE.—Gross income includes amounts received as alimony or separate maintenance payments.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'alimony or separate maintenance payment' means any payment in cash if—

"(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

"(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

"(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

"(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (and the divorce or separation instrument states that there is no such liability).

"(2) DIVORCE OR SEPARATION INSTRUMENT.—The term 'divorce or separation instrument' means—

"(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

"(B) a written separation agreement, or

"(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

"(c) PAYMENTS TO SUPPORT CHILDREN.—

"(1) IN GENERAL.—Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

"(2) TREATMENT OF CERTAIN REDUCTIONS RELATED TO CONTINGENCIES INVOLVING CHILD.—For purposes of paragraph (1), if any amount specified in the instrument will be reduced—

"(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

"(B) at a time which can clearly be associated with a contingency of a kind specified in paragraph (1),

an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

"(3) SPECIAL RULE WHERE PAYMENT IS LESS THAN AMOUNT SPECIFIED IN INSTRUMENT.—For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

"(d) SPOUSE.—For purposes of this section, the term 'spouse' includes a former spouse.

"(e) EXCEPTION FOR JOINT RETURNS.—This section and section 215 shall not apply if the spouses make a joint return with each other.

"(f) SPECIAL RULES TO PREVENT EXCESS FRONT-LOADING OF ALIMONY PAYMENTS.—

"(1) REQUIREMENT THAT PAYMENTS BE FOR MORE THAN 6 YEARS.—Alimony or separate maintenance payments (in excess of $10,000 during any calendar year) paid by the payor spouse to the payee spouse shall not be treated as alimony or separate maintenance payments unless such payments are to be made by the payor spouse to the payee spouse in each of the 6 post-separation years (not taking into account any termination contingent on the death of either spouse or the remarriage of the payee spouse).

"(2) RECOMPUTATION WHERE PAYMENTS DECREASE BY MORE THAN $10,000.—If there is an excess amount determined under paragraph (3) for any computation year—

"(A) the payor spouse shall include such excess amount in gross income for the payor spouse's taxable year beginning in the computation year, and

"(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for such excess amount for the payee spouse's taxable year beginning in the computation year.

"(3) DETERMINATION OF EXCESS AMOUNT.—The excess amount determined under this paragraph for any computation year is the sum of—

"(A) the excess (if any) of—

"(i) the amount of alimony or separate maintenance payments paid by the payor spouse during the immediately preceding post-separation year, over

"(ii) the amount of the alimony or separate maintenance payments paid by the payor spouse during the computation year increased by $10,000, plus

"(B) a like excess for each of the other preceding post-separation years.

In determining the amount of the alimony or separate maintenance payments paid by the payor spouse during any preceding post-separation year, the amount paid during such year shall be reduced by any excess previously determined in respect of such year under this paragraph.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) POST-SEPARATION YEAR.—The term 'post-separation year' means any calendar year in the 6 calendar year period beginning with the first calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies.

"(B) COMPUTATION YEAR.—The term 'computation year' means the post-separation year for which the excess under paragraph (3) is being determined.

"(5) EXCEPTIONS.—

"(A) WHERE PAYMENTS CEASE BY REASON OF DEATH OR REMARRIAGE.—Paragraph (2) shall not apply to any post-separation year (and subsequent post-separation years) if—

"(i) either spouse dies before the close of such post-separation year or the payee spouse remarries before the close of such post-separation year, and

"(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

"(B) SUPPORT PAYMENTS.—For purposes of this subsection, the term 'alimony or separate maintenance payment' shall not include any payment received under a decree described in subsection (b)(2)(C).

"(C) FLUCTUATING PAYMENTS NOT WITHIN CONTROL OF PAYOR SPOUSE.—For purposes of this subsection, the term 'alimony or separate maintenance payment' shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 6 years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment.

(b) AMENDMENT OF SECTION 215.—Section 215 (relating to deduction for alimony, etc., payments) is amended to read as follows:

"SEC. 215. ALIMONY, ETC., PAYMENTS.

"(a) GENERAL RULE.—In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section, the term 'alimony or separate maintenance payment' means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

"(c) REQUIREMENT OF IDENTIFICATION NUMBER.—The Secretary may prescribe regulations under which—

"(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

"(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

"(d) COORDINATION WITH SECTION 682.—No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income."

(c) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER.—Section 6676 (relating to failure to supply identifying number) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER UNDER SECTION 215.—If any person who is required by regulations prescribed under section 215—

"(1) to furnish his taxpayer identification number to another person, or

"(2) to include on his return the taxpayer identification number of another person, fails to comply with such requirement at the time prescribed by such regulations, such person shall, unless it is shown that such failure is due to reasonable cause and not to willful neglect, pay a penalty of $50 for each such failure."

(d) TECHNICAL AMENDMENTS.—

(1) Subparagraph (B) of section 219(b)(4) (relating to certain divorced individuals) is amended by striking out all that follows "gross income" and inserting in lieu thereof "under section 71 (relating to alimony and separate maintenance payments) by reason of a payment under a decree of divorce or separate maintenance or a written instrument incident to such a decree."

(2) Subsection (b) of section 682 (relating to income of an estate or trust in case of divorce, etc.) is amended—

(A) by striking out "or section 71", and

(B) by striking out the last sentence.

(3) Paragraph (17) of section 7701(a) (defining husband and wife) is amended by striking out "71, 152(b)(4), 215, and 682" and inserting in lieu thereof "152(b)(4) and 682".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply with respect to divorce or separation instruments (as defined in section 71(b)(2) of the Internal Revenue Code of 1954, as amended by this section) executed after December 31, 1984.

(2) MODIFICATIONS OF INSTRUMENTS EXECUTED BEFORE JANUARY 1, 1985.—The amendments made by this section shall also apply to any divorce or separation instrument (as so defined) executed before January 1, 1985, but modified on or after such date if the modification expressly provides that the amendments made by this section shall apply to such modification.

(3) REQUIREMENT OF IDENTIFICATION NUMBER.—Section 215(c) of the Internal Revenue Code of 1954 (as amended by subsection (b)) and the amendments made by subsection (c) shall apply to payments made after December 31, 1984.

SEC. 422. DEPENDENCY EXEMPTION IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.

(a) GENERAL RULE.—Subsection (e) of section 152 (relating to support test in case of child of divorced parents, etc.) is amended to read as follows:

"(e) SUPPORT TEST IN CASE OF CHILD OF DIVORCED PARENTS, ETC.—

"(1) CUSTODIAL PARENT GETS EXEMPTION.—Except as otherwise provided in this subsection, if—

"(A) a child (as defined in section 151(e)(3)) receives over half of his support during the calendar year from his parents—

"(i) who are divorced or legally separated under a decree of divorce or separate maintenance,

"(ii) who are separated under a written separation agreement, or

"(iii) who live apart at all times during the last 6 months of the calendar year, and

"(B) such child is in the custody of one or both of his parents for more than one-half of the calendar year,

such child shall be treated, for purposes of subsection (a), as receiving over half of his support during the calendar year from the parent having custody for a greater portion of the calendar year (hereinafter in this subsection referred to as the 'custodial parent').

"(2) EXCEPTION WHERE CUSTODIAL PARENT RELEASES CLAIM TO EXEMPTION FOR THE YEAR.—A child of parents described in paragraph (1) shall be treated as having received over half of his support during a calendar year from the noncustodial parent if—

"(A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and

"(B) the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.

For purposes of this subsection, the term 'noncustodial parent' means the parent who is not the custodial parent.

"(3) EXCEPTION FOR MULTIPLE-SUPPORT AGREEMENT.—This subsection shall not apply in any case where over half of the support of the child is treated as having been received from a taxpayer under the provisions of subsection (c).

"(4) EXCEPTION FOR CERTAIN PRE-1985 INSTRUMENTS.—

"(A) IN GENERAL.—A child of parents described in paragraph (1) shall be treated as having received over half his support during a calendar year from the noncustodial parent if—

"(i) a qualified pre-1985 instrument between the parents applicable to the taxable year beginning in such calendar year provides that the noncustodial parent shall be entitled to any deduction allowable under section 151 for such child, and

"(ii) the noncustodial parent provides at least $600 for the support of such child during such calendar year.

For purposes of this subparagraph, amounts expended for the support of a child or children shall be treated as received from the noncustodial parent to the extent that such parent provided amounts for such support.

"(B) QUALIFIED PRE-1985 INSTRUMENT.—For purposes of this paragraph, the term 'qualified pre-1985 instrument' means any decree of divorce or separate maintenance or written agreement—

"(i) which is executed before January 1, 1985,

"(ii) which on such date contains the provision described in subparagraph (A)(i), and

"(iii) which is not modified on or after such date in a modification which expressly provides that this paragraph shall not apply to such decree or agreement.

"(5) SPECIAL RULE FOR SUPPORT RECEIVED FROM NEW SPOUSE OF PARENT.—For purposes of this subsection, in the case of the remarriage of a parent, support of a child received from the parent's spouse shall be treated as received from the parent.

"(6) CROSS REFERENCE.—

"For provision treating child as dependent of both parents for purposes of medical expense deduction, see section 213(d)(4)."

(b) TREATMENT AS DEPENDENT OF BOTH PARENTS FOR MEDICAL EXPENSE DEDUCTION.—

(1) Subsection (d) of section 213 (relating to definitions) is amended by redesignating paragraphs (4), (5), and (6) as paragraphs (5), (6), and (7), respectively, and by inserting after paragraph (3) the following new paragraph:

"(4) SPECIAL RULE IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.—Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this section."

(2) Subsection (b) of section 105 is amended by adding at the end thereof the following new sentence: "Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this subsection."

(3) Paragraph (6) of section 213(d) (as redesignated by paragraph (1)) is amended by striking out "the limitations of paragraph (4)" and inserting in lieu thereof "the limitations of paragraph (5)".

(c) TREATMENT OF CERTAIN MARRIED INDIVIDUALS LIVING APART.—

(1) Subsection (b) of section 143 (relating to certain married individuals living apart) is amended to read as follows:

"(b) CERTAIN MARRIED INDIVIDUALS LIVING APART.—For purposes of those provisions of this title which refer to this subsection, if—

"(1) an individual who is married (within the meaning of subsection (a)) and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child (within the meaning of section 151(e)(3)) with respect to whom such individual is entitled to a deduction for the taxable year under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e)),

"(2) such individual furnishes over one-half of the cost of maintaining such household during the taxable year, and

"(3) during the last 6 months of the taxable year, such individual's spouse is not a member of such household,

such individual shall not be considered as married."

(2) Subparagraph (A) of section 2(b)(1) (defining head of household) is amended—

(A) by striking out "which constitutes for such taxable year" and inserting in lieu thereof "which constitutes for more than one-half of such taxable year", and

(B) by striking out "under section 151" in clause (i) and inserting in lieu thereof "under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e))".

(3) Paragraph (1) of section 43(c) (defining eligible individual) is amended—

(A) by inserting after "section 151(e)(3))" in subparagraph (A)(i) the following: "or would be so entitled but for paragraph (2) or (4) of section 152(e)", and

(B) by striking out "the child has the same principal place of abode as the individual" in subparagraph (B) and inserting in lieu thereof "the child has the same principal place of abode as the individual for more than one-half of the taxable year".

(4) Paragraph (5) of section 44A(f) (relating to special dependency test in case of divorced parents, etc.) is amended to read as follows:

"(5) SPECIAL DEPENDENCY TEST IN CASE OF DIVORCED PARENTS, ETC.—If—

"(A) paragraph (2) or (4) of section 152(e) applies to any child with respect to any calendar year, and

"(B) such child is under the age of 15 or is physically or mentally incapable of caring for himself,

in the case of any taxable year beginning in such calendar year, such child shall be treated as a qualifying individual described in subparagraph (A) or (B) of subsection (c)(1) (whichever is appropriate) with respect to the custodial parent (within the meaning of section 152(e)(1)), and shall not be treated as a qualifying individual with respect to the noncustodial parent."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 424. INNOCENT SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.

(a) GENERAL RULE.—Subsection (e) of section 6013 (relating to spouse relieved of liability in certain cases) is amended to read as follows:

"(e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, if—

"(A) a joint return has been made under this section for a taxable year,

"(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

"(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

"(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

"(2) GROSSLY ERRONEOUS ITEMS.—For purposes of this subsection, the term 'grossly erroneous items' means, with respect to any spouse—

"(A) any item of gross income attributable to such spouse which is omitted from gross income, and

"(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

"(3) SUBSTANTIAL UNDERSTATEMENT.—For purposes of this subsection, the term 'substantial understatement' means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

"(4) UNDERSTATEMENT MUST EXCEED SPECIFIED PERCENTAGE OF SPOUSE'S INCOME.—

"(A) ADJUSTED GROSS INCOME OF $20,000 OR LESS.—If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.

"(B) ADJUSTED GROSS INCOME OF MORE THAN $20,000.—If the spouse's adjusted gross income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting '25 percent' for '10 percent'.

"(C) PREADJUSTMENT YEAR.—For purposes of this paragraph, the term 'preadjustment year' means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.

"(D) COMPUTATION OF SPOUSE'S ADJUSTED GROSS INCOME.—If the spouse is married to another spouse at the close of the preadjustment year, the spouse's adjusted gross income shall include the income of the new spouse (whether or not they file a joint return).

"(E) EXCEPTION FOR OMISSIONS FROM GROSS INCOME.—This paragraph shall not apply to any liability attributable to the omission of an item from gross income.

"(5) SPECIAL RULE FOR COMMUNITY PROPERTY INCOME.—For purposes of this subsection, the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws."

(b) TREATMENT OF COMMUNITY INCOME.—

(1) IN GENERAL.—Section 66 (relating to treatment of community income where spouses live apart) is amended by redesignating subsection (b) as subsection (d) and by inserting after subsection (a) the following new subsections:

"(b) SECRETARY MAY DISREGARD COMMUNITY PROPERTY LAWS WHERE SPOUSE NOT NOTIFIED OF COMMUNITY INCOME.— The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

"(c) SPOUSE RELIEVED OF LIABILITY IN CERTAIN OTHER CASES.—Under regulations prescribed by the Secretary, if—

"(1) an individual does not file a joint return for any taxable year,

"(2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,

"(3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

"(4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,

then, for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual)."

(2) CLERICAL AMENDMENTS.—

(A) The section heading of section 66 is amended by striking out "WHERE SPOUSES LIVE APART".

(B) The subsection heading of subsection (a) of section 66 is amended by striking out "GENERAL RULE" and inserting in lieu thereof "TREATMENT OF COMMUNITY INCOME WHERE SPOUSES LIVE APART".

(C) The table of sections for part I of subchapter B of chapter 1 is amended by striking out "where spouses live apart" in the item relating to section 66.

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies. Corresponding provisions shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to all taxable years to which such Code applies.

(2) AUTHORITY TO DISREGARD COMMUNITY PROPERTY LAWS.—Subsection (b) of section 66 of the Internal Revenue Code of 1954, as added by subsection (b), shall apply to taxable years beginning after December 31, 1984.

SEC. 423. TREATMENT OF CERTAIN PROPERTY SETTLEMENTS FOR PURPOSES OF ESTATE AND GIFT TAXES.

(a) DEDUCTION ALLOWED AGAINST ESTATE TAX FOR TRANSFERS SATISFYING SECTION 2516.—

(1) IN GENERAL.—Subsection (b) of section 2043 (relating to transfers for insufficient consideration) is amended to read as follows:

"(b) MARITAL RIGHTS NOT TREATED AS CONSIDERATION.—

"(1) IN GENERAL.—For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth'.

"(2) EXCEPTION.—For purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth."

(2) CROSS REFERENCE.—Subsection (e) of section 2053 (relating to deduction for expenses, indebtedness, and taxes) is amended to read as follows:

"(e) MARITAL RIGHTS.—

"For provisions treating certain relinquishments of marital rights as consideration in money or money's worth, see section 2043(b)(2)."

(b) SECTION 2516 EXTENDED TO AGREEMENTS ENTERED INTO WITHIN 1 YEAR AFTER DIVORCE.—Section 2516 (relating to certain property settlements) is amended by striking out so much of such section as precedes paragraph (1) thereof and inserting in lieu thereof the following:

"Where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement—".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall apply to estates of decedents dying after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to transfers after the date of the enactment of this Act.

SEC. 424. INCOME FROM SHELTERED WORKSHOPS NOT TAKEN INTO ACCOUNT IN DETERMINING DEPENDENCY EXEMPTION.

(a) IN GENERAL.—Subsection (e) of section 151 (relating to additional personal exemption for dependents) is amended by adding at the end thereof the following new paragraph:

"(5) CERTAIN INCOME OF HANDICAPPED DEPENDENTS NOT TAKEN INTO ACCOUNT.—

"(A) IN GENERAL.—For purposes of paragraph (1)(A), the gross income of an individual who is permanently and totally disabled shall not include income attributable to services performed by the individual at a sheltered workshop if—

"(i) the availability of medical care at such workshop is the principal reason for his presence there, and

"(ii) the income arises solely from activities at such workshop which are incident to such medical care.

"(B) SHELTERED WORKSHOP DEFINED.—For purposes of subparagraph (A), the term 'sheltered workshop' means a school—

"(i) which provides special instruction or training designed to alleviate the disability of the individual, and

"(ii) which is operated by—

"(I) an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

"(II) a State, a possession of the United States, any political subdivision of any of the foregoing, the United States, or the District of Columbia.

"(C) PERMANENT AND TOTAL DISABILITY DEFINED.—An individual shall be treated as permanently and totally disabled for purposes of this paragraph if such individual would be so treated under paragraph (3) of section 37(e)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31 1984.

Subtitle C—Revision of At-Risk Rules

SEC. 431. REVISION OF INVESTMENT CREDIT AT RISK RULES.

(a) IN GENERAL.—So much of paragraph (8) of section 46(c) (relating to limitation to amount at risk) as precedes subparagraph (E) thereof is amended to read as follows:

"(8) CERTAIN NONRECOURSE FINANCING EXCLUDED FROM CREDIT BASE.—

"(A) LIMITATION.—The credit base of any property to which this paragraph applies shall be reduced by the nonqualified nonrecourse financing with respect to such property (as of the close of the taxable year in which placed in service).

"(B) PROPERTY TO WHICH PARAGRAPH APPLIES.—This paragraph applies to any property which—

"(i) is placed in service during the taxable year by a taxpayer described in section 465(a)(1), and

"(ii) is used in connection with an activity with respect to which any loss is subject to limitation under section 465.

"(C) CREDIT BASE DEFINED.—For purposes of this paragraph, the term 'credit base' means—

"(i) in the case of new section 38 property, the basis of the property, or

"(ii) in the case of used section 38 property, the cost of such property.

"(D) NONQUALIFIED NONRECOURSE FINANCING.—

"(i) IN GENERAL.—For purposes of this paragraph and paragraph (9), the term 'nonqualified nonrecourse financing' means any nonrecourse financing which is not qualified commercial financing.

"(ii) QUALIFIED COMMERCIAL FINANCING.—For purposes of this paragraph, the term 'qualified commercial financing' means any financing with respect to any property if—

"(I) such property is acquired by the taxpayer from a person who is not a related person,

"(II) the amount of the nonrecourse financing with respect to such property does not exceed 80 percent of the credit base of such property, and

"(III) such financing is borrowed from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government.

Such term shall not include any convertible debt.

"(iii) NONRECOURSE FINANCING.—For purposes of this subparagraph, the term 'nonrecourse financing' includes—

"(I) any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and

"(II) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to a person (other than the taxpayer) having such an interest.

In the case of amounts borrowed by a corporation from a shareholder, subclause (II) shall not apply to an interest as a shareholder.

"(iv) QUALIFIED PERSON.—For purposes of this paragraph, the term 'qualified person' means any person which is actively and regularly engaged in the business of lending money and which is not—

"(I) a related person with respect to the taxpayer,

"(II) a person from which the taxpayer acquired the property (or a related person to such person), or

"(III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

"(v) RELATED PERSON.—For purposes of clause (i), the term 'related person' has the meaning given such term by section 168(e)(4). Except as otherwise provided in regulations prescribed by the Secretary, the determination of whether a person is a related person shall be made as of the close of the taxable year in which the property is placed in service.

"(E) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.—For purposes of this paragraph and paragraph (9)—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, in the case of any partnership or S corporation, the determination of whether a partner's or shareholder's allocable share of any financing is nonqualified nonrecourse financing shall be made at the partner or shareholder level.

"(ii) SPECIAL RULE FOR CERTAIN RECOURSE FINANCING OF S CORPORATION.—A shareholder of an S corporation shall be treated as liable for his allocable share of any financing provided by a qualified person to such corporation if—

"(I) such financing is recourse financing (determined at the corporate level), and

"(II) such financing is provided with respect to qualified business property of such corporation.

"(iii) QUALIFIED BUSINESS PROPERTY.—For purposes of clause (ii), the term 'qualified business property' means any property if—

"(I) such property is used by the corporation in the active conduct of a trade or business,

"(II) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 3 full-time employees who were not owner-employees (as defined in section 465(c)(7)(E)(i)) and substantially all the services of whom were services directly related to such trade or business, and

"(III) during the entire 12-month period ending on the last day of such taxable year, such corporation had at least 1 full-time employee substantially all of the services of whom were in the active management of the trade or business.

Such term shall not include any master sound recording or other tangible or intangible asset associated with literary, artistic, or musical properties.

"(iv) DETERMINATION OF ALLOCABLE SHARE.—The determination of any partner's or shareholder's allocable share of any financing shall be made in the same manner as the credit allowable by section 38 with respect to such property."

(b) TREATMENT OF SUBSEQUENT INCREASES AND DECREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

(1) SUBSEQUENT DECREASES.—Paragraph (9) of section 46(c) (relating to subsequent increases in the taxpayer's amount at risk with respect to the property) is amended to read as follows:

"(9) SUBSEQUENT DECREASES IN NONQUALIFIED NONRECOURSE FINANCING WITH RESPECT TO THE PROPERTY.—

"(A) IN GENERAL.—If, at the close of a taxable year following the taxable year in which the property was placed in service, there is a net decrease in the amount of nonqualified nonrecourse financing with respect to such property, such net decrease shall be taken into account as additional qualified investment in such property in accordance with subparagraph (C).

"(B) CERTAIN TRANSACTIONS NOT TAKEN INTO ACCOUNT.—For purposes of this paragraph, nonqualified nonrecourse financing shall not be treated as decreased through the surrender or other use of property financed by nonqualified nonrecourse financing.

"(C) MANNER IN WHICH TAKEN INTO ACCOUNT.—

"(i) CREDIT DETERMINED BY REFERENCE TO TAXABLE YEAR PROPERTY PLACED IN SERVICE.—For purposes of determining the amount of credit allowable under section 38 and the amount of credit subject to the early disposition or cessation rules under section 47, any increase in a taxpayer's qualified investment in property by reason of this paragraph shall be deemed to be additional qualified investment made by the taxpayer in the year in which the property referred to in subparagraph (A) was first placed in service.

"(ii) CREDIT ALLOWED FOR YEAR OF DECREASE IN NONQUALIFIED NONRECOURSE FINANCING.—Any credit allowable under this subpart for any increase in qualified investment by reason of this paragraph shall be treated as earned during the taxable year of the decrease in the amount of nonqualified nonrecourse financing."

(2) SUBSEQUENT INCREASES.—So much of subsection (d) of section 47 (relating to property ceasing to be at risk) as precedes paragraph (3) thereof is amended to read as follows:

"(d) INCREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

"(1) IN GENERAL.—If, as of the close of the taxable year, there is a net increase with respect to the taxpayer in the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)) with respect to any property to which section 46(c)(8) applied, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in credits allowed under section 38 for all prior taxable years which would have resulted from reducing the qualified investment taken into account with respect to such property by the amount of such net increase.

"(2) TRANSFERS OF DEBT MORE THAN 1 YEAR AFTER INITIAL BORROWING NOT TREATED AS INCREASING NONQUALIFIED NONRECOURSE FINANCING.—For purposes of paragraph (1), the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)(D)) with respect to the taxpayer shall not be treated as increased by reason of a transfer of (or agreement to transfer) any evidence of an indebtedness if such transfer occurs (or such agreement is entered into) more than 1 year after the date such indebtedness was incurred."

(c) CLARIFICATION OF COORDINATION OF SECTION 48(d) WITH AT-RISK RULES.—Subsection (d) of section 48 (relating to certain leased property) is amended by adding at the end thereof the following new paragraph:

"(6) COORDINATION WITH AT-RISK RULES.—

"(A) EXTENSION OF AT-RISK RULES TO CERTAIN LESSORS.—

"(i) IN GENERAL.—If—

"(I) a lessor makes an election under this subsection with respect to any at-risk property leased to an at-risk lessee, and

"(II) but for this clause, section 46(c)(8) would not apply to such property in the hands of the lessor,

section 46(c)(8) shall apply to the lessor with respect to such property.

"(ii) EXCEPTIONS.—Clause (i) shall not apply—

"(I) if the lessor manufactured or produced the property,

"(II) if the property has a readily ascertainable fair market value, or

"(III) in circumstances which the Secretary determines by regulations to be circumstances where the application of clause (i) is not necessary to carry out the purposes of section 46(c)(8).

"(B) REQUIREMENT THAT LESSOR BE AT RISK.—In the case of any property which, in the hands of the lessor, is property to which section 46(c)(8) applies, the amount of the credit allowable to the lessee under section 38 with respect to such property by reason of an election under this subsection shall at no time exceed the credit which would have been allowable to the lessor with respect to such property (determined without regard to section 46(e)(3)) if—

"(i) the lessor's basis in such property were equal to the lessee acquisition amount, and

"(ii) no election had been made under this subsection.

"(C) LESSEE SUBJECT TO AT-RISK LIMITATIONS.—

"(i) IN GENERAL.—In the case of any lease where—

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"(I) the lessee is an at-risk lessee,
"(II) the property is at-risk property, and
"(III) the at-risk percentage is less than the required percentage,
any credit allowable under section 38 to the lessee by reason of an election under this subsection (hereinafter in this paragraph referred to as the 'total credit') shall be allowable only as provided in subparagraph (D).

"(ii) AT-RISK PERCENTAGE.—For purposes of this paragraph, the term 'at-risk percentage' means the percentage obtained by dividing—

"(I) the present value (as of the time the lease is entered into) of the aggregate lease at-risk payments, by

"(II) the lessee acquisition amount.

For purposes of subclause (I), the present value shall be determined by using a discount rate equal to the rate in effect under section 6621 as of the time the lease is entered into.

"(iii) REQUIRED PERCENTAGE.—For purposes of clause (i)(III), the term 'required percentage' means the sum of—

"(I) 2 times the sum of the percentages applicable to the property under section 46(a), plus

"(II) 10 percent.

In the case of 3-year property, such term means 60 percent of the required percentage determined under the preceding sentence.

"(iv) LESSEE ACQUISITION AMOUNT.—For purposes of this paragraph, the term 'lessee acquisition amount' means the amount for which the lessee is treated as having acquired the property by reason of an election under this subsection.

"(v) LEASE AT-RISK PAYMENT.—For purposes of this paragraph, the term 'lease at-risk payment' means any rental payment—

"(I) which the lessee is required to make under the lease in all events, and

"(II) with respect to which the lessee is not protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.

"(D) YEAR FOR WHICH CREDIT ALLOWABLE.—

"(i) IN GENERAL.—Except as provided in clause (ii), in any case to which subparagraph (C)(i) applies, the portion of the total credit allowable for any taxable year shall be an amount which bears the same ratio to such total credit as—

"(I) the aggregate rental payments made by the lessee under the lease during such taxable year, bears to

"(II) the lessee acquisition amount.

"(ii) REMAINING AMOUNT ALLOWABLE FOR YEAR IN WHICH AGGREGATE RENTAL PAYMENTS EXCEED REQUIRED PERCENTAGE OF ACQUISITION AMOUNT.—The total credit (to the extent not allowable for a preceding taxable year) shall be allowable for the first taxable year as of the close of which the aggregate rental payments made by the lessee under the lease equal or exceed the required percentage (as defined in subparagraph (C)(iii)) of the lessee acquisition amount.

"(E) DEFINITION OF AT-RISK LESSEE AND AT-RISK PROPERTY.—For purposes of this paragraph—

"(i) At risk lessee.—The term 'at-risk lessee' means any lessee who is a taxpayer described in section 465(a)(1).

"(ii) AT-RISK PROPERTY.—The term 'at-risk property' means any property used by an at-risk lessee in connection with an activity with respect to which any loss is subject to limitation under section 465.

"(F) SPECIAL RULES FOR SUBPARAGRAPHS (C) AND (D).—

"(i) SUBPARAGRAPHS (C) AND (D) APPLY IN LIEU OF OTHER AT-RISK RULES.—In the case of any election under this subsection, paragraphs (8) and (9) of section 46(c) and subsection (d) of section 47 shall only apply with respect to the lessor.

"(ii) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.—For purposes of subparagraphs (C) and (D), rules similar to the rules of subparagraph (E) of section 46(c)(8) shall apply.

"(iii) SUBSEQUENT REDUCTIONS IN AT-RISK AMOUNT.—Under regulations prescribed by the Secretary, the principles of subsection (d) of section 47 shall apply for purposes of subparagraphs (C) and (D).

"(G) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations—

"(i) providing for such adjustments as may be appropriate where expenses connected with the lease are borne by the lessor, and

"(ii) providing the extent to which contingencies in the lease will be disregarded."

(d) TECHNICAL AMENDMENTS.—

(1) Clause (i) of section 46(c)(8)(F) (relating to special rule for certain energy property) is amended to read as follows:

"(i) IN GENERAL.—Subparagraph (A) shall not apply with respect to qualified energy property."

(2) Subclause (III) of section 46(c)(8)(F)(ii) (defining qualified energy property) is amended to read as follows:

"(III) as of the close of the taxable year in which the property is placed in service, not more than 75 percent of the basis of such property is attributable to nonqualified nonrecourse financing, and".

(3) Subclause (IV) of section 46(c)(8)(F)(ii) is amended by striking out "nonrecourse financing (other than financing described in section 46(c)(8)(B)(ii))" and inserting in lieu thereof "nonqualified nonrecourse financing".

(4) Subparagraph (A) of section 47(d)(3) is amended by striking out "ceasing to be at risk" and inserting in lieu thereof "increasing the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8))".

(5) Clause (i) of section 47(d)(3)(B) is amended by striking out "other than a loan described in section 46(c)(8)(B)(ii)".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act in taxable years ending after such date; except that such amendments shall not apply to any property to which the amendments made by section 211(f) of the Economic Recovery Tax Act of 1981 do not apply.

(2) AMENDMENTS MAY BE ELECTED RETROACTIVELY.—At the election of the taxpayer, the amendments made by this section shall apply as if included in the amendments made by section 211(f) of the Economic Recovery Tax Act of 1981. Any election made under the preceding sentence shall apply to all property of the taxpayer to which the amendments made by such section 211(f) apply and shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 432. EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS FROM AT-RISK RULES, ETC.

(a) EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS FROM AT-RISK RULES.—Subsection (c) of section 465 (relating to deductions limited to amount at risk) is amended by adding at the end thereof the following new paragraph:

"(7) EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS.—

"(A) IN GENERAL.—In the case of a taxpayer which is a qualified C corporation—

"(i) each qualifying business carried on by such taxpayer shall be treated as a separate activity, and

"(ii) subsection (a) shall not apply to losses from such business.

"(B) QUALIFIED C CORPORATION.—For purposes of subparagraph (A), the term 'qualified C corporation' means any corporation described in subparagraph (B) of subsection (a)(1) which is not—

"(i) a personal holding company (as defined in section 542(a)),

"(ii) a foreign personal holding company (as defined in section 552(a)), or

"(iii) a personal service corporation (as defined in section 269A(b) but determined by substituting '5 percent' for '10 percent' in section 269A(b)(2)).

"(C) QUALIFYING BUSINESS.—For purposes of this paragraph, the term 'qualifying business' means any active business if—

"(i) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 1 full-time employee substantially all the services of whom were in the active management of such business,

"(ii) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 3 full-time, nonowner employees substantially all of the services of whom were services directly related to such business,

"(iii) the amount of the deductions attributable to such business which are allowable to the taxpayer solely by reason of sections 162 and 404 for the taxable year exceeds 15 percent of the gross income from such business for such year, and

"(iv) such business is not an excluded business.

"(D) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (C).—

"(i) PARTNERSHIPS IN WHICH TAXPAYER IS A QUALIFIED CORPORATE PARTNER.—In the case of an active business of a partnership, if—

"(I) the taxpayer is a qualified corporate partner in the partnership, and

"(II) during the entire 12-month period ending on the last day of the partnership's taxable year, there was at least 1 full-time employee of the partnership (or of a qualified corporate partner) substantially all the services of whom were in the active management of such business,

then the taxpayer's proportionate share (determined on the basis of its profits interest) of the activities of the partnership in such business shall be treated as activities of the taxpayer (and clause (i) of subparagraph (C) shall not apply in determining whether such business is a qualifying business of the taxpayer).

"(ii) QUALIFIED CORPORATE PARTNER.—For purposes of clause (i), the term 'qualified corporate partner' means any corporation if—

"(I) such corporation is a general partner in the partnership,

"(II) such corporation has an interest of 20 percent or more in the profits and losses of the partnership, and

"(III) such corporation has contributed property to the partnership in an amount not less than the lesser of $500,000 or 10 percent of the net worth of the corporation.

For purposes of subclause (III), any contribution of property other than money shall be taken into account at its fair market value.

"(iii) DEDUCTION FOR OWNER EMPLOYEE COMPENSATION NOT TAKEN INTO ACCOUNT.—For purposes of clause (iii) of subparagraph (C), there shall not be taken into account any deduction in respect of compensation for personal services rendered by any employee (other than a non-owner employee) of the taxpayer or any member of such employee's family (within the meaning of section 318(a)(1)).

"(iv) SPECIAL RULE FOR BANKS.—For purposes of clause (iii) of subparagraph (C), in the case of a bank (as defined in section 581)

or a financial institution to which section 591 applies—

"(I) gross income shall be determined without regard to the exclusion of interest from gross income under section 103, and

"(II) in addition to the deductions described in such clause, there shall also be taken into account the amount of the deductions which are allowable for amounts paid or credited to the accounts of depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts under section 163 or 591.

"(v) SPECIAL RULE FOR LIFE INSURANCE COMPANIES.—

"(I) IN GENERAL.—Clause (iii) of subparagraph (C) shall not apply to any insurance business of a qualified life insurance company.

"(II) INSURANCE BUSINESS.—For purposes of subclause (I), the term 'insurance business' means any business which is not a noninsurance business (within the meaning of section 806(c)(3)).

"(III) QUALIFIED LIFE INSURANCE COMPANY.—For purposes of subclause (I), the term 'qualified life insurance company' means any company which would be a life insurance company as defined in section 816 if unearned premiums were not taken into account under subsections (a)(2) and (c)(2) of section 816.

"(E) DEFINITIONS.—For purposes of this paragraph—

"(i) NON-OWNER EMPLOYEE.—The term 'non-owner employee' means any employee who does not own, at any time during the taxable year, more than 5 percent in value of the outstanding stock of the taxpayer. For purposes of the preceding sentence, section 318 shall apply, except that '5 percent' shall be substituted for '50 percent' in section 318(a)(2)(C).

"(ii) EXCLUDED BUSINESS.—The term 'excluded business' means—

"(I) equipment leasing (as defined in paragraph (6)), and

"(II) any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

"(iii) SPECIAL RULES RELATING TO COMMUNICATIONS INDUSTRY, ETC.—

"(I) BUSINESS NOT EXCLUDED WHERE TAXPAYER NOT COMPLETELY AT RISK.—A business involving the use, exploitation, sale, lease, or other disposition of property described in subclause (II) of clause (ii) shall not constitute an excluded business by reason of such subclause if the taxpayer is at risk with respect to all amounts paid or incurred (or chargeable to capital account) in such business.

"(II) CERTAIN LICENSED BUSINESSES NOT EXCLUDED.—For purposes of subclause (II) of clause (ii), the provision of radio, television, cable television, or similar services pursuant to a license or franchise granted by the Federal Communications Commission or any other Federal, State, or local authority shall not constitute an excluded business by reason of such subclause.

"(F) AFFILIATED GROUP TREATED AS 1 TAXPAYER.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as provided in clause (iii), the component members of an affiliated group of corporations shall be treated as a single taxpayer.

"(ii) AFFILIATED GROUP OF CORPORATIONS.—The term 'affiliated group of corporations' means an affiliated group (as defined in section 1504(a)) which files or is required to file consolidated income tax returns.

"(iii) COMPONENT MEMBER.—The term 'component member' means an includible corporation (as defined in section 1504) which is a member of the affiliated group.

"(G) LOSS OF 1 MEMBER OF AFFILIATED GROUP MAY NOT OFFSET INCOME OF PERSONAL HOLDING COMPANY OR PERSONAL SERVICE CORPORATION.—Nothing in this paragraph shall permit any loss of a member of an affiliated group to be used as an offset against the income of any other member of such group which is a personal holding company (as defined in section 542(a)) or a personal service corporation (as defined in section 269A(b) but determined by substituting '5 percent' for '10 percent' in section 269A(b)(2))."

(b) ACTIVITIES TREATED AS SEPARATE ACTIVITIES BY STATUTE MAY BE AGGREGATED WHERE TAXPAYER ACTIVELY PARTICIPATES IN THE MANAGEMENT OF EACH ACTIVITY.—Paragraph (2) of section 465(c) (relating to activities to which risk applies) is amended to read as follows:

"(2) SEPARATE ACTIVITIES.—For purposes of this section—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a taxpayer's activity with respect to each—

"(i) film or video tape,

"(ii) section 1245 property which is leased or held for leasing,

"(iii) farm,

"(iv) oil and gas property (as defined under section 614), or

"(v) geothermal property (as defined under section 614),

shall be treated as a separate activity.

"(B) AGGREGATION RULES.—

"(i) SPECIAL RULE FOR LEASES OF SECTION 1245 PROPERTY BY PARTNERSHIPS OR S CORPORATIONS.—In the case of any partnership or S corporation, all activities with respect to section 1245 properties which—

"(I) are leased or held for lease, and

"(II) are placed in service in any taxable year of the partnership or S corporation,

shall be treated as a single activity.

"(ii) OTHER AGGREGATION RULES.—Rules similar to the rules of subparagraphs (B) and (C) of paragraph (3) shall apply for purposes of this paragraph."

(c) CORPORATIONS CONSIDERED AT RISK WITH RESPECT TO AMOUNTS BORROWED FROM SHAREHOLDERS, ETC.—Paragraph (3) of section 465(b) (relating to certain borrowed amounts excluded) is amended to read as follows:

"(3) CERTAIN BORROWED AMOUNTS EXCLUDED.—

"(A) IN GENERAL.—Except to the extent provided in regulations, for purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

"(B) EXCEPTIONS.—

"(i) INTEREST AS CREDITOR.—Subparagraph (A) shall not apply to an interest as a creditor in the activity.

"(ii) INTEREST AS SHAREHOLDER WITH RESPECT TO AMOUNTS BORROWED BY CORPORATION.—In the case of amounts borrowed by a corporation from a shareholder, subparagraph (A) shall not apply to an interest as a shareholder.

"(C) RELATED PERSON DEFINED.—For purposes of subparagraph (A), the term 'related person' has the meaning given such term by section 168(e)(4)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983; except that any loss from an activity described in section 465(c)(7)(A) of the Internal Revenue Code of 1954 (as amended by this section) which (but for the amendments made by this section) would have been treated as a deduction for the taxpayer's first taxable year beginning after December 31, 1983, under section 465(a)(2) of such Code shall be allowed as a deduction for such first taxable year notwithstanding such amendments.

Subtitle D—Miscellaneous Treasury Administrative Provisions

PART I—PROVISIONS NOT RELATING TO DISTILLED SPIRITS TAX

SEC. 441. SIMPLIFICATION OF CERTAIN REPORTING REQUIREMENTS.

(a) REPORT ON POSSESSIONS CORPORATIONS.—The Secretary of the Treasury shall, for the calendar year 1981 and each second calendar year thereafter, submit a report to the Congress within 24 months following the close of such calendar year setting forth an analysis of the operation and effect of sections 936 and 934(b) of the Internal Revenue Code of 1954.

(b) HIGH INCOME TAXPAYER REPORT.—

(1) Section 2123 of the Tax Reform Act of 1976 is amended to read as follows:

"SEC. 2123. HIGH INCOME TAXPAYER REPORT.

"The Secretary of the Treasury shall publish annually information on the amount of tax paid by individual taxpayers with high total incomes. Total income for this purpose is to be calculated and set forth by adding to adjusted gross income any items of tax preference excluded from, or deducted in arriving at, adjusted gross income, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. These data are to include the number of such individuals with total income over $200,000 who owe no Federal income tax (after credits) and the deductions, exclusions, or credits used by them to avoid tax."

(2) The amendment made by paragraph (1) shall apply to information published after the date of the enactment of this Act.

(c) INTERNATIONAL BOYCOTT REPORTS.—

(1) Section 1067 of the Tax Reform Act of 1976 is amended to read as follows:

"SEC. 1067. REPORTS BY THE SECRETARY.

"(a) GENERAL RULE.—As soon after the close of each 4-year period as the data become available, the Secretary shall transmit a report to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate setting forth for such 4-year period—

"(1) the number of reports filed under section 999(a) of the Internal Revenue Code of 1954 for taxable years ending with or within each calendar year in such 4-year period,

"(2) the number of such reports with respect to each such calendar year on which the taxpayer indicated international boycott participation or cooperation (within the meaning of section 999(b)(3) of such Code), and

"(3) a detailed description of the manner in which the provisions of such Code relating to international boycott activity have been administered during such 4-year period.

"(b) 4-YEAR PERIOD.—For purposes of subsection (a), the term '4-year period' means the period consisting of 4 calendar years beginning with calendar year 1982 and each subsequent fourth calendar year."

(2) The amendment made by paragraph (1) shall apply to reports for periods after December 31, 1981.

SEC. 442. REMOVAL OF $1,000,000 LIMITATION ON WORKING CAPITAL FUND.

The last sentence of section 322(a) of title 31, United States Code (placing a $1,000,000 limitation on the working capital fund for the Department of the Treasury), is hereby repealed.

SEC. 443. INCREASE IN LIMITATION ON REVOLVING FUND FOR REDEMPTION OF REAL PROPERTY.

Subsection (a) of section 7810 (relating to revolving fund for redemption of real property) is amended by striking out "$1,000,000" and inserting in lieu thereof "$10,000,000".

SEC. 444. REMOVAL OF $1,000,000 LIMITATION ON SPECIAL AUTHORITY TO DISPOSE OF OBLIGATIONS.

Subsection (b) of section 324 of title 31, United States Code (relating to disposing and extending the maturity of obligations), is amended by striking out the last sentence.

SEC. 445. SECRETARY OF THE TREASURY AUTHORIZED TO ACCEPT GIFTS AND BEQUESTS.

Section 321 of title 31, United States Code, is amended by adding at the end thereof the following new subsection:

"(d)(1) The Secretary of the Treasury may accept, hold, administer, and use gifts and bequests of property, both real and personal, for the purpose of aiding or facilitating the work of the Department of the Treasury. Gifts and bequests of money and the proceeds from sales of other property received as gifts or bequests shall be deposited in the Treasury in a separate fund and shall be disbursed on order of the Secretary of the Treasury. Property accepted under this paragraph, and the proceeds thereof, shall be used as nearly as possible in accordance with the terms of the gift or bequest.

"(2) For purposes of the Federal income, estate, and gift taxes, property accepted under paragraph (1) shall be considered as a gift or bequest to or for the use of the United States.

"(3) The Secretary of the Treasury may invest and reinvest the fund in public debt securities with maturities suitable for the needs of the fund and bearing interest at rates determined by the Secretary of the Treasury, taking into consideration the current average market yield on outstanding marketable obligations of the United States of comparable maturities. Income accruing from the securities, and from any other property accepted under paragraph (1), shall be deposited to the credit of the fund, and shall be disbursed on order of the Secretary of the Treasury for purposes as nearly as possible in accordance with the terms of the gifts or bequests.

"(4) The Secretary of the Treasury shall, not less frequently than annually, make a public disclosure of the amount (and sources) of the gifts and bequests received under this subsection, and the purposes for which amounts in the separate fund established under this subsection are expended."

SEC. 446. EXTENSION OF PERIOD FOR COURT REVIEW OF JEOPARDY ASSESSMENT WHERE PROMPT SERVICE NOT MADE ON THE UNITED STATES.

(a) GENERAL RULE.—Paragraph (2) of section 7429(b) (relating to judicial review) is amended by adding at the end thereof the following new sentence:

"If the court determines that proper service was not made on the United States within 5 days after the date of the commencement of the action, the running of the 20-day period set forth in the preceding sentence shall not begin before the day on which proper service was made on the United States."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to actions commenced after the date of the enactment of this Act.

SEC. 447. EXTENSION OF PERIOD DURING WHICH ADDITIONAL TAX SHOWN ON AMENDED RETURN MAY BE ASSESSED.

(a) GENERAL RULE.—Subsection (c) of section 6501 (relating to exceptions) is amended by adding at the end thereof the following new paragraph:

"(7) SPECIAL RULE FOR CERTAIN AMENDED RETURNS.—Where, within the 60-day period ending on the day on which the time prescribed in this section for the assessment of any tax imposed by subtitle A for any taxable year would otherwise expire, the Secretary receives a written document signed by the taxpayer showing that the taxpayer owes an additional amount of such tax for such taxable year, the period for the assessment of such additional amount shall not expire before the day 60 days after the day on which the Secretary receives such document."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to documents received by the Secretary of the Treasury (or his delegate) after the date of the enactment of this Act.

SEC. 448. TREATMENT OF CERTAIN GUARANTEED DRAFTS ISSUED BY FINANCIAL INSTITUTIONS.

(a) GENERAL RULE.—Paragraph (2) of section 6311(b) (relating to liability of banks and others) is amended—

(1) by striking out "or cashier's check" and inserting in lieu thereof "or cashier's check (or other guaranteed draft)",

(2) by striking out "the amount of such check" and inserting in lieu thereof "the amount of such check (or draft)";

(3) by striking out "the bank or trust company" and inserting in lieu thereof "the financial institution", and

(4) by striking out "such bank" each place it appears and inserting in lieu thereof "such financial institution".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 449. DISCLOSURE OF WINDFALL PROFIT TAX INFORMATION TO STATE TAX OFFICIALS.

(a) GENERAL RULE.—Paragraph (1) of section 6103(d) (relating to disclosure to State tax officials) is amended by striking out "44, 51" and inserting in lieu thereof "44, 45, 51".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 450. FINANCIAL REPORTING OF INVESTMENT TAX CREDITS.

(a) IN GENERAL—Paragraph (1) of section 101(c) of the Revenue Act of 1971 (85 Stat. 499) (relating to accounting for investment credit in certain financial reports and reports to Federal agencies) is amended—

(1) by inserting "and" at the end of subparagraph (A),

(2) by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period, and

(3) by striking out subparagraph (C).

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the Revenue Act of 1971.

PART II—PROVISIONS RELATING TO DISTILLED SPIRITS

SEC. 451. REPEAL OF OCCUPATIONAL TAX ON MANUFACTURERS OF STILLS AND CONDENSERS; NOTICES OF MANUFACTURE AND SET UP OF STILLS.

(a) IN GENERAL.—Subpart C of part II of subchapter A of chapter 51 (relating to manufacturers of stills) is amended to read as follows:

"Subpart C—Manufacturers of Stills

"Sec. 5101. Notice of manufacture of still; notice of set up of still.

"Sec. 5102. Definition of manufacturer of stills.

"SEC. 5101. NOTICE OF MANUFACTURE OF STILL; NOTICE OF SET UP OF STILL.

"(a) NOTICE REQUIREMENTS.—

"(1) NOTICE OF MANUFACTURE OF STILL.—The Secretary may, pursuant to regulations, require any person who manufactures any still, boiler, or other vessel to be used for the purpose of distilling, to give written notice, before the still, boiler, or other vessel is removed from the place of manufacture, setting forth by whom it is to be used, its capacity, and the time of removal from the place of manufacture.

"(2) NOTICE OF SET UP OF STILL.—The Secretary may, pursuant to regulations, require that no still, boiler, or other vessel be set up without the manufacturer of the still, boiler, or other vessel first giving written notice to the Secretary of that purpose.

"(b) PENALTIES, ETC.—

"(1) For penalty and forfeiture for failure to give notice of manufacture, or for setting up a still without first giving notice, when required by the Secretary, see sections 5615(2) and 5687.

"(2) For penalty and forfeiture for failure to register still or distilling apparatus when set up, see section 5601(a)(1) and 5615(1).

"SEC. 5102. DEFINITION OF MANUFACTURER OF STILLS.

"Any person who manufactures any still or condenser to be used in distilling shall be deemed a manufacturer of stills."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 5179(b) (relating to registration of stills) is amended to read as follows:

"(2) For provisions requiring notification to set up a still, boiler, or other vessel for distilling, see section 5101(a)(2)."

(2) Paragraph (2) of section 5615 (relating to property subject to forfeiture) is amended to read as follows:

"(2) DISTILLING APPARATUS REMOVED WITHOUT NOTICE OR SET UP WITHOUT NOTICE.—Any still, boiler, or other vessel to be used for the purpose of distilling—

"(A) which is removed without notice having been given when required by section 5101(a)(1), or

"(B) which is set up without notice having been given when required by section 5101(a)(2); and".

(3) Subsection (a) of section 5691 (relating to penalties for nonpayment of special taxes relating to liquors) is amended by striking out "limited retail dealer, or manufacturer of stills" and inserting in lieu thereof "or limited retail dealer".

SEC. 452. ALLOWANCE OF DRAWBACK CLAIMS EVEN WHERE CERTAIN REQUIREMENTS NOT MET.

Section 5134 (relating to drawback) is amended by adding at the end thereof the following new subsection:

"(c) ALLOWANCE OF DRAWBACK EVEN WHERE CERTAIN REQUIREMENTS NOT MET.—

"(1) IN GENERAL.—No claim for drawback under this section shall be denied in the case of a failure to comply with any requirement imposed under this subpart or any rule or regulation issued thereunder upon the claimant's establishing to the satisfaction of the Secretary that distilled spirits on which the tax has been paid or determined were in fact used in the manufacture or production of medicines, medicinal preparations, food products, flavors, or flavoring extracts, which were unfit for beverage purposes.

"(2) PENALTY.—

"(A) IN GENERAL.—In the case of a failure to comply with any requirement imposed under this subpart or any rule or regulation issued thereunder, the claimant shall be liable for a penalty of $1,000 for each failure to comply unless it is shown that the failure to comply was due to reasonable cause.

"(B) PENALTY MAY NOT EXCEED AMOUNT OF CLAIM.—The aggregate amount of the penalties imposed under subparagraph (A) for failures described in paragraph (1) in respect of any claim shall not exceed the

amount of such claim (determined without regard to subparagraph (A)).

"(3) PENALTY TREATED AS TAX.—The penalty imposed by paragraph (2) shall be assessed, collected, and paid in the same manner as taxes, as provided in section 6662(a)."

SEC. 451. DISCLOSURE OF ALCOHOL FUEL PRODUCERS TO ADMINISTRATORS OF STATE ALCOHOL LAWS.

(a) IN GENERAL.—Subsection (l) of section 6103 (relating to confidentiality and disclosure of returns and return information) is amended by adding at the end thereof the following new paragraph:

"(9) DISCLOSURE OF ALCOHOL FUEL PRODUCERS TO ADMINISTRATORS OF STATE ALCOHOL LAWS.—Notwithstanding any other provision of this section, the Secretary may disclose—

"(A) the name and address of any person who is qualified to produce alcohol for fuel use under section 5181, and

"(B) the location of any premises to be used by such person in producing alcohol for fuel,

to any State agency, body, or commission, or its legal representative, which is charged under the laws of such State with responsibility for administration of State alcohol laws solely for use in the administration of such laws."

(b) TECHNICAL AMENDMENTS.—

(1) Subparagraph (A) of section 6103(p)(3) (relating to records of inspection and disclosure) is amended by striking out "(5), or (7)" and inserting in lieu thereof "(5), (7), (8), or (9)".

(2) The material preceding subparagraph (A) of paragraph (4) of section 6103(p) is amended by striking out "or (7)" and inserting in lieu thereof "(7), (8), or (9)".

(3) Clause (i) of section 6103(p)(4)(F) is amended by striking out "(l) (6) or (7)" and inserting in lieu thereof "(l) (6), (7), (8), or (9)".

(4) Paragraph (2) of section 7213(a) (relating to unauthorized disclosure of information) is amended by striking out "or (8)" and inserting in lieu thereof "(8), or (9)".

(5) Section 127(a)(1) of Public Law 96-249 is amended by striking out "Subsection (i)" and inserting in lieu thereof "Subsection (l)".

(6) The paragraph (7) of section 6103(l) added by Public Law 96-265 is hereby redesignated as paragraph (8).

SEC. 454. REPEAL OF STAMP REQUIREMENT FOR DISTILLED SPIRITS.

(a) IN GENERAL.—Section 5205 (relating to stamps) is hereby repealed.

(b) BOTTLES MUST HAVE OTHER ANTITAMPERING CLOSURE.—Section 5301 is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) CLOSURES.—The immediate container of distilled spirits withdrawn from bonded premises, or from customs custody, on determination of tax shall bear a closure or other device which is designed so as to require breaking in order to gain access to the contents of such container. The preceding sentence shall not apply to containers of bulk distilled spirits."

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The second sentence of section 5062(b) (relating to drawback in case of exportation) is amended by striking out "stamped or restamped, and".

(2) Paragraph (2) of section 5066(a) (relating to bottled distilled spirits eligible for export with benefit of drawback) is amended by striking out "stamped or restamped, and marked," and inserting in lieu thereof "marked".

(3) Subsection (b) of section 5116 (relating to cross references) is amended to read as follows:

"(b) CROSS REFERENCE.—

"For provisions relating to containers of distilled spirits, see section 5206."

(4) Subsection (c) of section 5204 (relating to gauging) is amended—

(A) by striking out "STAMPING," in the heading, and

(B) by striking out "stamping," in the text.

(5)(A) Section 5206 (relating to containers) is amended by redesignating subsections (d) and (e) as subsections (e) and (f), respectively, and by inserting after subsection (c) the following new subsection:

"(d) EFFACEMENT OF MARKS AND BRANDS ON EMPTIED CONTAINERS.—Every person who empties, or causes to be emptied, any container of distilled spirits bearing any mark or brand required by law (or regulations pursuant thereto) shall at the time of emptying such container efface and obliterate such mark or brand; except that the Secretary may, by regulations, waive any requirement of this subsection where he determines that no jeopardy to the revenue will be involved."

(B) Subsection (f) of section 5206, as redesignated by subparagraph (A), is amended by adding at the end thereof the following new paragraphs:

"(3) For provisions relating to the marking and branding of containers of distilled spirits by proprietors, see section 5204(c).

"(4) For penalties and forfeitures relating to marks and brands, see sections 5604 and 5613."

(6) Paragraph (4) of section 5207(a) (relating to records and reports) is amended by striking out subparagraph (D), by adding "and" at the end of subparagraph (B), and by striking out "; and" at the end of subparagraph (C) and inserting in lieu thereof a period.

(7) Subsection (c) of section 5215 (relating to return of tax determined distilled spirits to bonded premises) is amended—

(A) by striking out "RESTAMPING" in the heading and inserting in lieu thereof "RECLOSING", and

(B) by striking out "restamping" in the text and inserting in lieu thereof "reclosing".

(8) Section 5235 (relating to bottling of alcohol for industrial purposes) is amended by striking out "stamped," in the first sentence and by striking out the second sentence.

(9) Subsection (c) of section 5301 (relating to regulation of traffic in containers of distilled spirits) is amended—

(A) by striking out "stamping" in paragraphs (1) and (3) and inserting in lieu thereof "tax determination", and

(B) by striking out ", if the liquor bottles are to be again stamped under the provisions of this chapter".

(10) Subsection (a) of section 5555 (relating to records, statements, and returns) is amended by striking out "or for the affixing of any stamp required to be affixed by this chapter,".

(11)(A) Section 5684 (relating to penalties relating to stamps, marks, brands, and containers) is amended to read as follows:

"SEC. 5684. PENALTIES RELATING TO MARKS, BRANDS, AND CONTAINERS.

"(a) IN GENERAL.—Any person who shall—

"(1) transport, possess, buy, sell, or transfer any distilled spirits unless the immediate container bears the type of closure or other device required by section 5301(d);

"(2) with intent to defraud the United States, empty a container bearing the closure or other device required by section 5301(d) without breaking such closure or other device,

"(3) empty, or cause to be emptied, any distilled spirits from an immediate container bearing any mark or brand required by law without effacing and obliterating such mark or brand as required by section 5206(d),

"(4) place any distilled spirits in any bottle, or reuse any bottle for the purpose of containing distilled spirits, which has once been filled and fitted with a closure or other device under the provisions of this chapter, without removing and destroying such closure or other device,

"(5) willfully and unlawfully remove, change, or deface any mark, brand, label, or seal affixed to any case of distilled spirits, or to any bottle contained therein,

"(6) with intent to defraud the United States, purchase, sell, receive with intent to transport, or transport any empty cask or package having thereon any mark or brand required by law to be affixed to any cask or package containing distilled spirits, or

"(7) change or alter any mark or brand on any cask or package containing distilled spirits, or put into any cask or package spirits of greater strength than is indicated by the inspection mark thereon, or fraudulently use any cask or package having any inspection mark thereon, for the purpose of selling other spirits, or spirits of quantity or quality different from the spirits previously inspected,

shall be fined not more than $10,000 or imprisoned not more than 5 years, or both, for each such offense.

"(b) CROSS REFERENCES.—

"For provisions relating to the authority of internal revenue officers to enforce provisions of this section, see sections 5203, 5557, and 7608."

(B) The table of sections for part I of subchapter J of chapter 51 is amended by striking out the item relating to section 5604 and inserting in lieu thereof the following:

"Sec. 5604. Penalties relating to marks, brands, and containers."

(12)(A) Subsection (b) of section 5613 (relating to forfeiture of distilled spirits not stamped, marked, or branded as required by law) is amended to read as follows:

"(b) CONTAINERS WITHOUT CLOSURES.—All distilled spirits found in any container which is required by this chapter to bear a closure or other device and which does not bear a closure or other device in compliance with this chapter shall be forfeited to the United States."

(B) The section heading of section 5613 is amended by striking out "STAMPED" and inserting in lieu thereof "CLOSED".

(C) The item relating to section 5613 in the table of sections for part I of subchapter J of chapter 51 is amended by striking out "stamped" and inserting in lieu thereof "closed".

(13) Subsection (b) of section 6801 (relating to authority for establishment, alteration, and distribution) is amended by striking out "several stamp taxes;" and all that follows and inserting in lieu thereof "several stamp taxes."

(14) The table of sections for part I of subchapter C of chapter 51 is amended by striking out the item relating to section 5205.

SEC. 455. COOKING WINE MAY BE FORTIFIED USING DISTILLED SPIRITS.

(a) IN GENERAL.—Subsection (a) of section 5214 (relating to withdrawal of distilled spirits from bonded premises free of tax or without payment of tax) is amended by striking out the period at the end of paragraph (12) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(13) without payment of tax for use on bonded wine cellar premises in the production of wine or wine products which will be

rendered unfit for beverage use and removed pursuant to section 5362(d)."

(b) LIABILITY FOR TAX.—

(1) Paragraph (1) of section 5005(e) (relating to withdrawals without payment of tax) is amended by striking out "or (10)" and inserting in lieu thereof "(10), or (13)".

(2) Paragraph (2) of section 5005(e) is amended by inserting "used in the production of nonbeverage wine or wine products," after "used in the production of wine,".

(c) TECHNICAL AMENDMENT.—Section 5354 (relating to bonds for bonded wine cellars) is amended by striking out "wine spirits" each place it appears and inseting in lieu thereof "distilled spirits".

SEC. 458. EFFECTIVE DATES.

(a) IN GENERAL.—Except as otherwise provided in this section the amendments made by this part shall take effect on the first day of the first calendar month which begins more than 90 days after the date of the enactment of this Act.

(b) REPEAL OF STAMP REQUIREMENT.—The amendments made by section 454 shall take effect on July 1, 1985.

(c) FORTIFICATION OF COOKING WINE.—The amendments made by section 455 shall take effect on the date of the enactment of this Act.

Subtitle E—Tax Court Provisions

SEC. 461. INCREASE IN JURISDICTIONAL LIMIT FOR SMALL CASES.

(a) INCREASE IN JURISDICTIONAL LIMIT FOR SMALL TAX CASES.—

(1) IN GENERAL.—Subsection (a) of section 7463 (relating to disputes involving $5,000 or less) is amended by striking out "$5,000" each place it appears and inserting in lieu thereof "$10,000".

(2) CLERICAL AMENDMENTS.—

(A) The section heading for section 7463 is amended by striking out "$5,000" and inserting in lieu thereof "$10,000".

(B) The table of sections for part II of subchapter C of chapter 76 is amended by striking out "$5,000" in the item relating to section 7463 and inserting in lieu thereof "$10,000".

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 462. ANNUITIES TO SURVIVORS OF TAX COURT JUDGES.

(a) ENTITLEMENT TO ANNUITY.—Subsection (h) of section 7448 (relating to entitlement to annuity) is amended—

(1) by striking out "$900 per year divided by the number of such children or $360 per year," in paragraph (2) and inserting in lieu thereof "$4,644 per year divided by the number of such children or $1,548 per year,", and

(2) by striking out "$480 per year" in paragraph (3) and inserting in lieu thereof "$5,580 per year divided by the number of such children or $1,860 per year, whichever is lesser".

(b) EFFECTIVE DATE.—The amendments made by this subsection (a) shall apply to annuities payable with respect to months beginning after the date of the enactment of this Act.

SEC. 463. PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.

(a) IN GENERAL.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners) is amended to read as follows:

"(d) PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.—The chief judge may assign—

"(1) any declaratory judgment proceeding,

"(2) any proceeding under section 7463,

"(3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any claimed overpayment exceeds $10,000; and

"(4) any other proceeding which the chief judge may designate,

to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3), subject to such conditions and review as the court may provide."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if enacted as part of the Miscellaneous Revenue Act of 1982.

SEC. 464. SPECIAL TRIAL JUDGES.

(a) IN GENERAL.—Subsection (a) of section 7456 (relating to administration of oaths and procurement of testimony) is amended by striking out "commissioner" each place it appears and inserting in lieu thereof "special trial judge".

(b) APPOINTMENT AND COMPENSATION.—Subsection (c) of section 7456 (relating to commissioners) is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(c) PROCEEDINGS WHICH MAY BE ASSIGNED TO SPECIAL TRIAL JUDGES.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners), as amended by section 463, is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(d) CONFORMING AMENDMENT.—Subsection (c) of section 7471 (cross reference relating to compensation and travel and subsistence allowances of commissioners) is amended by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES", and by striking out "commissioners" and inserting in lieu thereof "special trial judges".

(e) EFFECTIVE DATE.—

(1) The amendments made by this section shall take effect on the date of the enactment of this Act.

(2) Any reference in any law to a commissioner of the Tax Court shall be treated as a reference to a special trial judge of the Tax Court.

SEC. 465. PUBLICITY OF TAX COURT PROCEEDINGS.

(a) IN GENERAL.—Section 7461 (relating to publicity of proceedings) is amended to read as follows:

"SEC. 7461. PUBLICITY OF PROCEEDINGS.

"(a) GENERAL RULE.—Except as provided in subsection (b), all reports of the Tax Court and all evidence received by the Tax Court and its divisions, including a transcript of the stenographic report of the hearings, shall be public records open to the inspection of the public.

"(b) EXCEPTIONS.—

"(1) TRADE SECRETS OR OTHER CONFIDENTIAL INFORMATION.—The Tax Court may make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information, including a provision that any document or information be placed under seal to be opened only as directed by the court.

"(2) EVIDENCE, ETC.—After the decision of the Tax Court in any proceeding has become final, the Tax Court may, upon motion of the taxpayer or the Secretary, permit the withdrawal by the party entitled thereto of originals of books, documents, and records, and of models, diagrams, and other exhibits, introduced in evidence before the Tax Court or any division; or the Tax Court may, on its own motion, make such other disposition thereof as it deems advisable."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

Subtitle F—Simplification of Income Tax Credits

SEC. 471. CREDITS GROUPED TOGETHER IN MORE LOGICAL ORDER.

(a) CREDITS DIVIDED INTO 4 CATEGORIES.—The table of subparts for part IV of subchapter A of chapter 1 (relating to credits against tax) is amended to read as follows:

"Subpart A. Nonrefundable personal credits.

"Subpart B. Foreign tax credit, etc.

"Subpart C. Refundable credits.

"Subpart D. Business-related credits."

(b) EXISTING CREDITS ASSIGNED TO APPROPRIATE CATEGORY.—Part IV of subchapter A of chapter 1 is amended by striking out the heading and table of sections for subpart A and inserting in lieu thereof the following:

"Subpart A—Nonrefundable Personal Credits

"Sec. 21. Expenses for household and dependent care services necessary for gainful employment.

"Sec. 22. Credit for the elderly and the permanently and totally disabled.

"Sec. 23. Residential energy credit.

"Sec. 24. Contributions to candidates for public office.

"Sec. 25. Limitation based on tax liability: definition of tax liability.

"Subpart B—Foreign Tax Credit, Etc.

"Sec. 27. Taxes of foreign countries and possessions of the United States: possession tax credit.

"Sec. 28. Clinical testing expenses for certain drugs for rare diseases or conditions.

"Sec. 29. Credit for producing fuel from a nonconventional source.

"Sec. 30. Credit for increasing research activities.

"Subpart C—Refundable Credits

"Sec. 31. Tax withheld on wages.

"Sec. 32. Earned income.

"Sec. 33. Tax withheld at source on nonresident aliens and foreign corporations.

"Sec. 34. Certain uses of gasoline and special fuels.

"Sec. 35. Overpayments of tax.

"Subpart D—Business Related Credits

"Sec. 38. General business credit.

"Sec. 39. Carryback and carry forward of unused credits.

"Sec. 40. Alcohol used as fuel.

"Sec. 41. Employee stock ownership credit."

(c) SECTIONS MOVED TO APPROPRIATE PLACE IN PART IV.—

(1) DESIGNATION.—The following sections of such part IV are henceforth to be designated in accordance with the following table:

Old section number:	New section number:	New subpart designation:
44A	21	A
37	22	A
44C	23	A
41	24	A
33	27	B
44H	28	B
44D	29	B
44F	30	B
31	31	C
43	32	C
32	33	C
39	34	C
45	35	C
44E	40	D
44G	41	D

(2) PLACED IN APPROPRIATE SUBPARTS.—Each section for which paragraph (1) provides a new section number is hereby moved to the appropriate place in the appropriate subpart of such part IV.

SEC. 472. UNIFORM LIMITATION ON PERSONAL NONREFUNDABLE CREDITS.

Subpart A of part IV of subchapter A of chapter 1 is amended by adding after section 24 the following new section:

"SEC. 25. LIMITATION BASED ON TAX LIABILITY; DEFINITION OF TAX LIABILITY.

"(a) LIMITATION BASED ON AMOUNT OF TAX.—The aggregate amount of credits allowed by this subpart for the taxable year shall not exceed the taxpayer's tax liability for such taxable year.

"(b) TAX LIABILITY.—For purposes of this section—

"(1) IN GENERAL.—The term 'tax liability' means the tax imposed by this chapter for the taxable year.

"(2) EXCEPTION FOR CERTAIN TAXES.—For purposes of paragraph (1), any tax imposed by any of the following provisions shall not be treated as tax imposed by this chapter:

"(A) section 56 (relating to corporate minimum tax),

"(B) subsection (m)(5)(B), (o)(2), or (q) of section 72 (relating to additional tax on certain distributions),

"(C) section 408(f) (relating to additional tax on income from certain retirement accounts),

"(D) section 531 (relating to accumulated earnings tax),

"(E) section 541 (relating to personal holding company tax),

"(F) section 1351(d)(1) (relating to recoveries of foreign expropriation losses),

"(G) section 1374 (relating to tax on certain capital gains of S corporations), and

"(H) section 1375 (relating to tax imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts).

"(c) SIMILAR RULE FOR ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.—

"For treatment of tax imposed by section 55 as not imposed by this chapter, see section 55(c)."

SEC. 473. UNIFORM CARRYOVER PROVISIONS FOR BUSINESS-RELATED CREDITS.

Subpart D of part IV of subchapter A of chapter 1 is amended by inserting before section 40 the following new sections:

"SEC. 38. GENERAL BUSINESS CREDIT.

"(a) ALLOWANCE OF CREDIT.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

"(1) the business credit carryforwards carried to such taxable year,

"(2) the amount of the current year business credit, plus

"(3) the business credit carrybacks carried to such taxable year.

"(b) CURRENT YEAR BUSINESS CREDIT.—For purposes of this subpart, the amount of the current year business credit is the sum of the following credits determined for the taxable year:

"(1) the investment credit determined under section 46(a),

"(2) the targeted jobs credit determined under section 51(a),

"(3) the alcohol fuels credit determined under section 40(a), plus

"(4) the employee stock ownership credit determined under section 41(a).

"(c) LIMITATION BASED ON AMOUNT OF TAX.—

"(1) IN GENERAL.—The credit allowed under subsection (a) for any taxable year shall not exceed the sum of—

"(A) so much of the taxpayer's net tax liability for the taxable year as does not exceed $25,000, plus

"(B) 85 percent of so much of the taxpayer's net tax liability for the taxable year as exceeds $25,000.

"(2) NET TAX LIABILITY.—For purposes of paragraph (1), the term 'net tax liability' means the tax liability (as defined in section 25(b)), reduced by the sum of the credits allowable under subparts A and B of this part.

"(3) SPECIAL RULES.—

"(A) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (1) shall be $12,500 in lieu of $25,000. This subparagraph shall not apply if the spouse of the taxpayer has no business credit carryforward or carryback to, and has no current year business credit for, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(B) CONTROLLED GROUPS.—In the case of a controlled group, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced for each component member of such group by apportioning $25,000 among the component members of such group in such manner as the Secretary shall by regulations prescribe. For purposes of the preceding sentence, the term 'controlled group' has the meaning given to such term by section 1563(a).

"(C) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—In the case of a person described in subparagraph (A) or (B) of section 46(e)(1), the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall equal such person's ratable share (as determined under section 46(e)(2)) of such amount.

"(D) ESTATES AND TRUSTS.—In the case of an estate or trust, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced to an amount which bears the same ratio to $25,000 as the portion of the income of the estate or trust which is not allocated to beneficiaries bears to the total income of the estate or trust.

"(d) SPECIAL RULES FOR CERTAIN REGULATED COMPANIES.—In the case of any taxpayer to which section 46(f) applies, for purposes of sections 46(f), 47(a), 196(a), and 404(i) and any other provision of this title where it is necessary to ascertain the extent to which the credits determined under section 40(a), 41(a), 46(a), or 51(a) are used in a taxable year or as a carryback or carryforward, the order in which such credits are used shall be determined on the basis of the order in which they are listed in subsection (b).

"SEC. 39. CARRYBACK AND CARRYFORWARD OF UNUSED CREDITS.

"(a) IN GENERAL.—

"(1) 3 YEAR CARRYBACK AND 15 YEAR CARRYFORWARD.—If the sum of the business credit carryforwards to the taxable year plus the amount of the current year business credit for the taxable year exceeds the amount of the limitation imposed by subsection (c) of section 38 for such taxable year (hereinafter in this section referred to as the 'unused credit year'), such excess (to the extent attributable to the amount of the current year business credit) shall be—

"(A) a business credit carryback to each of the 3 taxable years preceding the unused credit year, and

"(B) a business credit carryforward to each of the 15 taxable years following the unused credit year,

and, subject to the limitations imposed by subsections (b) and (c), shall be taken into account under the provisions of section 38(a) in the manner provided in section 38(a).

"(2) AMOUNT CARRIED TO EACH YEAR.—

"(A) ENTIRE AMOUNT CARRIED TO FIRST YEAR.—The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 18 taxable years to which (by reason of paragraph (1)) such credit may be carried.

"(B) AMOUNT CARRIED TO OTHER 17 YEARS.—The amount of the unused credit for the unused credit year shall be carried to each of the other 17 taxable years to the extent that such unused credit may not be taken into account under section 38(a) for a prior taxable year because of the limitations of subsections (b) and (c).

"(b) LIMITATION ON CARRYBACKS.—The amount of the unused credit which may be taken into account under section 38(a)(3) for any preceding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of—

"(1) the amounts determined under paragraphs (1) and (2) of section 38(a) for such taxable year, plus

"(2) the amounts which (by reason of this section) are carried back to such taxable year and are attributable to taxable years preceding the unused credit year.

"(c) LIMITATION ON CARRYFORWARDS.—The amount of the unused credit which may be taken into account under section 38(a)(1) for any succeeding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of the amounts which, by reason of this section, are carried to such taxable year and are attributable to taxable years preceding the unused credit year.

"(d) TRANSITIONAL RULES.—

"(1) CARRYFORWARDS.—

"(A) IN GENERAL.—Any carryforward from an unused credit year under section 46, 50A, 53, 44E, or 44G which has not expired before the beginning of the first taxable year beginning after December 31, 1983, shall be aggregated with other such carryforwards from such unused credit year and shall be a business credit carryforward to each taxable year beginning after December 31, 1983, which is 1 of the first 15 taxable years after such unused credit year.

"(B) AMOUNT CARRIED FORWARD.—The amount carried forward under subparagraph (A) to any taxable year shall be properly reduced for any amount allowable as a credit with respect to such carryforward for any taxable year before the year to which it is being carried.

"(2) CARRYBACKS.—In determining the amount allowable as a credit for any taxable year beginning before January 1, 1984, as the result of the carryback of a general business tax credit from a taxable year beginning after December 31, 1983—

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"(A) paragraph (1) of subsection (b) shall be applied as if it read as follows:

"'(1) the sum of the credits allowable for such taxable year under sections 38, 40, 44B, 44E, and 44G (as in effect before enactment of the Tax Reform Act of 1984), plus', and

"(B) for purposes of section 38(c) the net tax liability for such taxable year shall be the tax liability (as so defined in section 25(b)) reduced by the sum of the credits allowable for such taxable year under sections 33, 37, 41, 44A, 44C, 44D, 44F, and 44H (as so in effect)."

SEC. 474. TECHNICAL AND CONFORMING AMENDMENTS

(a) REFERENCES TO OLD AND NEW PROVISIONS.—Whenever in this section reference is made to an old or new section or other provision, the reference is to the provision before (in the case of "old") or after (in the case of "new") the changes made by section 471 of this Act.

(b) OLD SECTION 21.—

(1) REDESIGNATION.—Old section 21 (relating to effect of changes) is redesignated as section 15.

(2) CONFORMING AMENDMENTS.—Sections 441(f)(2)(A) and 6013(c) are each amended by striking out "21" and inserting in lieu thereof "15".

(3) TABLE OF SECTIONS.—The table of sections for part III of subchapter A of chapter 1 is amended by striking out the item relating to section 21 and inserting in lieu thereof the following:

"Sec. 15. Effect of changes."

(c) NEW SECTION 21.—New section 21 (relating to expenses for household and dependent care services necessary for gainful employment) is amended—

(1) by striking out subsection (b) and by redesignating subsections (c), (d), (e), (f), and (g) as subsections (b), (c), (d), (e), and (f), respectively,

(2) by striking out "subsection (c)(1)" in subsection (a) and inserting in lieu thereof "subsection (b)(1)",

(3) by striking out "subsection (c)(2)" in subsection (a) and inserting in lieu thereof "subsection (b)(2)",

(4) by striking out "subsection (c)(1)(C)" in paragraph (2) of subsection (d) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)(C)",

(5) by striking out "subsection (d)(1)" in subparagraph (A) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof, "subsection (c)(1)",

(6) by striking out "subsection (d)(2)" in subparagraph (B) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (c)(2)", and

(7) by striking out "subsection (c)(1)" in subsection (e)(5) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)".

(d) NEW SECTION 22.—New Section 22 (relating to the credit for the elderly and the permanently and totally disabled) is amended—

(1) by striking out "Section 37 amount" each place it appears in the text and inserting in lieu thereof "section 22 amount",

(2) by striking out the heading of subsection (c) and inserting in lieu thereof "(c) SECTION 22 AMOUNT.—", and

(3) by amending subsection (d) to read as follows:

"(d) ADJUSTED GROSS INCOME LIMITATION.—If the adjusted gross income of the taxpayer exceeds—

"(1) $7,500 in the case of a single individual,

"(2) $10,000 in the case of a joint return, or

"(3) $5,000 in the case of a married individual filing a separate return,

the section 22 amount shall be reduced by one-half of the excess of the adjusted gross income over $7,500, $10,000, or $5,000, as the case may be."

(e) NEW SECTION 23.—Subsection (b) of new section 23 (relating to residential energy credit) is amended by striking out paragraphs (5) and (6) and inserting in lieu thereof the following:

"(5) CARRYFORWARD OF UNUSED CREDIT.—

"(A) IN GENERAL.—If the credit allowable under subsection (a) for any taxable year exceeds the limitation imposed by section 25(a) for such taxable year reduced by the sum of the credits allowable under this subpart (other than this section), such excess shall be carried to the succeeding taxable year and added to the credit allowable under subsection (a) for such succeeding taxable year.

"(B) NO CARRYFORWARD TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1987.—No amount may be carried under subparagraph (A) to any taxable year beginning after December 31, 1987."

(f) NEW SECTION 24.—Subsection (b) of new section 24 (relating to contributions to candidates for political office) is amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(g) NEW SECTION 28.—

(1) New section 28 is amended—

(A) by striking out "section 44F" each place it appears and inserting in lieu thereof "section 30", and

(B) by striking out "section 44F(b)" in subsection (c)(2) and inserting in lieu thereof "section 30(b)," and

(C) by striking out "section 44F(f)" in subsection (d)(4) and inserting in lieu thereof "section 30(f)".

(2) Paragraph (2) of new section 28(d) is amended to read as follows:

"(2) LIMITATION BASED ON AMOUNT OF TAX.—The credit allowed by this section for any taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and section 27."

(h) NEW SECTION 29.—Paragraph (5) of new section 29(b) (relating to credit for producing fuel from a nonconventional source) is amended to read as follows:

"(5) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) for a taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and sections 27 and 28."

(i) NEW SECTION 30.—

(1) New section 30 (relating to credit for increasing research activities) is amended—

(A) by striking out "in computing the credit under section 40 or 44B" in subsection (b)(2)(D)(iii) and inserting in lieu thereof "in determining the targeted jobs credit under section 51(a)", and

(B) by amending subparagraph (A) of subsection (g)(1) to read as follows:

"(A) IN GENERAL.—Except as provided in subparagraph (B), the credit allowed by subsection (a) for any taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and sections 27, 28, and 29."

(2) NEW SECTION 30 TREATED AS CONTINUATION OF OLD SECTION 44F.—For purposes of determining—

(A) whether any excess credit under old section 44F for a taxable year beginning before January 1, 1984, is allowable as a carryover under new section 30, and

(B) the period during which new section 30 is in effect,

new section 30 shall be treated as a continuation of old section 44F (and shall apply only to the extent old section 44F would have applied).

(j) NEW SECTION 33.—New section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds) is amended to read as follows:

"SEC. 33. TAX WITHHELD AT SOURCE ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.

"There shall be allowed as a credit against the tax imposed by this subtitle the amount of tax withheld at source under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and on foreign corporations)."

(k) NEW SECTION 40.—New section 40 (relating to alcohol used as fuel) is amended—

(1) by amending subsection (a) to read as follows:

"(a) GENERAL RULE.—For purposes of section 38, the alcohol fuels credit determined under this section for the taxable year is an amount equal to the sum of—

"(1) the alcohol mixture credit, plus

"(2) the alcohol credit.",

(2) by striking out "the credit allowable under this section" in subsection (c) and inserting in lieu thereof "the credit determined under this section",

(3) by striking out "credit was allowable" each place it appears in paragraph (3) of subsection (d) and inserting in lieu thereof "credit was determined",

(4) by striking out subsection (e) and redesignating subsection (f) as subsection (e),

(5) by amending paragraph (2) of subsection (e) (as redesignated by paragraph (4)) to read as follows:

"(2) NO CARRYOVERS TO YEARS AFTER 1994.—No amount may be carried under section 39 by reason of this section (treating the amount allowed by reason of this section as the first amount allowed by this subpart) to any taxable year beginning after December 31, 1994.", and

(6) by adding at the end thereof the following new subsection:

"(f) ELECTION TO HAVE ALCOHOL FUELS CREDIT NOT APPLY.—

"(1) IN GENERAL.—A taxpayer may elect to have this section not apply for any taxable year.

"(2) TIME FOR MAKING ELECTION.—An election under paragraph (1) for any taxable year may be made (or revoked) at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for such taxable year (determined without regard to extensions).

"(3) MANNER OF MAKING ELECTION.—An election under paragraph (1) (or revocation thereof) shall be made in such manner as the Secretary may by regulations prescribe."

(l) NEW SECTION 41.—New section 41 (relating to employee stock ownership plan) is amended—

(1) by amending paragraph (1) of subsection (a) to read as follows:

"(1) AMOUNT OF CREDIT.—In the case of a corporation which elects to have this section apply for the taxable year and which meets the requirements of subsection (c)(1), for purposes of section 38, the amount of the employee stock ownership credit determined under this section for the taxable year is an amount equal to the amount of the credit determined under paragraph (2) for such taxable year.",

(2) by amending subsection (b) to read as follows:

"(b) CERTAIN REGULATED COMPANIES.—No credit attributable to compensation taken into account for the ratemaking purposes

involved shall be determined under this section with respect to a taxpayer if—

"(1) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to a tax credit employee stock ownership plan which meets the requirements of section 409;

"(2) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan; or

"(3) any portion of the amount of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

Under regulations prescribed by the Secretary, rules similar to the rules of paragraphs (4) and (7) of section 46(f) shall apply for purposes of the preceding sentence.", and

(3) by striking out "the credit allowed under this section" in subsection (c)(3) and inserting in lieu thereof "the credit determined under this section".

(m) REPEAL OF CERTAIN OLD PROVISIONS.—

(1) Old sections 38, 40, 44, and 44B are hereby repealed.

(2) Old subpart C of part IV of subchapter A of chapter 1 is hereby repealed.

(n) REDESIGNATION OF OLD SUBPARTS.—

(1) Old subparts B and D of part IV of subchapter A of chapter 1 are redesignated as subparts E and F, respectively.

(2) The subpart heading for subpart F of part IV of subchapter A of chapter 1 (as so redesignated) is amended to read as follows:

"Subpart F—Rules for Computing Targeted Jobs Credit".

(3) The table of subparts for such part IV (as amended by subsection (a) of section 471) is amended by adding at the end thereof the following:

"Subpart E. Rules for computing credit for investment in certain depreciable property.

"Subpart F. Rules for computing targeted jobs credit."

(o) INVESTMENT TAX CREDIT.—

(1) Section 46 (relating to amount of investment tax credit) is amended by striking out subsections (a) and (b) and inserting in lieu thereof the following:

"(a) AMOUNT OF INVESTMENT CREDIT.—For purposes of section 38, the amount of the investment credit determined under this section for any taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

"(1) the regular percentage,

"(2) in the case of energy property, the energy percentage, and

"(3) in the case of that portion of the basis of any property which is attributable to qualified rehabilitation expenditures, the rehabilitation percentage.

"(b) DETERMINATION OF PERCENTAGES.—For purposes of subsection (a)—

"(1) REGULAR PERCENTAGE.—The regular percentage is 10 percent.

"(2) ENERGY PERCENTAGE.—

"(A) IN GENERAL.—The energy percentage shall be determined in accordance with the following table:

"Column A—Description	Column B—Percentage	Column C—Period	
In the case of:	The energy percentage is:	For the period: Beginning on:	And ending on:
(i) GENERAL RULE.—Property not described in any of the following provisions of this column.	10 percent	Oct. 1, 1978	Dec. 31, 1982.
(ii) SOLAR WIND, OR GEOTHERMAL PROPERTY.—Property described in section 48(l)(2)(A)(ii) or 48(l)(3)(A)(vii).	A. 10 percent	Oct. 1, 1978	Dec. 31, 1979.
	B. 15 percent	Jan. 1, 1980	Dec. 31, 1985.
(iii) OCEAN THERMAL PROPERTY.—Property described in section 48(l)(3)(A)(ix)	15 percent	Jan. 1, 1980	Dec. 31, 1985.
(iv) QUALIFIED HYDROELECTRIC GENERATING PROPERTY.—Property described in section 48(l)(2)(A)(vii).	11 percent	Jan. 1, 1980	Dec. 31, 1985.
(v) QUALIFIED INTERCITY BUSES.—Property described in section 48(l)(2)(A)(ix)	10 percent	Jan. 1, 1980	Dec. 31, 1985.
(vi) BIOMASS PROPERTY.—Property described in section 48(l)(15)	10 percent	Oct. 1, 1978	Dec. 31, 1985.
(vii) CHLOR-ALKALI ELECTROLYTIC CELLS.—Property described in section 48(l)(5)(M).	10 percent	Jan. 1, 1980	Dec. 31, 1982.

"(B) PERIODS FOR WHICH PERCENTAGE NOT SPECIFIED.—In the case of any energy property, the energy percentage shall be zero for any period for which an energy percentage is not specified for such property under subparagraph (A) (as modified by subparagraphs (C) and (D)).

"(C) LONGER PERIOD FOR CERTAIN LONG-TERM PROJECTS.—For the purpose of applying the energy percentage contained in clause (i) of subparagraph (A) with respect to property which is part of a project with a normal construction period of 2 years or more (within the meaning of subsection (d)(2)(A)(i)), 'December 31, 1990' shall be substituted for 'December 31, 1982' if—

"(i) before January 1, 1983, all engineering studies in connection with the commencement of the construction of the project have been completed and all environmental and construction permits required under Federal, State, or local law in connection with the commencement of the construction of the project have been applied for, and

"(ii) before January 1, 1986, the taxpayer has entered into binding contracts for the acquisition, construction, reconstruction, or erection of equipment specially designed for the project and the aggregate cost to the taxpayer of that equipment is at least 50 percent of the reasonably estimated cost for all such equipment which is to be placed in service as part of the project upon its completion.

"(D) LONGER PERIOD FOR CERTAIN HYDROELECTRIC GENERATING PROPERTY.—If an application has been docketed by the Federal Energy Regulatory Commission before January 1, 1986, with respect to the installation of any qualified hydroelectric generating property, for purposes of applying the energy percentage contained in clause (iv) of subparagraph (A) with respect to such property, 'December 31, 1988' shall be substituted for 'December 31, 1985'.

"(3) SPECIAL RULE FOR CERTAIN ENERGY PROPERTY.—The regular percentage shall not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. In the case of any qualified hydroelectric generating property which is a fish passageway, the preceding sentence shall not apply to any period after 1979 for which the energy percentage for such property is greater than zero.

"(4) REHABILITATION PERCENTAGE.—

"(A) IN GENERAL.—

"In the case of qualified rehabilitation expenditures with respect to a:	The rehabilitation percentage is:
30-year building	15
40-year building	20
Certified historic structure	25.

"(B) REGULAR AND ENERGY PERCENTAGES NOT TO APPLY.—The regular percentages and the energy percentages shall not apply to that portion of the basis of any property which is attributable to qualified rehabilitation expenditures.

"(C) DEFINITIONS.—For purpose of this paragraph—

"(i) 30-YEAR BUILDING.—The term '30-year building' means a qualified rehabilitated building other than a 40-year building and other than a certified historic structure.

"(ii) 40-YEAR BUILDING.—The term '40-year building' means a qualified rehabilitated building (other than a certified historic structure) which would meet the requirements of section 48(g)(1)(B) if '40' were substituted for '30' each place it appears in subparagraph (B) thereof.

"(iii) CERTIFIED HISTORIC STRUCTURE.—The term 'certified historic structure' means a qualified rehabilitated building which meets the requirements of section 48(g)(3)."

(2) Subclause (II) of section 46(c)(8)(F)(ii) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "subsection (b)(2)".

(3)(A) Paragraph (1) of section 46(e) is amended—

(i) by striking out "and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(3)", and

(ii) by striking out "such items" and inserting in lieu thereof "such qualified investment".

(B) Paragraph (2) of section 46(e) is amended by striking out "the items described therein" and inserting in lieu thereof "qualified investment".

(4)(A) Paragraphs (1) and (2) of section 46(f) are each amended by striking out "no credit shall be allowed by section 38" and inserting in lieu thereof "no credit determined under subsection (a) shall be allowed by section 38".

(B) Paragraphs (1) and (2) of section 46(f) are each amended by striking out "the credit allowable by section 38" each place it appears and inserting in lieu thereof "the credit determined under subsection (a) and allowable by section 38".

(C) Subparagraph (B) of section 46(f)(4) is amended by striking out "the credit allowed by section 38" and inserting in lieu thereof

"the credit determined under subsection (a) and allowed by section 38".

(5) Paragraph (8) of section 46(f) is amended—

(A) by striking out "the credit allowable under section 38" each place it appears and inserting in lieu thereof "the credit determined under subsection (a) and allowable under section 38", and

(B) by striking out "(within the meaning of subsection (a)(7)(C))" and inserting in lieu thereof "(within the meaning of the first sentence of subsection (c)(3)(B))".

(6) Paragraph (2) of section 46(g) is amended by striking out "the limitation of subsection (a)(3)" and inserting in lieu thereof "the limitation of section 38(c)".

(7) Paragraph (1) of section 46(h) is amended—

(A) by striking out "the credit allowable to the organization under section 38" and inserting in lieu thereof "the credit determined under subsection (a) and allowable to the organization under section 38", and

(B) by striking out "the limitation contained in subsection (a)(3)" and inserting in lieu thereof "the limitation contained in section 38(c)".

(8) Paragraphs (5) and (6) of section 47(a) are each amended by striking out "under section 46(b)" and inserting in lieu thereof "under section 39".

(9) Subsection (c) of section 47 is amended by striking out "subpart A" and inserting in lieu thereof "subpart A, B, or D".

(10) Subparagraph (B) of section 48(c)(3) is amended by striking out "section 46(b)" and inserting in lieu thereof "section 39".

(11) Subparagraph (B) of section 48(d)(1) is amended by striking out "section 46(a)(6)" and inserting in lieu thereof "section 38(c)(3)(B)".

(12) Subsection (f) of section 48 is amended—

(A) by adding "and" at the end of paragraph (1),

(B) striking out ", and" at the end of paragraph (2) and inserting in lieu thereof a period, and

(C) by striking out paragraph (3).

(13) Paragraph (1) of section 48(l) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "section 46(b)(2)".

(14) Subsection (m) of section 48 is amended by striking out "subsection (a)(2)" and inserting in lieu thereof "subsection (b)".

(15) Subsection (n) of section 48 (relating to requirements for allowance of employee plan percentage) is hereby repealed; except that paragraph (4) of section 48(n) of the Internal Revenue Code of 1954 (as in effect before its repeal by this paragraph) shall continue to apply in the case of any recapture under section 47(f) of such Code of a credit allowable for a taxable year beginning before January 1, 1984.

(16) Subsection (o) of section 48 (defining certain credits) is amended by striking out paragraphs (3), (4), (5), (6), and (7) and by redesignating paragraph (8) as paragraph (3).

(17) Subsection (q) of section 48 is amended—

(A) by striking out "section 46(a)(2)" each place it appears and inserting in lieu thereof "section 46(a)"; and

(B) by striking out "section 46(a)(2)(B)" each place it appears and inserting in lieu thereof "section 46(b)(1)".

(18) Subsection (r) of section 48 is amended by striking out "section 381(c)(23)" and inserting in lieu thereof "section 381(c)(26)".

(p) TARGETED JOBS CREDIT.—

(1) Subsection (a) of section 51 (relating to amount of targeted jobs credit) is amended to read as follows:

"(a) DETERMINATION OF AMOUNT.—For purposes of section 38, the amount of the targeted jobs credit determined under this section for the taxable year shall be the sum of—

"(1) 50 percent of the qualified first-year wages for such year, and

"(2) 25 percent of the qualified second-year wages for such year."

(2) Subsection (g) of section 51 is amended by striking out "the credit provided by section 44B" and inserting in lieu thereof "the targeted jobs credit determined under this subpart".

(3) Section 51 is amended by adding at the end thereof the following new subsection:

"(j) ELECTION TO HAVE TARGETED JOBS CREDIT NOT APPLY.—

"(1) IN GENERAL.—A taxpayer may elect to have this section not apply for any taxable year.

"(2) TIME FOR MAKING ELECTION.—An election under paragraph (1) for any taxable year may be made (or revoked) at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for such taxable year (determined without regard to extensions).

"(3) MANNER OF MAKING ELECTION.—An election under paragraph (1) (or revocation thereof) shall be made in such manner as the Secretary may by regulations prescribe."

(4) Subsection (a) of section 52 is amended by striking out "the credit (if any) allowable by section 44B to each such member" and inserting in lieu thereof "the credit (if any) determined under section 51(a) with respect to each such member".

(5) Subsection (b) of section 52 is amended by striking out "the credit (if any) allowable by section 44B" and inserting in lieu thereof "the credit (if any) determined under section 51(a)".

(6) Subsection (c) of section 52 is amended by striking out "credit shall be allowed under section 44B" and inserting in lieu thereof "credit shall be allowed under section 38 for any targeted jobs credit determined under this subpart".

(7) Paragraph (2) of section 52(d) is amended by striking out ", subject to section 53, a credit under section 44B" and inserting in lieu thereof ", subject to section 38(c), a credit under section 38(a)".

(8) Section 53 (relating to limitation based on amount of tax) is hereby repealed.

(9) The table of sections for old subpart D of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 53.

(q) SECTION 55.—

(1) Paragraph (1) of section 55(c) (relating to credits) is amended—

(A) by striking out "subpart A of part IV" and inserting in lieu thereof "subpart A, B, or D of part IV", and

(B) by striking out "section 33(a)" each place it appears and inserting in lieu thereof "section 27(a)".

(2) Clause (i) of section 55(c)(2)(B) is amended by striking out "section 33(a)" and inserting in lieu thereof "section 27(a)".

(3) Paragraph (3) of section 55(c) is amended to read as follows:

"(3) CARRYOVER AND CARRYBACK OF CERTAIN CREDITS.—In the case of any taxable year for which a tax is imposed by this section, for purposes of determining the amount of any carryover or carryback to any other taxable year of any credit allowable under section 23, 30 or 38, the amount of the limitation under section 25, 30(g), or 38(c) (as the case may be) shall be deemed to be—

"(A) the amount of such limitation for such taxable year (determined without regard to this paragraph), reduced (but not below zero) by

"(B) the amount of the tax imposed by this section for the taxable year, reduced by—

"(i) the amount of the credit allowable under section 27(a),

"(ii) in the case of the limitation under section 30(g), the amount of such tax taken into account under this subparagraph with respect to the limitation under section 25, and

"(iii) in the case of the limitation under section 38(c), the amount of such tax taken into account under this subparagraph with respect to limitations under sections 25 and 30(g)."

(4) Paragraph (2) of section 55(f) is amended by striking out "allowable under subpart A of part IV of this subchapter (other than under sections 31, 39, and 43)" and inserting in lieu thereof "allowable under subparts A, B, and D of part IV of this subchapter".

(r) TECHNICAL AND CONFORMING AMENDMENTS TO OTHER PROVISIONS.—

(1) SECTION 56.—

(A) Subsection (c) of section 56 (defining regular tax deduction) is amended—

(i) by striking out "subpart A of part IV other than sections 39 and 44G" and inserting in lieu thereof "subparts A, B, and D of part IV", and

(ii) by amending the last sentence to read as follows: "For purposes of the preceding sentence, the amount of the credit determined under section 38 for any taxable year shall be determined without regard to the employee stock ownership credit determined under section 41."

(B) Subparagraph (A) of section 56(e)(1) is amended by striking out clauses (i), (ii), (iii), and (iv) and inserting in lieu thereof the following:

"(i) section 27 (relating to foreign tax credit), and

"(ii) section 38 (relating to general business credit), exceed".

(2) SECTION 86.—Paragraph (1) of section 86(f) (relating to treatment as pension or annuity for certain purposes) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(3) SECTION 87.—Section 87 (relating to alcohol fuel credit included in income) is amended to read as follows:

"SEC. 87. ALCOHOL FUEL CREDIT.

"Gross income includes the amount of the alcohol fuel credit determined with respect to the taxpayer for the taxable year under section 40(a)."

(4) SECTION 103.—Clause (iv) of section 103(b)(6)(F) (relating to certain capital expenditures not taken into account) is amended by striking out "section 44F(b)(2)(A)" and inserting in lieu thereof "section 30(b)(2)(A)".

(5) SECTION 108.—Subparagraph (B) of section 108(b)(2) (relating to reduction of tax attributes in title 11 case or insolvency) is amended to read as follows:

"(B) RESEARCH CREDIT AND GENERAL BUSINESS CREDIT.—Any carryover to or from the taxable year of a discharge of an amount for purposes of determining the amount allowable as a credit under—

"(i) section 30 (relating to credit for increasing research activities), or

"(ii) section 38 (relating to general business credit).

For purposes of this subparagraph, there shall not be taken into account any portion of a carryover which is attributable to the employee stock ownership credit determined under section 41."

(6) SECTION 129.—

(A) Paragraph (2) of section 129(b) (relating to earned income limitation) is amended by striking out "section 44A(e)(2)" and inserting in lieu thereof "section 21(d)(2)".

(B) Paragraph (1) of section 129(e) (defining dependent care assistance) is amended

by striking out "section 44A(c)(2)" and inserting in lieu thereof "section 21(b)(2)".

(C) Paragraph (2) of section 129(e) (defining earned income) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(7) SECTION 168.—

(A) Clause (i) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(B) Clause (iii) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section 53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(C) Subparagraph (A) of section 168(i)(4), as added section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV of subchapter A of this chapter" and inserting in lieu thereof "section 38".

(D) Clause (i) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(E) Clause (iii) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section 53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(8) SECTION 196.—

(A) Section 196 (relating to deduction for certain unused investment credits) is amended to read as follows:

"SEC. 196. DEDUCTION FOR CERTAIN UNUSED BUSINESS CREDITS.

"(a) ALLOWANCE OF DEDUCTION.—If any portion of the qualified business credits determined for any taxable year has not, after the application of section 38(c), been allowed to the taxpayer as a credit under section 38 for any taxable year, an amount equal to the credit not so allowed shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year for which such credit could, under section 39, have been allowed as a credit.

"(b) TAXPAYER'S DYING OR CEASING TO EXIST.—If a taxpayer dies or ceases to exist before the first taxable year following the last taxable year for which the qualified business credits could, under section 39, have been allowed as a credit, the amount described in subsection (a) (or the proper portion thereof) shall, under regulations prescribed by the Secretary, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs.

"(c) QUALIFIED BUSINESS CREDITS.—For purposes of this section, the term 'qualified business credits' means—

"(1) the investment credit determined under section 46(a) (but only to the extent attributable to property the basis of which is reduced by section 48(q)),

"(2) the targeted jobs credit determined under section 51(a), and

"(3) the alcohol fuels credit determined under section 40(a).

"(d) SPECIAL RULE FOR INVESTMENT TAX CREDIT.—In the case of the investment credit determined under section 46(a) (other than a credit to which section 48(q)(3) applies), subsection (a) shall be applied by substituting "an amount equal to 50 percent of" for "an amount equal to".

(B) The table of sections for part VI of subchapter B of chapter 1 is amended by striking out the item relating to section 196 and inserting in lieu thereof:

"Sec. 196. Deduction for certain unused business credits."

(9) SECTION 213.—Subsection (e) of section 213 (relating to exclusion of amounts allowed for care of certain dependents) is amended by striking out "section 44A" and inserting in lieu thereof "section 21".

(10) SECTION 280C.—

(A) Section 280C (relating to certain expenses for which credits are allowable) is amended by striking out subsection (a) and by redesignating subsections (b) and (c) as subsections (a) and (b), respectively.

(B) Subsection (a) of section 280C (as so redesignated) is amended—

(i) by striking out the first sentence and inserting in lieu thereof the following: "No deduction shall be allowed for that portion of the wages or salaries paid or incurred for the taxable year which is equal to the amount of the credit determined for the taxable year under section 51(a).", and

(ii) by striking out "SECTION 44B CREDIT" in the subsection heading and inserting in lieu thereof "TARGETED JOBS CREDIT".

(C) Subsection (b) of section 280C (as so redesignated) is amended by striking out "44H" each place it appears and inserting in lieu thereof "29".

(D) Paragraph (3) of section 280C(b) (as so redesignated) is amended—

(i) by striking out "section 44F(f)(5)" and inserting in lieu thereof "section 30(f)(5)",

(ii) by striking out "section 44F(f)(1)(B)" and inserting in lieu thereof "section 30(f)(1)(B)",

(iii) by striking out "section 44F(f)(1)" and inserting in lieu thereof "section 30(f)(1)".

(11) SECTION 381.—Subsection (c) of section 381 is amended—

(A) by striking out paragraphs (23), (24), (26), (27), and (30),

(B) by redesignating paragraphs (25), (28), and (29) as paragraphs (23), (24), and (25), respectively,

(C) by striking out "44F" each place it appears in paragraph (25) (as so redesignated) and inserting in lieu thereof "30", and

(D) by adding at the end thereof the following new paragraph:

"(26) CREDIT UNDER SECTION 38.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation."

(12) SECTION 383.—

(A) Section 383 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation which can otherwise be carried forward under section 39, to any unused credit of the corporation which could otherwise be carried forward under section 30(g)(2), to any excess foreign taxes of the corporation which could otherwise be carried forward under section 904(c), and to any net capital loss of the corporation which can otherwise be carried forward under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, RESEARCH CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(B) Section 383 (as amended by the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation under section 39, to any unused credit of the corporation under section 30(g)(2), to any excess foreign taxes of the corporation under section 904(c), and to any net capital loss of the corporation under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, RESEARCH CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(C) The table of sections for part V of subchapter C of chapter 1 is amended by striking out the item relating to section 383 and inserting in lieu thereof the following:

"Sec. 383. Special limitations on unused business credits, research credits, foreign taxes, and capital losses."

(13) Paragraph (21) of section 401(a) is amended by striking out "allowable—" and all that follows and inserting in lieu thereof "allowable under section 41 if the employer made the transfer described in section 41(c)(1)(B)."

(14) SECTION 404.—Subsection (i) of section 404 (relating to deductibility of unused portions of employee stock ownership credit) is amended to read as follows:

"(i) DEDUCTIBILITY OF UNUSED PORTIONS OF EMPLOYEE STOCK OWNERSHIP CREDIT.—

"(1) UNUSED CREDIT CARRYOVERS.—If any portion of the employee stock ownership credit determined under section 41 for any taxable year has not, after the application of section 38(c), been allowed under section 38 for any taxable year, such portion shall be allowed as a deduction (without regard to any limitations provided under this section) for the last taxable year to which such portion could have been allowed as a credit under section 39.

"(2) REDUCTIONS IN CREDIT.—There shall be allowed as a deduction (subject to the limitations provided under this section) an amount equal to any reduction of the credit allowed under section 41 resulting from a final determination of such credit to the extent such reduction is not taken into account under section 41(c)(3)."

(15) SECTION 409.—

(A) Section 409 (relating to qualifications for tax credit employee stock ownership plans), as redesignated by section 491 of this Act, is amended by striking out "44G" each place it appears in subsections (b), (g), (i), (m), and (n) and inserting in lieu thereof "41".

(B) Paragraph (1) of section 409(b), as so redesignated, is amended by striking out "48(n)(1)(A) or".

(C) Subsection (g) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the references to section 48(n)(1) and the employee plan credit shall refer to such section and credit as in effect before the enactment of the Tax Reform Act of 1984."

(D) Subparagraph (A) of section 409(l)(1), as so redesignated, is amended by striking out "48(n)(1) or".

(E) Subsection (k) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, the reference to the matching employee plan credit shall refer to such credit as in effect before the enactment of the Tax Reform Act of 1984."

(16) SECTION 527(g)(1).—Paragraph (1) of section 527(g) (relating to treatment of newsletter funds) is amended by striking out

"section 41(c)(2)" and inserting in lieu thereof "section 24(c)(2)".

(17) SECTION 642(a)(2).—Paragraph (2) of section 642(a) (relating to credit for political contributions) is amended by striking out "section 41" and inserting in lieu thereof "section 24".

(18) SECTION 691(b).—Subsection (b) of section 691 (relating to allowance of deductions and credit) is amended by striking out "section 33" each place it appears and inserting in lieu thereof "section 27".

(19) SECTIONS 874(a) AND 882(c)(2).—Sections 874(a) and 882(c)(2) are each amended—

(A) by striking out "32" and inserting in lieu thereof "33", and

(B) by striking out "section 39" and inserting in lieu thereof "section 34".

(20) SECTION 901(a).—Subsection (a) of section 901 (relating to allowance of foreign tax credit) is amended by striking out the last sentence and inserting in lieu thereof the following: "The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 25(b)."

(21) SECTION 904(g).—Subsection (g) of section 904 (relating to limitation on foreign tax credit) is amended to read as follows:

"(g) COORDINATION WITH NONREFUNDABLE PERSONAL CREDITS.—In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter."

(22) SECTION 936.—

(A) Clause (i)(I)(a) of section 936(h)(5)(C) is amended by striking out "section 44F(b)" and inserting in lieu thereof "section 30(b)".

(B) Clause (i)(IV)(c) of section 936(h)(5)(C) is amended—

(i) by striking out "section 44F" and inserting in lieu thereof "section 30", and

(ii) by striking out "section 44F(f)" and inserting in lieu thereof "section 30(f)".

(23) SECTION 1016(a)(21).—Paragraph (21) of section 1016(a) (relating to adjustments to basis) is amended—

(A) by striking out "section 44C(e)" and inserting in lieu thereof "section 23(e)", and

(B) by striking out "section 44C" and inserting in lieu thereof "section 23".

(24) SECTION 1033(g)(3)(A).—Subparagraph (A) of section 1033(g)(3) (relating to election to treat outdoor advertising displays as real property) is amended by striking out "the credit allowed by section 38 (relating to investment in certain depreciable property)" and inserting in lieu thereof "the investment credit determined under section 46(a)".

(25) SECTION 1351(i).—Subsection (i) of section 1351 (relating to adjustments for succeeding years) is amended—

(A) by striking out "section 33" and inserting in lieu thereof "section 27", and

(B) by striking out "section 38 (relating to investment credit)" and inserting in lieu thereof "section 38 (relating to general business credit)".

(26) SECTION 1366(f).—Paragraph (1) of section 1366(f) (relating to special rules) is amended by striking out "section 39" each place it appears and inserting in lieu thereof "section 34".

(27) SECTION 1374(b).—Subsection (b) of section 1374 (relating to amount of tax imposed on certain capital gains) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(28) SECTION 1375(c).—Paragraph (1) of section 1375(c) (relating to disallowance of credit) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(29) SECTION 1451.—

(A) Chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds) is amended by striking out subchapter B and by redesignating subchapter C as subchapter B.

(B) The table of subchapters for chapter 3 is amended by striking out the items relating to subchapters B and C and inserting in lieu thereof the following:

"SUBCHAPTER B. Application of withholding provisions."

(C) The heading of chapter 3 is amended by striking out "AND TAX-FREE COVENANT BONDS".

(D) The table of chapters for subtitle A is amended by striking out "and tax-free covenant bonds" in the item relating to chapter 3.

(E) Section 12 is amended by striking out paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(F) Subsection (f) of section 164 (as in effect before its redesignation by the Social Security Amendments of 1983) is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(G) Subsection (a) of section 1441 is amended by striking out "except in the cases provided for in section 1451 and".

(H) Paragraph (3) of section 1441(c) is amended by striking out "section 1451" and inserting in lieu thereof "section 1451 (as in effect before its repeal by the Tax Reform Act of 1984)".

(I) Subsection (a) of section 1442 is amended—

(i) by striking out "or section 1451", and

(ii) by striking out "; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein".

(J) Paragraph (2) of section 6049(b) (relating to amounts not treated as interest) is amended—

(i) by adding "and" at the end of subparagraph (C),

(ii) by striking out ", and" at the end of subparagraph (D) and inserting in lieu thereof a period, and

(iii) by striking out subparagraph (E).

(K) Paragraph (16) of section 7701(a) is amended by striking out "1451,".

(30) SECTION 3507.—Subsections (b), (c), and (e) of section 3507 (relating to advanced payment of earned income credit) are each amended by striking out "section 43" each place it appears and inserting in lieu thereof "section 32".

(31) SECTION 6096(b).—Subsection (b) of section 6096 (defining income tax liability) is amended by striking out "allowable under sections 33, 37, 38, 40, 41, 42, 44, 44A, 44B, 44C, 44D, 44E, 44F, 44G, and 44H" and inserting in lieu thereof "allowable under part IV of subchapter A of chapter 1 (other than subpart C thereof)".

(32) SECTION 6201(a)(4).—Paragraph (4) of section 6201(a) (relating to erroneous credit under section 39 or 43) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34",

(B) by striking out "section 43" and inserting in lieu thereof "section 32", and

(C) by striking out "SECTION 39 OR 43" in the paragraph heading and inserting in lieu thereof "SECTION 32 OR 34".

(33) SECTION 6211(b).—

(A) Paragraph (1) of section 6211(b) is amended by striking out "without regard to so much of the credit under section 32 as exceeds 2 percent of the interest on obligations described in section 1451" and inserting in lieu thereof "without regard to the credit under section 33".

(B) Paragraph (4) of section 6211(b) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(34) SECTION 6213(h)(3).—Paragraph (3) of section 6213(h) is amended by striking out "section 39" and inserting in lieu thereof "section 32 or 34".

(35) SECTION 6362(c)(1).—Paragraph (1) of section 6362(c) (relating to qualified resident tax which is a percentage of the Federal tax) is amended by striking out "sections 31 and 39" and inserting in lieu thereof "sections 31 and 34".

(36) SECTION 6401(b).—Subsection (b) of section 6401 (relating to excessive credits treated as overpayments) is amended to read as follows:

"(b) EXCESSIVE CREDITS.—

"(1) IN GENERAL.—If the amount allowable as credits under subpart C of part IV of subchapter A of chapter 1 (relating to refundable credits) exceeds the tax imposed by subtitle A (reduced by the credits allowable under subparts A, B, and D of such part IV), the amount of such excess shall be considered an overpayment.

"(2) SPECIAL RULE FOR CREDIT UNDER SECTION 33.—For purposes of paragraph (1), any credit allowed under section 33 (relating to withholding of tax on nonresident aliens and on foreign corporations) for any taxable year shall be treated as a credit allowable under subpart C of part IV of subchapter A of chapter 1 only if an election under subsection (g) or (h) of section 6013 is in effect for such taxable year."

(37) SECTION 6411.—

(A) So much of subsection (a) of section 6411 as precedes paragraph (2) thereof (relating to tentative carryback and refund adjustments) is amended to read as follows:

"(a) APPLICATION FOR ADJUSTMENT.—A taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback provided in section 172(b), by a business credit carryback provided in section 39, by a research credit carryback provided in section 30(g)(2) or by a capital loss carryback provided in section 1212(a)(1), from any taxable year. The application shall be verified in the manner prescribed by section 6065 in the case of a return of such taxpayer and shall be filed, on or after the date of filing for the return for the taxable year of the net operating loss, net capital loss, or unused business credit from which the carryback results and within a period of 12 months after such taxable year or, with respect to any portion of a research credit carryback or a business credit carryback attributable to a net operating loss carryback or a net capital loss carryback from a subsequent taxable year, within a period of 12 months from the end of such subsequent taxable year (or, with respect to any portion of a business credit carryback attributable to a research credit carryback from a subsequent taxable year within a period of 12 months from the end of such subsequent taxable year), in the manner and form required by regulations prescribed by the Secretary. The applications shall set forth in such detail and with such supporting data and explanation as such regulations shall require—

"(1) The amount of the net operating loss, net capital loss, unused research credit, or unused business credit;".

(B) Subsections (b) and (c) of section 6411 are each amended by striking out "unused investment credit, unused work incentive program credit, unused new employee credit, unused research credit, or unused employee stock ownership credit" each place it appears and inserting in lieu thereof "unused research credit, or unused business credit".

(38) SECTIONS 6420(g)(2), ETC.—Sections 6420(g)(2), 6421(i)(3), and 6427(i)(3) are each amended by striking out "section 39" and inserting in lieu thereof "section 34".

(39) SECTION 6501(p).—Section 6501 is amended by striking out subsection (p) and by redesignating subsection (q) as subsection (p).

(40) SECTION 6511(d)(4)(C).—Subparagraph (C) of section 6511(d)(4) (defining credit carryback) is amended to read as follows:

"(C) CREDIT CARRYBACK DEFINED.—For purposes of this paragraph, the term 'credit carryback' means any business carryback under section 39 and any research credit carryback under section 30(g)(2)."

(41) SECTION 7871.—Subparagraph (A) of section 7871(a)(6) is amended by striking out "section 41(c)(4)" and inserting in lieu thereof "section 24(c)(4)".

(42) SECTION 9502(d).—Paragraph (3) of section 9502(d) (relating to transfers from the Airport and Airway Trust Fund on account of certain section 39 credits) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34", and

(B) by striking out "SECTION 39 CREDITS" in the heading and inserting in lieu thereof "SECTION 34 CREDITS".

(43) SECTION 9503(c).—Clause (ii) of section 9503(c)(2)(A) (relating to transfers from the Highway Trust Fund for certain repayments and credits) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

SEC. 475. EFFECTIVE DATES.

(a) GENERAL RULE.—The amendments made by this title shall apply to taxable years beginning after December 31, 1983, and to carrybacks from such years.

(b) TAX-FREE COVENANT BONDS.—The amendments made by subsections (j) and (r)(29) of section 474 shall not apply with respect to obligations issued before January 1, 1984.

(c) CLARIFICATION OF EFFECT OF AMENDMENTS ON INVESTMENT TAX CREDIT.—Nothing in the amendments made by section 474(o) shall be construed as reducing the amount of any credit allowable for qualified investment in taxable years beginning before January 1, 1984.

Subtitle G—Miscellaneous Simplification Provisions

SEC. 481. PREFERRED STOCK ELIGIBLE UNDER SECTION 1244.

(a) GENERAL RULE.—Subsections (c)(1) and (d)(2) of section 1244 (relating to losses on small business stock) are each amended by striking out "common stock" and inserting in lieu thereof "stock".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to stock issued after the date of the enactment of this Act in taxable years ending after such date.

SEC. 482. MEDICAL CARE DEDUCTION ALLOWED FOR LODGING AWAY FROM HOME IN CERTAIN CASES.

(a) IN GENERAL.—Subsection (d) of section 213 (relating to definitions for purposes of the deduction for medical, dental, etc., expenses), as amended by section 423(b), is amended by redesignating paragraphs (2), (3), (4), (5), (6), and (7) as paragraphs (3), (4), (5), (6), (7), and (8), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) AMOUNTS PAID FOR CERTAIN LODGING AWAY FROM HOME TREATED AS PAID FOR MEDICAL CARE.—Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

"(A) the medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and

"(B) there is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount taken into account under the preceding sentence shall not exceed $50 for each night for each individual."

(b) TECHNICAL AMENDMENT.—

(1) Paragraph (7) of section 213(d), as redesignated by subsection (a), is amended by striking out "paragraph (5)" and inserting in lieu thereof "paragraph (6)".

(2) Paragraph (6) of section 152(e), as amended by section 423 of this Act, is amended by striking out "section 213(d)(4)" and inserting in lieu thereof "section 213(d)(5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

Subtitle H—Repeal of Certain Obsolete Provisions

SEC. 491. TERMINATION OF RULES RELATING TO QUALIFIED BOND PURCHASE PLANS AND RETIREMENT BONDS WITH RESPECT TO BONDS ISSUED AFTER DECEMBER 31, 1983.

(a) QUALIFIED BOND PURCHASE PLANS.—Section 405 (relating to qualified bond purchase plans) is hereby repealed.

(b) RETIREMENT BONDS.—Section 409 (relating to retirement bonds) is hereby repealed.

(c) EXISTING BONDS MAY BE ROLLED OVER INTO QUALIFIED EMPLOYER PLANS.—

(1) Subparagraph (A) of section 405(d)(3) (as in effect before its repeal by subsection (a)) is amended to read as follows:

"(A) IN GENERAL.—If—

"(i) any qualified bond is redeemed,

"(ii) any portion of the excess of the proceeds from such redemption over the basis of such bond is transferred to an individual retirement plan which is maintained for the benefit of the individual redeeming such bond, or to a qualified trust (as defined in section 402(a)(5)(D)(iii)) for the benefit of such individual, and

"(iii) such transfer is made on or before the 60th day after the individual received the proceeds of such redemption,

then gross income shall not include the proceeds to the extent so transferred and the transfer shall be treated as a rollover contribution described in section 408(d)(3)."

(2) Subsection (e) of section 402 (relating to tax on lump-sum distributions) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE WHERE PORTION OF LUMP-SUM DISTRIBUTION ATTRIBUTABLE TO ROLLOVER OF BOND PURCHASED UNDER QUALIFIED BOND PURCHASE PLAN.—If any portion of a lump-sum distribution is attributable to a transfer described in section 405(d)(3)(A)(ii) (as in effect before its repeal by the Tax Reform Act of 1984), paragraphs (1) and (3) of this subsection and paragraph (2) of subsection (a) shall not apply to such portion."

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 55(f) (defining regular tax) is amended by striking "409(c),".

(2) Paragraph (7) of section 62 (defining adjusted gross income) is amended—

(A) by striking out "the deductions allowed by section 404 and section 405(c)" and inserting in lieu thereof "the deduction allowed by section 404", and

(B) by striking out "ANNUITY, AND BOND PURCHASE" in the heading and inserting in lieu thereof "AND ANNUITY".

(3) Paragraph (1) of section 72(o) is amended by striking out "402, 403, and 405" and inserting in lieu thereof "402 and 403".

(4) Paragraph (4) of section 72(o) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(5) Subparagraph (D) of section 172(d)(4) is amended by striking out "or section 405(c)".

(6) Paragraph (2) of section 219(d) is amended by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)".

(7) Paragraph (1) of section 219(e) is amended by striking out the last sentence.

(8) Paragraph (3) of section 219(e) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (B) and by redesignating subparagraph (D) as subparagraph (C).

(9) Clause (iv) of section 402(a)(5)(D) is amended by striking out subclause (III) and by redesignating subclauses (IV) and (V) as subclauses (III) and (IV), respectively.

(10) Clause (i) of section 402(a)(5)(F), as amended by this Act, is amended by striking out ", (II), or (III)" and inserting in lieu thereof "or (II)".

(11) Clause (ii) of section 402(a)(5)(F), as amended by this Act, is amended by striking out "(IV) or (V)" and inserting in lieu thereof "(III) or (IV)".

(12) The last sentence of section 403(b)(1) is amended by striking out "or 409(b)(3)(C)".

(13) Subsection (a) of section 406 is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(14) Paragraph (3) of section 406(a) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(15) Subsection (d) of section 406 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(16) Paragraph (1) of section 407(a) is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(17) Subparagraph (B) of section 407(a)(1) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(18) Subsection (d) of section 407 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(19) Paragraph (1) of section 408(a) is amended by striking out "403(b)(8), 405(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 403(b)(8)".

(20) Clause (i) of section 408(d)(3)(A) is amended by striking out "or retirement bond".

(21) Subparagraph (B) of section 408(d)(3) is amended by striking out ", individual retirement annuity, or a retirement bond" and inserting in lieu thereof "or an individual retirement annuity".

(22) Clause (ii) of section 408(d)(3)(D) (relating to partial rollovers) is amended by striking out "bond,".

(23) Paragraph (6) of section 408(d) is amended—

(A) by striking out ", individual retirement annuity, or retirement bond" and inserting in lieu thereof "or an individual retirement annuity", and

(B) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(24) Subparagraph (E) of section 408(k)(3) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(25) Paragraph (2) of section 412(a) is amended by striking out "or 405(a)".

(26) Subsection (h) of section 414 is amended by striking out "or 405(a)".

(27) Subsection (l) of section 414 is amended by striking out "or 405".

(28) Paragraph (2) of section 415(a) is amended by striking out subparagraph (D), by striking out "or" at the end of subparagraph (C), by adding "or" at the end of subparagraph (B), and by striking out "405(a),".

(29) Subparagraph (A) of section 415(b)(2) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(30) Subparagraph (B) of section 415(b)(2) is amended by striking out "408(d)(3) and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(31) Paragraph (2) of section 415(c) is amended by striking out "405(d)(3), 408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(32) Paragraph (1) of section 415(k) is amended by striking out subparagraphs (C) and (H), by redesignating subparagraphs (D), (E), (F), and (G) as subparagraphs (C), (D), (E), and (F), respectively, by striking out ", or" at the end of subparagraph (F) (as so redesignated) and inserting in lieu thereof a period, and by adding "or" at the end of subparagraph (E) (as so redesignated).

(33) Paragraph (2) of section 457(e) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) and (E) as subparagraphs (C) and (D), respectively.

(34) Subsection (e) of section 2039 is amended—

(A) by striking out paragraph (3),

(B) by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period,

(C) by adding "or" at the end of paragraph (1),

(D) by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)", and

(E) by striking out ", annuity, or bond" each place it appears and inserting in lieu thereof "or annuity".

(35) Paragraph (5) of section 2517(a) is amended by striking out ", an individual retirement annuity described in section 408(b), or a retirement bond described in section 409(a)" and inserting in lieu thereof "or an individual retirement annuity described in section 408(b)".

(36) Paragraph (5) of section 3121(a) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(37) Paragraph (5) of section 3306(b) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(38) Paragraph (12) of section 3401(a) is amended by striking out subparagraph (C) and by redesignating subparagraph (D) as subparagraph (C).

(39) Subsection (e) of section 209 of the Social Security Act is amended by inserting "(as in effect before the enactment of the Tax Reform Act of 1984)" after "Internal Revenue Code of 1954" in paragraph (4) thereof.

(40) Subsection (a) of section 4972 is amended by striking out the last sentence and inserting in lieu thereof "This section applies only to plans which include a trust described in section 401(a) or which are described in section 403(a)."

(41) Subsection (a) of section 4973 is amended—

(A) by striking out paragraph (3),

(B) by striking out "or" at the end of paragraph (2),

(C) by adding "or" at the end of paragraph (1),

(D) by striking out ", annuities, or bonds" and inserting in lieu thereof "or annuities", and

(E) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(42) Subparagraph (A) of section 4973(b)(1) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(43) The last sentence of section 4973(b) is amended by striking out ", individual retirement annuity, or bond" and inserting in lieu thereof "or the individual retirement annuity".

(44) Paragraph (1) of section 4973(c) is amended by striking out ", 408(d)(3)(A)(iii), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)(A)(iii)".

(45) The last sentence of section 4975(d) is amended by striking out ", individual retirement annuity, or an individual retirement bond (as defined in section 408 or 409)" and inserting in lieu thereof "or an individual retirement annuity (as defined in section 408)".

(46) Paragraph (1) of section 4975(e) is amended—

(A) by striking out "or 405(a)",

(B) by striking out "or a retirement bond described in section 409",

(C) by striking out "annuity, or bond" and inserting in lieu thereof "or annuity", and

(D) by striking out "account, or bond" and inserting in lieu thereof "or account".

(47) Section 6047 is amended by striking out subsection (c) and by redesignating subsections (d), (e), and (f) as subsections (c), (d), and (e), respectively.

(48) Subsection (e) of section 6058 is amended by striking out paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(49) Clause (i) of section 6104(a)(1)(B) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(50) Subsection (f) of section 6652 is amended by striking out "and bond purchase".

(51) Section 7207 is amended by striking out "or (c)".

(52) Subsection (c) of section 7476 is amended by striking out paragraph (3), by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period, and by adding ", or" at the end of paragraph (1).

(53) Paragraph (37) of section 7701(a) is amended by striking out subparagraph (C), by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period, and by adding "and" at the end of subparagraph (A).

(54) The table of sections of subpart A of part I of subchapter D of chapter 1 is amended by striking out the items relating to sections 405 and 409.

(55) The section heading for section 4973 is amended by striking out "CERTAIN INDIVIDUAL RETIREMENT ANNUITIES, AND CERTAIN RETIREMENT BONDS" and inserting in lieu thereof "AND CERTAIN INDIVIDUAL RETIREMENT ANNUITIES".

(56) The table of sections for chapter 43 is amended by striking out "certain individual retirement annuities, and certain retirement bonds" in the item relating to section 4973 and inserting in lieu thereof "and certain individual retirement annuities".

(57) The section heading for section 6047 is amended by striking out "AND BOND PURCHASE".

(58) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out "and bond purchase" in the item relating to section 6047.

(59) The first sentence of section 3107 of title 31, United States Code, is amended by inserting before the period ", as in effect before the enactment of the Tax Reform Act of 1984".

(e) SECTION 409A REDESIGNATED AS SECTION 409.—

(1) The section heading for section 409A is amended by striking out "SEC. 409a." and inserting in lieu thereof "SEC. 409.".

(2) Subsection (c)(1)(A)(i) of old section 44G is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(3) Paragraph (6) of old section 44G(c) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(4) Paragraph (22) of section 401(a) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(5) Paragraph (23) of section 401(a) is amended by striking out "section 409A(h)" each place it appears and inserting in lieu thereof "section 409(h)".

(6) Clause (ii) of section 415(c)(6)(B) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(7) Paragraph (7) of section 4975(e) is amended—

(A) by striking out "section 409A(h)" and inserting in lieu thereof "section 409(h)",

(B) by striking out "section 409A(e)(4)" and inserting in lieu thereof "section 409(e)(4)", and

(C) by striking out "section 409A(e)" and inserting in lieu thereof "section 409(e)".

(8) Paragraph (8) of section 4975(e) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(9) Paragraphs (1) and (3) of section 6699(a) are each amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(10) The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by striking out "Sec. 409A" and inserting in lieu thereof "Sec. 409".

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments and repeals made by subsections (a), (b), and (d) shall apply to obligations issued after December 31, 1983.

(2) SUBSECTION (c).—The amendment made by subsection (c) shall apply to redemptions after the date of the enactment of this Act in taxable years ending after such date.

(3) SUBSECTION (e).—The amendments made by subsection (e) shall take effect on January 1, 1984.

(4) BONDS UNDER QUALIFIED BOND PURCHASE PLANS MAY BE REDEEMED AT ANY TIME.—Notwithstanding—

(A) subparagraph (D) of section 405(b)(1) of the Internal Revenue Code of 1954 (as in effect before its repeal by this section), and

(B) the terms of any bond described in subsection (b) of such section 405,

such a bond may be redeemed at any time after the date of the enactment of this Act in the same manner as if the individual redeeming the bond had attained age 59½.

(5) TREATMENT OF TAX IMPOSED UNDER SECTION 409(c).—For purposes of section 26(b) of the Internal Revenue Code of 1954 (as amended by this Act), any tax imposed by section 409(c) of such Code (as in effect before its repeal by this section) shall be treated as a tax imposed by section 408(f) of such Code.

SEC. 492. REPEAL OF RULES RELATING TO GAINS FROM DISPOSITION OF PROPERTY USED IN FARMING WHERE FARM LOSSES OFFSET NONFARM INCOME.

(a) IN GENERAL.—Section 1251 (relating to gain from disposition of property used in farming where farm losses offset nonfarm income) is hereby repealed.

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) SECTION 170.—

(A) The second sentence of section 170(e)(1) (relating to certain contributions of ordinary income and capital gain property) is amended by striking out "1251(c),".

(B) Subparagraph (C) of section 170(e)(3) (relating to special rule for certain contributions of inventory and other property) is amended by striking out "1251,".

(2) SECTION 341.—Paragraph (12) of section 341(e) (relating to nonapplication of section 1245(a)) is amended by striking out "1251(c),".

(3) SECTION 453B.—The second sentence of section 453B(d)(2) (relating to liquidations to which section 337 applies) is amended by striking out "1251(c),".

(4) SECTION 751.—The second sentence of subsection (c) of section 751 (defining unrealized receivables) is amended—

(A) by striking out "farm recapture property (as defined in section 1251(e)(1)),", and

(B) by striking out "1251(c),".

(5) SECTION 1252.—The second sentence of section 1252(a)(1) (relating to gains from disposition of farm land) is amended by striking out ", except that this section shall not apply to the extent section 1251 applies to such gain".

(c) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter P of chapter 1 is amended by striking out the item relating to section 1251.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

TITLE V—EMPLOYEE BENEFIT PROVISIONS

Subtitle A—Welfare Benefit Plans

SEC. 511. TREATMENT OF FUNDED WELFARE BENEFIT PLANS.

(a) GENERAL RULE.—Part I of subchapter D of chapter 1 (relating to pension, profit sharing, stock bonus plans, etc.) is amended by adding at the end thereof the following new subpart:

"Subpart D—Treatment of Welfare Benefit Funds

"Sec. 419. Treatment of funded welfare benefit plans.

"Sec. 419A. Qualified asset account; limitation on additions to account.

"SEC. 419. TREATMENT OF FUNDED WELFARE BENEFIT PLANS.

"(a) GENERAL RULE.—Contributions paid or accrued by an employer to a welfare benefit fund—

"(1) shall not be deductible under section 162 or 212, but

"(2) if they testify the requirements of either of such sections, shall (subject to the limitation of subsection (b)) be deductible under this section for the taxable year in which paid.

"(b) LIMITATION.—The amount of the deduction allowable under subsection (a)(2) for any taxable year shall not exceed the welfare benefit fund's qualified cost for the taxable year.

"(c) QUALIFIED COST.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the term 'qualified cost' means, with respect to any taxable year, the sum of—

"(A) the qualified direct cost for such taxable year, and

"(B) subject to the limitation of section 419A(b), any addition to a qualified asset account for the taxable year.

"(2) REDUCTION FOR FUNDS AFTER-TAX INCOME.—In the case of any welfare benefit fund, the qualified cost for any taxable year shall be reduced by such fund's after-tax income for such taxable year.

"(3) QUALIFIED DIRECT COST.—

"(A) IN GENERAL.—The term 'qualified direct cost' means, with respect to any taxable year, the aggregate amount which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if—

"(i) such benefits were provided directly by the employer, and

"(ii) the employer used the cash receipts and disbursements method of accounting.

"(B) TIME WHEN BENEFITS PROVIDED.—For purposes of subparagraph (A), a benefit shall be treated as provided when such benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for any provision of this chapter excluding such benefit from gross income).

"(C) 60-month amortization of child care facilities.—

"(i) IN GENERAL.—In determining qualified direct costs with respect to any child care facility for purposes of subparagraph (A), in lieu of depreciation the adjusted basis of such facility shall be allowable as a deduction ratably over a period of 60 months beginning with the month in which the facility is placed in service.

"(ii) CHILD CARE FACILITY.—The term 'child care facility' means any tangible property which qualifies under regulations prescribed by the Secretary as a child care center primarily for children of employees of the employer; except that such term shall not include any property—

"(I) not of a character subject to depreciation; or

"(II) located outside the United States.

"(4) AFTER-TAX INCOME.—

"(A) IN GENERAL.—The term 'after-tax income' means, with respect to any taxable year, the gross income of the welfare benefit fund reduced by the sum of—

"(i) the deductions allowed by this chapter which are directly connected with the production of such gross income, and

"(ii) the tax imposed by this chapter on the fund for the taxable year.

"(B) TREATMENT OF CERTAIN AMOUNTS.—In determining the gross income of any welfare benefit fund—

"(i) contributions and other amounts received from employees shall be taken into account, but

"(ii) contributions from the employer shall not be taken into account.

"(5) ITEM ONLY TAKEN INTO ACCOUNT ONCE.—No item may be taken into account more than once in determining the qualified cost of any welfare benefit fund.

"(d) CARRYOVER OF EXCESS CONTRIBUTIONS.—If—

"(1) the amount of the contributions paid (or deemed paid under this subsection) by the employer during any taxable year to a welfare benefit fund, exceeds

"(2) the limitation of subsection (b),

such excess shall be treated as an amount paid by the employer to such fund during the succeeding taxable year.

"(e) WELFARE BENEFIT FUND.—For purposes of this section—

"(1) IN GENERAL.—The term 'welfare benefit fund' means any fund—

"(A) which is part of a plan of an employer, and

"(B) through which the employer provides welfare benefits to employees or their beneficiaries.

"(2) WELFARE BENEFIT.—The term 'welfare benefit' means any benefit other than a benefit with respect to which—

"(A) section 83(h) applies,

"(B) section 404 applies (determined without regard to section 404(b)(2)),

"(C) section 404A applies, or

"(D) an election under section 463 applies.

"(3) FUND.—The term 'fund' means—

"(A) any organization described in paragraph (7), (9), (17), or (20) of section 501(c),

"(B) any trust, corporation, or other organization not exempt from the tax imposed by this chapter, and

"(C) to the extent provided in regulations, any account held for an employer by any person.

"(f) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If—

"(1) there is no plan, but

"(2) there is a method or arrangement of employer contributions or benefits which has the effect of a plan,

this section shall apply as if there were a plan.

"(g) EXTENSION TO PLANS FOR INDEPENDENT CONTRACTORS.—If any fund would be a welfare benefit fund (as modified by subsection (f)) but for the fact that there is no employee-employer relationship—

"(1) this section shall apply as if there were such a plan, and

"(2) any reference in this section to the employer shall be treated as a reference to the person for whom services are provided, and any reference in this section to an employee shall be treated as a reference to the person providing the services.

"SEC. 419A. QUALIFIED ASSET ACCOUNT; LIMITATION ON ADDITIONS TO ACCOUNT.

"(a) GENERAL RULE.—For purposes of this subpart, the term 'qualified asset account' means any account consisting of assets set aside to provide for the payment of—

"(1) disability benefits,

"(2) medical benefits,

"(3) SUB or severance pay benefits, or

"(4) life insurance benefit.

"(b) LIMITATION ON ADDITIONS TO ACCOUNT.—No addition to any qualified asset account may be taken into account under section 419(c)(1)(B) to the extent such addition results in the amount in such account exceeding the account limit.

"(c) ACCOUNT LIMIT.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund—

"(A) claims incurred but unpaid (as of the close of such taxable year) for benefits referred to in subsection (a), and

"(B) administrative costs with respect to such claims.

"(2) ADDITIONAL RESERVE FOR POST-RETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS.—The account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate necessary for—

"(A) medical benefits provided for retired employees (determined on the basis of current medical costs), or

"(B) life insurance benefits provided to retired employees

"(3) AMOUNT TAKEN INTO ACCOUNT FOR SUB OR SEVERENCE PAY BENEFITS.—

"(A) IN GENERAL.—The account limit for any taxable year with respect to SUB or severance pay benefits is 75 percent of the sum of—

"(i) the average annual qualified direct costs for SUB or severance pay benefits for any 2 of the immediately preceding 7 taxable years (as selected by the fund), and

"(ii) the average annual administrative costs during such 2 preceding taxable years allocable to SUB or severance pay benefits.

"(B) SPECIAL RULE FOR CERTAIN NEW PLANS.—In the case of any new plan for which SUB or severance pay benefits are not available to any key employee, the Secretary shall, by regulations, provide for an interim amount to be taken into account under paragraph (1).

"(4) LIMITATION ON AMOUNTS TO BE TAKEN INTO ACCOUNT.—

"(A) DISABILITY BENEFITS.—For purposes of paragraph (1), disability benefits payable to any individual shall not be taken into account to the extent such benefits are payable at an annual rate in excess of the lower of—

"(i) 75 percent of such individual's average compensation for his high 3 years (within the meaning of section 415(b)(3)), or

"(ii) the limitation in effect under section 415(b)(1)(A).

"(B) LIMITATION ON SUB OR SEVERANCE PAY BENEFITS.—For purposes of paragraph (3), any SUB or severance pay benefit payable to any individual shall not be taken into account to the extent such benefit is payable at an annual rate in excess of 150 percent of the limitation in effect under section 415(c)(1)(A).

"(5) SPECIAL LIMITATION WHERE NO ACTUARIAL CERTIFICATION.—

"(A) IN GENERAL.—Unless there is an actuarial certification of the account limit determined under paragraph (1) for any taxable year, the account limit for such taxable year shall not exceed the sum of the safe harbor limits for such taxable year.

"(B) SAFE HARBOR LIMITS.—

"(i) SHORT-TERM DISABILITY BENEFITS.—In the case of short-term disability benefits, the safe harbor limit for any taxable year is 17.5 percent of the sum of—

"(I) the qualified direct costs for the immediately preceding taxable year with respect to such benefits, and

"(II) the administrative costs for such preceding taxable year allocable to such benefits.

"(ii) MEDICAL BENEFITS.—In the case of medical benefits, the safe harbor limit for any taxable year is 35 percent of the sum of—

"(I) the qualified direct costs for the immediately preceding taxable year with respect to medical benefits, and

"(II) the administrative costs for such preceding taxable year allocable to medical benefits.

"(iii) SUB OR SEVERANCE PAY BENEFITS.—In the case of SUB or severance pay benefits, the safe harbor limit for any taxable year is the amount determined under paragraph (3).

"(iv) LONG-TERM DISABILITY OR LIFE INSURANCE BENEFITS.—In the case of any long-term disability benefit or life insurance benefit, the safe harbor limit for any taxable year shall be the amount prescribed by regulations.

"(d) REQUIREMENT OF SEPARATE ACCOUNTS FOR POST-RETIREMENT MEDICAL OR LIFE INSURANCE BENEFITS PROVIDED TO KEY EMPLOYEES.—

"(1) IN GENERAL.—In the case of any employee who is a key employee—

"(A) a separate account shall be established for any medical benefits or life insurance benefits provided with respect to such employee after retirement, and

"(B) medical benefits and life insurance benefits provided with respect to such employee after retirement may only be paid from such separate account.

"(2) COORDINATION WITH SECTION 415.—For purposes of section 415, any amount attributable to medical benefits allocated to an account established under paragraph (1) shall be treated as an annual addition to a defined contribution plan for purposes of section 415(c).

"(3) KEY EMPLOYEE.—For purposes of this section, the term 'key employee' means any employee who, at any time during the plan year or any preceding plan year, is or was a key employee as defined in section 416(i).

"(e) SPECIAL LIMITATIONS ON RESERVES FOR MEDICAL BENEFITS OR LIFE INSURANCE BENEFITS PROVIDED TO RETIRED EMPLOYEES.—

"(1) BENEFITS MUST BE NONDISCRIMINATORY.—No reserve may be taken into account under subsection (c)(2) for medical benefits or life insurance benefits provided to retired employees unless the plan meets the requirements of section 505(b)(1) with respect to such benefits.

"(2) TAXABLE LIFE INSURANCE BENEFITS NOT TAKEN INTO ACCOUNT.—No life insurance benefit may be taken into account under subsection (c)(2) to the extent—

"(A) such benefit is includible in gross income under section 79, or

"(B) such benefit would be includible in gross income under section 101(b) (determined by substituting '$50,000' for '$5,000').

"(f) DEFINITIONS AND OTHER SPECIAL RULES.—For purposes of this section—

"(1) SUB OR SEVERANCE PAY BENEFIT.—The term 'SUB or severance pay benefit' means—

"(A) any supplemental unemployment compensation benefit (as defined in section 501(c)(17)(D)), and

"(B) any severance pay benefit.

"(2) MEDICAL BENEFIT.—The term 'medical benefit' means a benefit which consists of the providing (directly or through insurance) of medical care (as defined in section 213(d)).

"(3) LIFE INSURANCE BENEFIT.—The term 'life insurance benefit' includes any other death benefit.

"(4) VALUATION.—For purposes of this section, the amount of the qualified asset account shall be the value of the assets in such account (as determined under regulations).

"(5) HIGHER LIMIT IN CASE OF COLLECTIVELY BARGAINED PLANS.—Not later than July 1, 1985, the Secretary shall by regulations provide for special account limits in the case of any qualified asset account under a welfare benefit fund established under a collective bargaining agreement.

"(6) EXCEPTION FOR 10-OR-MORE EMPLOYER PLANS.—

"(A) IN GENERAL.—This subpart shall not apply in the case of any welfare benefit fund which is part of a 10 or more employer plan. The preceding sentence shall not apply to any plan which maintains experience-rating arrangements with respect to individual employers.

"(B) 10 OR MORE EMPLOYER PLAN.—For purposes of subparagraph (A), the term '10 or more employer plan' means a plan—

"(i) to which more than 1 employer contributes, and

"(ii) to which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers.

"(7) ADJUSTMENTS FOR EXISTING EXCESS RESERVES.—

"(A) INCREASE IN ACCOUNT LIMIT.—The account limit for any of the first 4 taxable years to which this section applies shall be increased by the applicable percentage of any existing excess reserves.

"(B) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A)—

"In the case of:	The applicable percentage is:
The first taxable year to which this section applies	80
The second taxable year to which this section applies	60
The third taxable year to which this section applies	40
The fourth taxable year to which this section applies	20.

"(C) EXISTING EXCESS RESERVE.—For purposes of this paragraph, the term 'existing excess reserve' means the excess (if any) of—

"(i) the amount of assets set aside for purposes described in subsection (a) as of the close of the first taxable year ending after the date of the enactment of the Tax Reform Act of 1984, over

"(ii) the account limit which would have applied under this section to such taxable year if this section had applied to such taxable year.

"(g) EMPLOYER TAXED ON INCOME OF WELFARE BENEFIT FUND IN CERTAIN CASES.—

"(1) IN GENERAL.—In the case of any welfare benefit fund which is not an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the employer shall include in gross income for any taxable year an amount equal to such fund's deemed unrelated income for the fund's taxable year ending within the employer's taxable year.

"(2) DEEMED UNRELATED INCOME.—For purposes of paragraph (1), the deemed unrelated income of any welfare benefit fund referred to in paragraph (1) shall be the amount which would have been its unrelated business taxable income under section 512(a)(3) if such fund were an organization described in paragraph (7), (9), (17), or (20) of section 501(c).

"(h) AGGREGATION RULES.—For purposes of this subpart—

"(1) AGGREGATION OF FUNDS.—At the election of the employer, 2 or more welfare benefit funds of such employer may be treated as 1 fund.

"(2) TREATMENT OF RELATED EMPLOYERS.—Rules similar to the rules of subsections (b), (c), (m), and (n) of section 414 shall apply.

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subpart. Such regulations may provide that the plan administrator of any welfare benefit fund which is part of a plan to which more than 1 employer contributes shall submit such information to the employers contributing to the fund as may be necessary to enable the employers to comply with the provisions of this section."

(b) AMENDMENTS TO TAX ON UNRELATED BUSINESS INCOME.—

(1) EXTENSION OF SECTION 512(a)(3) TO SUPPLEMENTAL UNEMPLOYMENT BENEFIT AND GROUP LEGAL TRUSTS.—

(A) Paragraph (3) of section 512(a) (relating to special rules applicable to organizations described in section 501(c) (7) or (9)) is amended by striking out "section 501(c) (7) or (9)" each place it appears (including in the paragraph heading) and inserting in lieu thereof "paragraph (7), (9), (17), or (20) of section 501(c)".

(B) Clause (ii) of section 512(a)(3)(B) is amended by striking out "section 501(c)(9)" and inserting lieu thereof "paragraph (9), (17), or (20) of section 501(c)".

(2) LIMITATION ON DEDUCTION FOR SETASIDE.—Paragraph (3) of section 512(a) is amended by adding at the end thereof the following new subparagraph:

"(E) Limitation on amount of setaside in the case of organizations described in paragraph (9), (17), or (20) of section 501(c).—

"(i) IN GENERAL.—In the case of any organization described in paragraph (9), (17), or (20) of section 501(c), a set-aside for any purpose specified in clause (ii) of subparagraph (B) may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under section 419A(c) for the taxable year (not taking into account any reserve for medical benefits provided to retired employees).

"(ii) NO SET ASIDE FOR FACILITIES.—No set aside for assets used in the provision of benefits described in clause (ii) of subparagraph (B) shall be taken into account.

"(iii) TREATMENT OF EXISTING RESERVES FOR MEDICAL BENEFITS OR LIFE INSURANCE BENEFITS PROVIDED TO RETIRED EMPLOYEES.—

"(I) Clause (i) shall not apply to any income attributable to an existing reserve for medical or life insurance benefits for retired employees.

"(II) For purposes of subclause (I), the term 'existing reserve for medical benefits or life insurance benefits for retired employees' means the amount of assets set aside as of the close of the last plan year ending before the date of the enactment of the Tax Reform Act of 1984 for purposes of providing medical benefits or life insurance benefits to retired employees.

"(III) All payments during taxable years to which this subparagraph applies of medical benefits or life insurance benefits to retired employees shall be charged against the reserve referred to in subclause (II).

"(iv) TREATMENT OF TAX EXEMPT ORGANIZATIONS.—This paragraph shall not apply to any organization if substantially all of the contributions to such organization are made by employers who were exempt from tax under this chapter throughout the 5-taxable year period ending with the taxable year in which the contributions are made."

(c) TAX ON CERTAIN FUNDED WELFARE BENEFIT PLANS.—

(1) IN GENERAL.—Chapter 43 (relating to qualified pension, etc., plans) is amended by adding at the end thereof the following new section:

"SEC. 4976. TAXES WITH RESPECT TO FUNDED WELFARE BENEFIT PLANS.

"(a) GENERAL RULE.—If—

"(1) an employer maintains a welfare benefit fund, and

"(2) there is a disqualified benefit provided during any taxable year,

there is hereby imposed on such employer a tax equal to 100 percent of such disqualified benefit.

"(b) DISQUALIFIED BENEFIT.—For purposes of subsection (a), the term 'disqualified benefit' means—

"(1) any medical benefit or life insurance benefit provided with respect to a key employee other than from a separate account established for such owner under section 419A(d), and

"(2) any medical or life insurance benefit provided with respect to a retired employee unless the plan meets the requirements of section 505(b)(1) with respect to such benefit, and

"(3) any portion of such fund reverting to the benefit of the employer.

"(c) DEFINITIONS.—For purposes of this section, the terms used in this section shall have the same respective meanings as when used in subpart D of part I of subchapter D of chapter 1."

(2) CONFORMING AMENDMENT.—The table of sections for chapter 43 (relating to qualified pension, etc., plans) is amended by adding at the end thereof the following new item:

"Sec. 4977. Taxes with respect to funded welfare benefit plans."

(d) CLERICAL AMENDMENT.—The table of subparts for part I of subchapter D of chapter 1 is amended by adding at the end thereof the following new item:

"Subpart D. Treatment of welfare benefit funds."

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to contributions paid or accrued after December 31, 1985, in taxable years ending after such date.

(2) SPECIAL RULE FOR COLLECTIVE BARGAINING AGREEMENTS.—In the case of plan maintained pursuant to 1 or more collective bargaining agreements—

(A) between employee representatives and 1 or more employers, and

(B) in effect on July 1, 1985 (or ratified on or before such date),

the amendments made by this section and section 514 shall not apply to years beginning before the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension thereof agreed to after July 1, 1985).

(3) SPECIAL RULE FOR PARAGRAPH (2).—For purposes of paragraph (2), any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section shall not be treated as a termination of such collective bargaining agreement.

(4) SPECIAL EFFECTIVE DATE FOR CONTRIBUTIONS OF FACILITIES.—Notwithstanding paragraphs (1) and (2), the amendments made by this section shall apply in the case of—

(A) any contribution after June 22, 1984, of a facility to a welfare benefit fund, and

(B) any other contribution after June 22, 1984, to a welfare benefit fund to be used to acquire a facility.

(5) BINDING CONTRACT EXCEPTION TO PARAGRAPH (4).—Paragraph (4) shall not apply to any facility—

(A) which is acquired pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or

(B) any facility the construction of which began before June 22, 1984.

SEC. 512. TREATMENT OF UNFUNDED DEFERRED BENEFITS.

(a) GENERAL RULE.—Subsection (b) of section 404 (relating to method of contributions, etc., having the effect of a plan) is amended to read as follows:

"(b) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN; UNFUNDED DEFERRED BENEFITS.—

"(1) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If—

"(A) there is no plan, but

"(B) there is a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation (including a plan described in paragraph (2)),

subsection (a) shall apply if there were such a plan.

"(2) PLANS PROVIDING UNFUNDED DEFERRED BENEFITS.—

"(A) IN GENERAL.—For purposes of this section, any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents shall be treated as a plan deferring the receipt of compensation. In the case of such a plan, for purposes of this section, the determination of when an amount is includible in gross income shall be made without regard to any provisions of this chapter excluding such benefits from gross income.

"(B) EXCEPTION FOR CERTAIN BENEFITS.—Subparagraph (A) shall not apply to—

"(i) any benefit provided through a welfare benefit fund (as defined in section 419(e)), or

"(ii) to any benefit with respect to which an election under section 463 applies."

(b) CROSS REFERENCE.—Subsection (i) of section 162 (relating to cross references) is amended by adding at the end thereof the following new paragraph:

"(3) For special rules relating to—

"(A) funded welfare benefit plans, see section 419, and

"(B) deferred compensation and other deferred benefits, see section 404."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to amounts paid or incurred after the date of the enactment of this Act, in taxable years ending after such date.

(2) EXCEPTION FOR CERTAIN EXTENDED VACATION PAY PLANS.—In the case of any extended vacation pay plan maintained pursuant to a collective bargaining agreement—

(A) between employee representatives and 1 or more employers, and

(B) in effect on June 22, 1984,

the amendments made by this section shall not apply before the date on which such collective bargaining agreement terminates (determined without regard to any extension thereof agreed to after June 22, 1984). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section shall not be treated as a termination of such collective bargaining agreement.

SEC. 513. ADDITIONAL REQUIREMENTS FOR TAX-EXEMPT STATUS OF CERTAIN ORGANIZATIONS.

(a) GENERAL RULE.—Part I of subchapter F of chapter 1 (relating to exempt organizations) is amended by adding at the end thereof the following new section:

"SEC. 505. ADDITIONAL REQUIREMENTS FOR ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).

"(a) CERTAIN REQUIREMENTS MUST BE MET IN THE CASE OF ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).—

"(1) VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS, ETC.—An organization described in paragraph (9) or (20) of subsection (c) of section 501 which is part of a plan of an employer shall not be exempt from tax under section 501(a) unless such plan meets the requirements of subsection (b) of this section.

"(3) EXCEPTION FOR COLLECTIVE BARGAINING AGREEMENTS.—Paragraph (1) shall not apply to any organization which is part of a plan maintained pursuant to 1 or more collective bargaining agreements between 1 or more employee organizations and 1 or more employers.

"(b) NONDISCRIMINATION REQUIREMENTS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), a plan meets the requirements of this subsection only if—

"(A) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and

"(B) in the case of each class of benefits, such benefits for not discriminate in favor of employees who are highly compensated employees.

A life insurance, disability, severance pay, or supplemental unemployment compensation benefit shall not be considered to fail to

meet the requirements of subparagraph (B) merely because the benefits available bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees covered by the plan.

"(2) Exclusion of certain employees.—For purposes of paragraph (1), there may be excluded from consideration—

"(A) employees who have not completed 3 years of service,

"(B) employees who have not attained age 21,

"(C) seasonal employees or less than half-time employees,

"(D) Employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and 1 or more employers which the Secretary finds to be a collective bargaining agreement if the class of benefits involved was the subject of good faith bargaining between such employee representatives and such employer or employers, and

"(E) employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3)).

"(3) APPLICATION OF SUBSECTION WHERE OTHER NONDISCRIMINATION RULES PROVIDED.—In the case of any benefit for which a provision of this chapter other than this subsection provides nondiscrimination rules, paragraph (1) shall not apply but the requirements of this subsection shall be met only if the nondiscrimination rules so provided are satisfied with respect to such benefit.

"(4) AGGREGATION RULES.—For purposes of this subsection—

"(A) AGGREGATION OF PLANS.—At the election of the employer, 2 or more plans of such employer may be treated as 1 plan.

"(B) TREATMENT OF RELATED EMPLOYERS.—Rules similar to the rules of subsections (b), (c), (m), and (n) of section 414 shall apply. For purposes of the preceding sentence, section 414(n) shall be applied without regard to paragraph (5).

"(5) HIGHLY COMPENSATED INDIVIDUAL.—For purposes of this subsection, the term 'highly compensated individual' has the meaning given such term by section 105(h)(5). For purposes of the preceding sentence, section 105(h)(5) shall be applied by substituting '10 percent' for '25 percent'.

"(c) REQUIREMENT THAT ORGANIZATION NOTIFY SECRETARY THAT IT IS APPLYING FOR TAX-EXEMPT STATUS.—

"(1) IN GENERAL.—An organization shall not be treated as an organization described in paragraph (9), (17), or (20) of section 501(c)—

"(A) unless it has given notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of such status, or

"(B) for any period before the giving of such notice, if such notice is given after the time prescribed by the Secretary by regulations for giving notice under this subsection.

"(2) SPECIAL RULE FOR EXISTING ORGANIZATIONS.—In the case of any organization in existence on the date of the enactment of the Tax Reform Act of 1984, the time for giving notice under paragraph (1) shall not expire before the date 1 year after such date of the enactment."

(b) CLERICAL AMENDMENT.—The table of sections for part I of subchapter F of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 505. Additional requirements for organizations described in paragraph (9), (17), or (20) of section 501(c)."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to years beginning after December 31, 1984.

(2) TREATMENT OF CERTAIN BENEFITS IN PAY STATUS AS OF JANUARY 1, 1985.—For purposes of determining whether a plan meets the requirements of section 505(b) of the Internal Revenue Code of 1954 (as added by subsection (a)), there may (at the election of the employer) be excluded from consideration all disability or severance payments payable to individuals who are in pay status as of January 1, 1985. The preceding sentence shall not apply to any payment to the extent such payment is increased by any plan amendment adopted after June 22, 1984.

Subtitle B—Provisions Relating to Pension Plans

SEC. 521. REQUIRED DISTRIBUTIONS.

(a) QUALIFIED PENSION PLANS.—

(1) IN GENERAL.—Paragraph (9) of section 401(a) (relating to required distributions), as in effect before the amendments made by section 242 of the Tax Equity and Fiscal Responsibility Act of 1982, is amended to read as follows:

"(9) REQUIRED DISTRIBUTIONS.—

"(A) IN GENERAL.—A trust shall not constitute a qualified trust under this subsection unless the plan provides that the entire interest of each employee—

"(i) will be distributed to such employee not later than the required beginning date, or

"(ii) will be distributed, beginning not later than the required beginning date, in accordance with regulations, over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary).

"(B) REQUIRED DISTRIBUTION WHERE EMPLOYEE DIES BEFORE ENTIRE INTEREST IS DISTRIBUTED.—

"(i) WHERE DISTRIBUTIONS HAVE BEGUN UNDER SUBPARAGRAPH (A)(ii).—A trust shall not constitute a qualified trust under this section unless the plan provides that if—

"(I) the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), and

"(II) the employee dies before his entire interest has been distributed to him,

the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used under subparagraph (A)(ii) as of the date of his death.

"(ii) 5-YEAR RULE FOR OTHER CASES.—A trust shall not constitute a qualified trust under this section unless the plan provides that, if an employee dies before the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), the entire interest of the employee will be distributed within 5 years after the death of such employee.

"(iii) EXCEPTION TO 5-YEAR RULE FOR CERTAIN AMOUNTS PAYABLE OVER LIFE OF BENEFICIARY.—If—

"(I) any portion of the employee's interest is payable to (or for the benefit of), a designated beneficiary,

"(II) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

"(III) such distributions begin not later than 1 year after the date of the employee's death or such later date as the Secretary may by regulations prescribe,

for purposes of clause (ii), the portion referred to in subclause (I) shall be treated as distributed on the date on which such distributions begin.

"(iv) SPECIAL RULE FOR SURVIVING SPOUSE OF EMPLOYEE.—If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee—

"(I) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained age 70½, and

"(II) if the surviving spouse dies before the distributions to such spouse begin, this subparagraph shall be applied as if the surviving spouse were the employee.

"(C) REQUIRED BEGINNING DATE.—For purposes of this paragraph, the term 'required beginning date' means April 1 of the calendar year following the later of—

"(i) the calendar year in which the employee attains age 70½, or

"(ii) the calendar year in which the employee retires.

Except as provided in section 409(A)(d), clause (ii) shall not apply in the case of an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains 70½.

"(D) LIFE EXPECTANCY.—For purposes of this paragraph, the life expectancy of an employee and the employee's spouse (other than in the case of a life annuity) may be redetermined but not more frequently than annually.

"(E) DESIGNATED BENEFICIARY.—For purposes of this paragraph, the term 'designated beneficiary' means any individual designated as a beneficiary by the employee.

"(F) TREATMENT OF PAYMENTS TO CHILDREN.—Under regulations prescribed by the Secretary, for purposes of this paragraph, any amount paid to a child shall be treated as if it had been paid to the surviving spouse if such amount will become payable to the surviving spouse upon such child reaching majority (or other designated event permitted under regulations)."

(2) REPEAL OF SECTION 242.—Section 242 of the Tax Equity and Fiscal Responsibility Act of 1982 is hereby repealed.

(b) INDIVIDUAL RETIREMENT ACCOUNTS AND ANNUITIES.—

(1) INDIVIDUAL RETIREMENT ACCOUNTS.—Section 408(a) (relating to individual retirement accounts) is amended by striking out paragraphs (6) and (7) and inserting in lieu thereof the following new paragraph:

"(6) Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) (relating to required distributions) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained."

(2) INDIVIDUAL RETIREMENT ANNUITIES.—Section 408(b) (relating to individual retirement annuities) is amended by striking out paragraphs (3) and (4), by redesignating paragraph (5) as paragraph (4), and by inserting after paragraph (2) the following new paragraph:

"(3) Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) (relating to required distributions) shall apply to the distribution of the entire interest of the owner."

(c) SPECIAL RULE FOR CUSTODIAL ACCOUNTS.—Paragraph (7) of section 403(b) (relating to custodial accounts for regulated investment company stock) is amended by adding at the end thereof the following new subparagraph:

"(D) DISTRIBUTION REQUIREMENTS.—For purposes of determining when the interest of an employee in a custodial account must be distributed, such account shall be treated in the same manner as an annuity contract."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to years beginning after December 31, 1984.

(2) REPEAL OF SECTION 242 OF TEFRA.—The amendment made by subsection (a)(2) shall take effect as if included in the Tax Equity and Fiscal Responsibility Act of 1982.

(3) TRANSITION RULE.—A trust forming part of a plan shall not be disqualified under paragraph (9) of section 401(a) of the Internal Revenue Code of 1954, as amended by subsection (a)(1), by reason of distributions under a designation (before January 1, 1984) by any employee in accordance with a designation described in section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (as in effect before the amendments made by this Act).

(4) SPECIAL RULE FOR GOVERNMENTAL PLANS.—In the case of a governmental plan (within the meaning of section 414(d) of the Internal Revenue Code of 1954), paragraph (1) shall be applied by substituting "1986" for "1984".

(5) SPECIAL RULE FOR COLLECTIVE BARGAINING AGREEMENTS.—In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified on or before the date of the enactment of this Act betweeen employee representatives and one or more employers, the amendments made by this section shall not apply to years beginning before the earlier of—

(A) the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of the enactment of this Act), or

(B) January 1, 1988.

For purposes of subparagraph (A), any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section shall not be treated as a termination of such collective bargaining agreement.

SEC. 522. ROLLOVER OF CERTAIN PARTIAL DISTRIBUTIONS PERMITTED.

(a) GENERAL RULE.—

(1) QUALIFIED TRUSTS.—Clause (i) of section 402(a)(5)(A) (relating to rollover amounts) is amended to read as follows—

"(i) any portion of the balance to the credit of an employee in a qualified trust is paid to him,".

(2) QUALIFIED ANNUITIES.—Clause (i) of section 403(a)(4)(A) (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an employee annuity described in paragraph (1) is paid to him,".

(3) SECTION 403(b) ANNUITIES.—Clause (i) of section 403(b)(8)(A) (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an annuity contract described in paragraph (1) is paid to him,".

(b) SPECIAL RULES FOR ROLLOVERS OF PARTIAL DISTRIBUTIONS.—Paragraph (5) of section 402(a) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) REQUIREMENTS.—Subparagraph (A) shall apply to a partial distribution only if—

"(I) such distribution is of an amount equal to at least 50 percent of the balance to the credit of the employee in a qualified trust (determined immediately before such distribution and without regard to subsection (e)(4)(C)),

"(II) such distribution is not one of a series of periodic payments, and

"(III) the employee elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have subparagraph (A) apply to such partial distribution.

"(ii) PARTIAL DISTRIBUTIONS MAY BE TRANSFERRED ONLY TO INDIVIDUAL RETIREMENT PLANS.—In the case of a partial distribution, a plan described in subclause (IV) or (V) of subparagraph (E)(iv) shall not be treated as an eligible retirement plan.

"(iii) DENIAL OF 10-YEAR AVERAGING AND CAPITAL GAINS TREATMENT FOR SUBSEQUENT DISTRIBUTIONS.—If an election under clause (i) is made with respect to any partial distribution paid to any employee—

"(I) paragraph (2) of this subsection,

"(II) paragraphs (1) and (3) of subsection (e), and

"(III) paragraph (2) of section 403(a),

shall not apply to any distribution (paid after such partial distribution) of the balance to the credit of such employee under the plan under which such partial distribution was made (or under any other plan which, under subsection (e)(4)(C), would be aggregated with such plan).

"(iv) SPECIAL RULE FOR UNREALIZED APPRECIATION.—If an election under clause (i) is made with respect to any partial distribution, the second and third sentences of paragraph (1) shall not apply to such distribution."

(c) PARTIAL DISTRIBUTIONS PAID TO SPOUSE OF EMPLOYEE AFTER EMPLOYEE'S DEATH ELIGIBLE FOR ROLLOVER.—Paragraph (7) of section 402(a) (relating to rollover where spouse receives lump-sum distribution at death of employee) is amended to read as follows:

"(7) ROLLOVER WHERE SPOUSE RECEIVES DISTRIBUTIONS AFTER DEATH OF EMPLOYEE.—If any distribution attributable to an employee is paid to the spouse of the employee after the employee's death, paragraph (5) shall apply to such distribution in the same manner as if the spouse were the employee.".

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The following provisions are each amended by striking out "qualifying rollover distribution" each place it appears and inserting in lieu thereof "qualified total distribution"—

(A) section 402(a)(5)(B),

(B) section 402(a)(5)(E)(i) (as redesignated by subsection (b)), and

(C) section 402(a)(6)(E)(i).

(2) Subparagraph (B) of section 402(a)(5) is amended by adding at the end thereof the following new sentence: "In the case of any partial distribution, the maximum amount transferred to which subparagraph (A) applies shall not exceed the portion of such distribution which is includible in gross income (determined without regard to subparagraph (A))."

(3) Clause (ii) of section 402(a)(5)(E) (as redesignated by subsection (b)) is amended by striking out "gross income" and inserting in lieu thereof "gross income (determined without regard to this paragraph)".

(4) Clause (v) of subparagraph (E) of section 402(a)(5) (as redesignated by subsection (b)) is amended to read as follows:

"(v) PARTIAL DISTRIBUTION.—The term 'partial distribution' means any distribution to an employee of any portion of the balance to the credit of such employee in a qualified trust; except that such term shall not include any distribution which is a qualified total distribution."

(5) Subparagraph (F) of section 402(a)(5) (as redesignated by subsection (b)) is amended by striking out "subparagraph (D)(iv)" each place it appears and inserting in lieu thereof "subparagraph (E)(iv)".

(6) Paragraph (6) of section 402(a) is amended by striking out "paragraph (5)(D)(i)" each place it appears and inserting in lieu thereof "paragraph (5)(E)(i)".

(7) Clauses (iii) and (iv) of section 402(a)(6)(D) are each amended by striking out "employee contributions" and inserting in lieu thereof "employee contributions" for, in the case of a partial distribution, the amount not includible in gross income)".

(8) Clause (i) of section 402(a)(6)(E) is amended by striking out "paragraph (5)(D)(i)(II)" and inserting in lieu thereof "paragraph (5)(D) or (5)(E)(i)(II)".

(9) Subparagraph (B) of section 403(a)(4) is amended by striking out "(B) through (E)" and inserting in lieu thereof "(B) through (F)".

(10) Subparagraph (B) of section 403(b)(8) is amended to read as follows:

"(B) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) IN GENERAL.—In the case of any distribution other than a total distribution, rules similar to the rules of clauses (i) and (ii) of section 402(a)(5)(D) shall apply.

"(ii) TOTAL DISTRIBUTION.—For purposes of subparagraph (A), the term 'total distribution' means one or more distributions from an annuity contract described in paragraph (1) which would constitute a lump-sum distribution within the meaning of section 402(e)(4)(A) (determined without regard to subparagraphs (B) and (H) of section 402(e)(4)) if such annuity contract were described in subsection (a), or 1 or more distributions of accumulated deductible employee contributions (within the meaning of section 72(o)(5)).

"(iii) AGGREGATION OF ANNUITY CONTRACTS.—For purposes of this paragraph, all annuity contracts described in paragraph (1) purchased by an employer shall be treated as a single contract, and section 402(e)(4)(C) shall not apply."

(11) Subparagraph (C) of section 403(b)(8) is amended by striking out "(D)(v), and (E)(i)" and inserting in lieu thereof "(F)(i)".

(12) Clause (ii) of section 408(d)(3)(A) is amended by striking out "rollover contribution from an employee's trust" and inserting in lieu thereof "rollover contribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) from an employee's trust".

(13) Subparagraph (C) of section 409(b)(3) is amended by striking out the second sentence and inserting in lieu thereof the following new sentences: "This subparagraph does not apply in the case of a transfer to such an employee's trust or such an annuity unless no part of the value of such proceeds is attributable to any source other than a qualified rollover contribution. For purposes of the preceding sentence, the term 'qualified rollover contribution' means any rollover contribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) which is from such an employee's trust or annuity plan (other than an annuity plan or a trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under such plan), and which did not qualify as a rollover contribution by reason of section 402(a)(7)."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after the date of the amendment of this Act, in taxable years ending after such date.

SEC. 523. TREATMENT OF DISTRIBUTIONS WHERE SUBSTANTIALLY ALL CONTRIBUTIONS ARE EMPLOYEE CONTRIBUTIONS.

(a) IN GENERAL.—Subsection (e) of section 72 (relating to amounts not received as annuities) is amended by adding at the end thereof the following new paragraph:

"(7) SPECIAL RULES FOR PLANS WHERE SUBSTANTIALLY ALL CONTRIBUTIONS ARE EMPLOYEE CONTRIBUTIONS.—

"(A) IN GENERAL.—In the case of any plan or contract to which this paragraph applies, subparagraph (D) of paragraph (5) shall not apply to any amount received from such plan or contract.

"(B) PLANS OR CONTRACTS TO WHICH THIS PARAGRAPH APPLIES.—This paragraph shall apply to any trust or contract—

"(i) which is described in clause (i) or subclause (I), (II), or (III) of clause (ii) of paragraph (5)(D), and

"(ii) with respect to which 85 percent of the total contributions during a representative period are derived from employee contributions.

"(C) SPECIAL RULE FOR CERTAIN FEDERAL PLANS.—If the Federal Government or an instrumentality thereof maintains more than 1 plan, subparagraph (B) shall be applied by aggregating all such plans which are actively administered by the Federal Government or such instrumentality.

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (D) of section 72(e)(5) (relating to contracts under qualified plans) is amended by striking out "This" and inserting in lieu thereof "Except as provided in paragraph (7), this".

(2) Paragraph (3) of section 72(p) (defining qualified employer plan) is amended by inserting "other than a plan described in subsection (e)(7)" after "section 219(e)(3)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to any amount received or loan made after the 90th day after the date of the enactment of this Act.

SEC. 524. PROVISIONS RELATING TO TOP-HEAVY PLANS.

(a) DEFINITION OF KEY EMPLOYEE.—

(1) IN GENERAL.—Clause (i) of section 416(i)(1)(A) (defining key employee) is amended by inserting "having an annual compensation greater than 150 percent of the amount in effect under section 415(c)(1)(A) for any such plan year" after "employer".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to plan years beginning after December 31, 1983.

(b) ACCRUED BENEFIT OF INDIVIDUAL NOT EMPLOYED WITHIN LAST 5 YEARS DISREGARDED.—

(1) IN GENERAL.—Paragraph (4) of section 416(g) (relating to other special rules) is amended by adding at the end thereof the following new subparagraph:

"(E) BENEFITS NOT TAKEN INTO ACCOUNT IF EMPLOYEE NOT EMPLOYED FOR LAST 5 YEARS.—If any individual has not received any compensation from any employer maintaining the plan (other than benefits under the plan) at any time during the 5-year period ending on the determination date, any accrued benefit for such individual (and the account of such individual) shall not be taken into account."

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to plan years beginning after December 31, 1984.

(c) SALARY REDUCTION ARRANGEMENTS MAY BE TAKEN INTO ACCOUNT.—

(1) IN GENERAL.—Paragraph (2) of section 416(c) (relating to minimum benefits for defined contribution plans) is amended by striking out subparagraph (C).

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to plan years beginning after December 31, 1984.

(d) CERTAIN GOVERNMENTAL PLANS EXEMPT FROM TOP-HEAVY PLAN RULES.—

(1) IN GENERAL.—Paragraph (10)(B) of section 401(a) (relating to plan requirements regarding top-heavy plans) is amended by adding at the end thereof the following new clause:

"(iii) EXEMPTION FOR GOVERNMENTAL PLANS.—This subparagraph shall not apply to any governmental plan."

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to plan years beginning after December 31, 1983.

(e) QUALIFICATION REQUIREMENTS MODIFIED IF REGULATIONS NOT ISSUED.—

(1) IN GENERAL.—If the Secretary of the Treasury or his delegate does not publish final regulations under section 416 of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) before January 1, 1985, the Secretary shall publish before such date plan amendment provisions which may be incorporated in a plan to meet the requirements of section 401(a)(10)(B)(ii) of such Code.

(2) EFFECT OF INCORPORATION.—If a plan is amended to incorporate the plan amendment provisions described in paragraph (1), such plan shall be treated as meeting the requirements of section 401(a)(10)(B)(ii) of the Internal Revenue Code of 1954 during the period such amendment is in effect but not later than 6 months after the final regulations described in paragraph (1) are published.

(3) FAILURE BY SECRETARY TO PUBLISH.—If the Secretary of the Treasury or his delegate does not publish plan amendment provisions described in paragraph (1), the plan shall be treated as meeting the requirements of section 401(a)(10)(B) of the Internal Revenue Code of 1954 if—

(A) such plan is amended to incorporate such requirements by reference, except that

(B) in the case of any optional requirement under section 416 of such Code, if such amendment does not specify the manner in which such requirement will be met, the employer shall be treated as having elected the requirement with respect to each employee which provides the maximum vested accrued benefit for such employee.

SEC. 525. REPEAL OF ESTATE TAX EXCLUSION FOR QUALIFIED PENSION PLAN BENEFITS.

(a) IN GENERAL.—Section 2039 (relating to inclusion in the gross estate of annuities) is amended by striking out subsections (c), (d), (e), (f), and (g) and inserting in lieu thereof the following new subsection:

"(c) EXCEPTION OF CERTAIN ANNUITY INTERESTS CREATED BY COMMUNITY PROPERTY LAWS.—

"(1) IN GENERAL.—In the case of an employee on whose behalf contributions or payments were made by his employer or former employer under a trust, plan, or contract to which this subsection applies, if the spouse of such employee predeceases such employee, then notwithstanding any provision of law, there shall be excluded from the gross estate of such spouse the value of any interest of such spouse in such trust, plan, or contract, to the extent such interest—

"(A) is attributable to such contributions or payments, and

"(B) arises solely by reason of such spouse's interest in community income under the community property laws of a State.

"(2) TRUSTS, PLANS, AND CONTRACTS TO WHICH SUBSECTION APPLIES.—This subsection shall apply to—

"(A) any trust, plan, or contract which at the time of the decedent's separation from employment (by death or otherwise), or if earlier, at the time of termination of the plan—

"(i) formed part of a plan which met the requirements of section 401(a), or

"(ii) was purchased pursuant to a plan described in section 403(a), or

"(B) a retirement annuity contract purchased for an employee by an employer which is—

"(i) an organization referred to in clause (ii) or (vi) of section 170(b)(1)(A), or

"(ii) a religious organization (other than a trust) exempt from taxation under section 501(a).

"(3) AMOUNT CONTRIBUTED BY EMPLOYEE.—For purposes of this subsection—

"(A) contributions or payments made by the decedent's employer or former employer under a trust, plan, or contract described in paragraph (2)(A) shall not be considered to be contributed by the decedent, and

"(B) contributions or payments made by the decedent's employer or former employer toward the purchase of an annuity contract described in paragraph (2)(B) shall not be considered to be contributed by the decedent to the extent excludable from gross income under section 403(b)."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to the estates of decedents dying after December 31, 1984.

(2) EXCEPTION FOR PARTICIPANTS IN PAY STATUS.—The amendments made by this section shall not apply to the estate of any decedent who—

(A) was a participant in any plan who was in pay status on December 31, 1984, and

(B) irrevocably elected the form of the benefit before the date of the enactment of this Act.

(3) PAY STATUS RULE EXTENDED TO $100,000 LIMITATION.—Subsection (c) of section 245 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by inserting ", except that such amendments shall not apply to the estate of any decedent who was a participant in any plan who was in pay status on December 31, 1982, and irrevocably elected before January 1, 1983, the form of benefit".

SEC. 526. AFFILIATED SERVICE GROUPS, EMPLOYEE LEASING ARRANGEMENTS, AND COLLECTIVE BARGAINING AGREEMENTS.

(a) ATTRIBUTION RULES FOR AFFILIATED SERVICE GROUPS.—

(1) IN GENERAL.—Subparagraph (B) of section 414(m)(6), as in effect for taxable years beginning after December 31, 1983, is amended by striking out "section 267(c)" and inserting in lieu thereof "section 318(a)".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to taxable years beginning after December 31, 1984.

(b) EMPLOYEE LEASING EXCEPTION ONLY APPLIES TO NON-EMPLOYEES.—

(1) IN GENERAL.—Paragraph (2) of section 414(n) (defining leased employee) is amended by striking out "any person" in the material preceding subparagraph (A) and inserting in lieu thereof "any person who is not an employee of the recipient and".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to taxable years beginning after December 31, 1983.

(c) DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.—

(1) IN GENERAL.—Subsection (a) of section 7701 (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(46) DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.—In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term 'employee representatives' shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer."

(2) EFFECTIVE DATE.—The amendment made by this subsection shall take effect on April 1, 1984.

(d) ADDITIONAL REGULATIONS.—

(1) IN GENERAL.—Section 414 (relating to definitions and special rules) is amended by

adding at the end thereof the following new subsection:

"(o) REGULATIONS.—The Secretary shall prescribe such regulations (which may provide rules in addition to the rules contained in subsections (m) and (n)) as may be necessary to prevent the avoidance of any employee benefit requirement listed in subsection (m)(4) or (n)(3) through the use of—

"(1) separate organizations,

"(2) employee leasing, or

"(3) other arrangements."

(2) CONFORMING AMENDMENT.—Subsection (m) of section 414 is amended by striking out paragraph (6).

(3) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on the date of the enactment of this Act.

SEC. 527. PROVISIONS RELATING TO CASH OR DEFERRED ARRANGEMENTS.

(a) PARTICIPATION AND DISCRIMINATION STANDARDS.—Subparagraph (A) of section 401(k)(3) is amended to read as follows:

"(A) A cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement unless—

"(i) those employees eligible to benefit under the arrangement satisfy the provisions of subparagraph (A) or (B) of section 410(b)(1), and

"(ii) the actual deferral percentage for highly compensated employees (as defined in paragraph (4)) for such year bears a relationship to the actual deferral percentage for all other eligible employees for such plan year which meets either of the following tests:

"(I) The actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.5.

"(II) The excess of the actual deferral percentage for the group of highly compensated employees over that of all other eligible employees is not more than 3 percentage points, and the actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.5.

If 2 or more plans which include cash or deferred arrangements are considered as 1 plan for purposes of section 401(a)(4) or 410(b), the cash or deferred arrangements included in such plans shall be treated as 1 arrangement for purposes of this subparagraph.

The deferral percentage taken into account under this subparagraph for any employee who is a participant under 2 or more cash or deferred arrangements of the employer shall be the sum of the deferral percentages for such employee under each of such arrangements."

(b) APPLICATION TO PRE-ERISA MONEY PURCHASE PLAN.—

(1) GENERAL RULE.—Paragraphs (1) and (2) of section 401(k) (relating to cash or deferred arrangements) are each amended by inserting "(or a pre-ERISA money purchase plan)" after "stock bonus plan".

(2) DEFINITION OF PRE-ERISA MONEY PURCHASE PLAN.—Subsection (k) of section 401 is amended by adding at the end thereof the following new paragraph:

"(5) PRE-ERISA MONEY PURCHASE PLAN.—For purposes of this subsection, the term 'pre-ERISA money purchase plan' means a pension plan—

"(A) which is a defined contribution plan (as defined in section 414(i)),

"(B) which was in existence on June 27, 1974, and which, on such date, included a salary reduction arrangement, and

"(C) under which neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on such date."

(3) TECHNICAL AMENDMENT.—Subparagraph (B) of section 401(k)(2) is amended by striking out ", hardship or the attainment of age 59½," and inserting in lieu thereof "(or in the case of a profit sharing or stock bonus plan, hardship or the attainment of age 59½)".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendment made by subsection (a) shall apply to plan years beginning after December 31, 1984.

(B) EXCEPTION FOR CERTAIN EXISTING PLANS.—The amendment made by subsection (a) shall not apply to any plan—

(i) which was maintained by a State on June 8, 1984, and

(ii) with respect to which a determination letter had been issued by the Secretary on December 6, 1982.

(2) SUBSECTION (b).—

(A) IN GENERAL.—The amendments made by this section shall apply with respect to plan years beginning after the date of the enactment of this Act.

(B) TRANSITIONAL RULE.—Rules similar to the rules under section 135(c)(2) of the Revenue Act of 1978 shall apply with respect to any pre-ERISA money purchase plan (as defined in section 401(k)(5) of the Internal Revenue Code of 1954) for plan years beginning after December 31, 1979, and on or before the date of the enactment of this Act.

SEC. 528. TREATMENT OF CERTAIN MEDICAL, ETC., BENEFITS UNDER SECTION 415.

(a) GENERAL RULE.—Section 415 (relating to limitations on benefits and contributions under qualified plan) is amended by adding at the end thereof the following new subsection:

"(l) TREATMENT OF CERTAIN MEDICAL BENEFITS.—

"(1) IN GENERAL.—For purposes of this section, contributions allocated to any individual medical account which is part of a defined benefit plan shall be treated as an annual addition to a defined contribution plan for purposes of subsection (c).

"(2) INDIVIDUAL MEDICAL BENEFIT ACCOUNT.—For purposes of paragraph (1), the term 'individual medical benefit account' means any separate account—

"(A) which is established for a participant under a defined benefit plan, and

"(B) from which benefits described in section 401(h) are payable solely to such participant, his spouse, or his dependents."

(b) REQUIREMENT THAT SEPARATE ACCOUNT BE MAINTAINED FOR 5-PERCENT OWNER.—Subsection (h) of section 401 (relating to medical, etc., benefits for retired employees and their spouses and dependents) is amended by striking out "and" at the end of paragraph (4), by striking out the period at the end of paragraph (5) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(6) in the case of an employee who is a 5-percent owner, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a 5-percent owner) are only payable to such employee (and his spouse and dependents) from such separate account.

For purposes of paragraph (6), the term '5-percent owner' means any employee who, at any time during the plan year or any preceding plan year during which contributions were made on behalf of such employee, is or was a 5-percent owner (as defined in section 416(i)(1)(B))."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after March 31, 1984.

SEC. 529. CERTAIN ALIMONY TREATED AS COMPENSATION.

(a) IN GENERAL.—Paragraph (1) of section 219(f) (defining compensation) is amended by adding at the end thereof the following new sentence: "The term 'compensation' shall include any amount includible in the individual's gross income under paragraph (1) of section 71(a) (relating to decree of divorce or separate maintenance)."

(b) CONFORMING AMENDMENT.—Subsection (b) of section 219 is amended by striking out paragraph (4).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

Subtitle C—Tax Treatment of Fringe Benefits

SEC. 531. EXCLUSION OF CERTAIN FRINGE BENEFITS FROM GROSS INCOME.

(a) EXCLUSION OF CERTAIN FRINGES BENEFITS.—

(1) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 132 as section 133 and by inserting after section 131 the following new section:

"SEC. 132. CERTAIN FRINGE BENEFITS.

"(a) EXCLUSION FROM GROSS INCOME.—Gross income shall not include any fringe benefit which qualifies as a—

"(1) no-additional-cost service,

"(2) qualified employee discount,

"(3) working condition fringe, or

"(4) de minimis fringe.

"(b) NO-ADDITIONAL-COST SERVICE DEFINED.—For purposes of this section, the term 'no-additional-cost service' means any service provided by an employer to an employee for use by such employee if—

"(1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and

"(2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).

"(c) QUALIFIED EMPLOYEE DISCOUNT DEFINED.—For purposes of this section—

"(1) QUALIFIED EMPLOYEE DISCOUNT.—The term 'qualified employee discount' means any employee discount with respect to qualified property or services to the extent such discount does not exceed—

"(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or

"(B) in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.

"(2) GROSS PROFIT PERCENTAGE.—

"(A) IN GENERAL.—The term 'gross profit percentage' means the percent which—

"(i) the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of

"(ii) the aggregate sale price of such property.

"(B) DETERMINATION OF GROSS PROFIT PERCENTAGE.—Gross profit percentage shall be determined on the basis of—

"(i) all property offered to customers in the ordinary course of the line of business of the employer in which the employee is performing services (or a reasonable classification of property selected by the employer), and

"(ii) the employer's experience during a representative period.

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"(3) EMPLOYEE DISCOUNT DEFINED.—The term 'employee discount' means the amount by which—

"(A) the price at which the property or services are provided to the employee by the employer, is less than

"(B) the price at which such property or services are being offered by the employer to customers.

"(4) QUALIFIED PROPERTY OR SERVICES.—The term 'qualified property or services' means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

"(d) WORKING CONDITION FRINGE DEFINED.—For purposes of this section, the term 'working condition fringe' means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

"(e) DE MINIMIS FRINGE DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'de minimis fringe' means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

"(2) TREATMENT OF CERTAIN EATING FACILITIES.—The operation by an employer of any eating facility for employees shall be treated as a de minimis fringe if—

"(A) such facility is located on or near the business premises of the employer, and

"(B) revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.

The preceding sentence shall apply with respect to any officer, owner, or highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(f) CERTAIN INDIVIDUALS TREATED AS EMPLOYEES FOR PURPOSES OF SUBSECTIONS (a)(1) AND (2).—For purposes of paragraphs (1) and (2) of subsection (a)—

"(1) RETIRED AND DISABLED EMPLOYEES AND SURVIVING SPOUSE OF EMPLOYEE TREATED AS EMPLOYEE.—With respect to a line of business of an employer, the term 'employee' includes—

"(A) any individual who was formerly employed by such employer in such line of business and who separated from service with such employer in such line of business by reason of retirement or disability, and

"(B) any widow or widower of any individual who died while employed by such employer in such line of business or while an employee within the meaning of subparagraph (A).

"(2) SPOUSE AND DEPENDENT CHILDREN.—

"(A) IN GENERAL.—Any use by the spouse or a dependent child of the employee shall be treated as use by the employee.

"(B) DEPENDENT CHILD.—For purposes of subparagraph (A), the term 'dependent child' means any child (as defined in section 151(e)(3)) of the employee—

"(i) who is a dependent of the employee, or

"(ii) both of whose parents are deceased.

For purposes of the preceding sentence, any child to whom section 152(e) applies shall be treated as the dependent of both parents.

"(g) SPECIAL RULES RELATING TO EMPLOYER.—For purposes of this section—

"(1) CONTROLLED GROUPS, ETC.—All employees treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section.

"(2) RECIPROCAL AGREEMENTS.—For purposes of paragraph (1) of subsection (a), any service provided by an employer to an employee of another employer shall be treated as provided by the employer of such employee if—

"(A) such service is provided pursuant to a written agreement between such employers, and

"(B) neither of such employers incurs any substantial additional cost (including forgone revenue) in providing such service or pursuant to such agreement.

"(h) SPECIAL RULES.—

"(1) EXCLUSIONS UNDER SUBSECTION (a) (1) AND (2) APPLY TO OFFICERS, ETC., ONLY IF NO DISCRIMINATION.—Paragraphs (1) and (2) of subsection (a) shall apply with respect to any fringe benefit described therein provided with respect to any officer, owner, or highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(2) SPECIAL RULE FOR LEASED SECTIONS OF DEPARTMENT STORES.—

"(A) IN GENERAL.—For purposes of paragraph (2) of subsection (a), in the case of a leased section of a department store—

"(i) such section shall be treated as part of the line of business of the person operating the department store, and

"(ii) employees in the leased section shall be treated as employees of the person operating the department store.

"(B) LEASED SECTION OF DEPARTMENT STORE.—For purposes of subparagraph (A), a leased section of a department store is any part of a department store where over-the-counter sales of property are made under a lease or similar arrangement where it appears to the general public that individuals making such sales are employed by the person operating the department store.

"(3) AUTO SALESMEN.—

"(A) IN GENERAL.—For purposes of subsection (a)(3), qualified automobile demonstration use shall be treated as a working condition fringe.

"(B) QUALIFIED AUTOMOBILE DEMONSTRATION USE.—For purposes of subparagraph (A), the term 'qualified automobile demonstration use' means any use of an automobile by a full-time automobile salesman in the sales area in which the automobile dealer's sales office is located if—

"(i) such use in provided primarily to facilitate the salesman's performance of services for the employer, and

"(ii) there are substantial restrictions on the personal use of such automobile by such salesman.

"(4) PARKING.—The term 'working condition fringe' includes parking provided to an employee on or near the business premises of the employer.

"(5) ON-PREMISES GYMS AND OTHER ATHLETIC FACILITIES.—

"(A) IN GENERAL.—Gross income shall not include the value of any on-premises athletic facility provided by an employer to his employees.

"(B) ON-PREMISES ATHLETIC FACILITY.—For purposes of this paragraph, the term 'on-premises athletic facility' means any gym or other athletic facility—

"(i) which is located on the premises of the employer,

"(ii) which is operated by the employer, and

"(iii) substantially all the use of which is by employees of the employer, their spouses, and their dependent children (within the meaning of subsection (f)).

"(i) CUSTOMERS NOT TO INCLUDE EMPLOYEES.—For purposes of this section (other than subsection (c)(2)(B)), the term 'customers' shall only include customers who are not employees.

"(j) SECTION NOT TO APPLY TO FRINGE BENEFITS EXPRESSLY PROVIDED FOR ELSEWHERE.—This section (other than subsection (e)) shall not apply to any fringe benefits of a type the tax treatment of which is expressly provided for in any other section of this chapter.

"(k) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(2) CLERICAL AMENDMENT.—The table of sections for such part III is amended by striking out the item relating to section 132 and inserting in lieu thereof the following:

"Sec. 132. Certain fringe benefits.

"Sec. 133. Cross references to other Acts."

(b) CAFETERIA PLAN.—

(1) Definition of cafeteria plan.—Paragraph (1) of section 125(d) (defining cafeteria plan) is amended to read as follows:

"(1) IN GENERAL.—The term 'cafeteria plan' means a written plan under which—

"(A) all participants are employees, and

"(B) the participants may choose among 2 or more benefits consisting of cash and statutory nontaxable benefits."

(2) DEFINITION OF STATUTORY NONTAXABLE BENEFIT.—

(A) In general subsection (f) of section 125 is amended to read as follows:

"(f) STATUTORY NONTAXABLE BENEFITS DEFINED.—For purposes of this section, the term 'statutory nontaxable benefit' means any benefit which, with the application of subsection (a) is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 117, 124, 127, or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79."

(B) CONFORMING AMENDMENT.—Subsection (c) of section 125 is amended by striking out "nontaxable benefits" each place it appears and inserting in lieu thereof "statutory nontaxable benefits".

(3) EXCEPTION FOR KEY EMPLOYEES.—Subsection (b) of section 125 (relating to exception for highly compensated participants) is amended to read as follows:

(b) EXCEPTION FOR HIGHLY COMPENSATED PARTICIPANTS AND KEY EMPLOYEES.—

(1) HIGHLY COMPENSATED PARTICIPANTS.—In the case of a highly compensated participant, subsection (a) shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of—

(A) highly compensated individuals as to eligibility to participate, or

(B) highly compensated participants as to contributions and benefits.

(2) KEY EMPLOYEES.—In the case of a key employee (within the meaning of section 416(i)(1)), subsection (a) shall not apply to any benefit attributable to a plan for which the statutory nontaxable benefits provided to key employees exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. For purposes of the preceding sentence, statutory nontaxable benefits shall be determined without regard to the last sentence of subsection (f).

(3) YEAR OF INCLUSION.—For purposes of determining the taxable year of inclusion, any benefit described in paragraph (1) or (2) shall be treated as received or accrued in the taxable year of the participant or key employee in which the plan year ends.

(d) REPORTING REQUIREMENTS.—

(A) Section 125 (relating to cafeteria plans) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(n) REPORTING REQUIREMENTS.—

"(1) IN GENERAL.—Each employer maintaining a cafeteria plan during any taxable year which begins after December 31, 1984, and to which this section applies shall file a return (at such time and in such manner as the Secretary shall by regulations prescribe) with respect to such plan showing for such year—

"(A) the number of employees of the employer,

"(B) the number of employees participating under the plan,

"(C) the total cost of the plan during the taxable year, and

"(D) the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged.

"(2) RECORDKEEPING REQUIREMENT.—Each employer maintaining a cafeteria plan during any year shall keep such records as may be necessary for purposes of determining whether the requirements of this section are met.

"(3) ADDITIONAL INFORMATION WHEN REQUIRED BY THE SECRETARY.—Any employer—

"(A) who maintains a cafeteria plan during any year for which a return is required under paragraph (1), and

"(B) who is required by the Secretary to file an additional return for such year,

shall file such additional return. Such additional return shall be filed at such time and in such manner as the Secretary shall prescribe and shall contain such information as the Secretary shall prescribe.".

(B) Subsection (f) of section 6652 is amended—

(i) by striking out "or 6047 (relating to information relating to certain trusts and annuity and bond purchase plans)" and inserting in lieu thereof ", 6047 (relating to information relating to certain trusts and annuity and bond purchases plans), or 125 (h) (relating to information with respect to cafeteria plans)", and

(ii) by striking out "Deferred Compensation.—" in the subsection heading and inserting in lieu thereof "Deferred Compensation; Etc.—".

(5) EXCEPTION FOR CERTAIN CAFETERIA PLANS AND BENEFITS.—

(A) GENERAL TRANSITIONAL RULE.—Any cafeteria plan in existence on February 10, 1984, which failed as of such date and continued to fail thereafter to satisfy the rules relating to section 125 under proposed Treasury regulations, and any benefit offered under such a cafeteria plan which failed as of such date and continued to fail thereafter to satisfy the rules of section 105, 106, 120, or 129 under proposed Treasury regulations, will not fail to be a cafeteria plan under section 125 or a nontaxable benefit under section 105, 106, 120, or 129 solely because of such failures. The preceding sentence shall apply only with respect to cafeteria plans and benefits provided under cafeteria plans before the earlier of—

(i) January 1, 1985, or

(ii) the effective date of any modification to provide additional benefits after February 10, 1984.

(B) SPECIAL TRANSITION RULE FOR ADVANCE ELECTION BENEFIT BANKS.—Any benefit offered under a cafeteria plan in existence on February 10, 1984, which failed as of such date and continued to fail thereafter to satisfy the rules of section 105, 106, 120, or 129 under proposed Treasury regulations because an employee was assured of receiving (in cash or any other benefit) amounts available but unused for covered reimbursement during the year without regard to whether he incurred covered expenses, will not fail to be a nontaxable benefit under such applicable section solely because of such failure. The preceding sentence shall apply only with respect to benefits provided under cafeteria plans before the earlier of—

(i) July 1, 1985, or

(ii) the effective date of any modification to provide additional benefits after February 10, 1984.

Except as provided in Treasury regulations, the special transition rule is available only for benefits with respect to which, after December 31, 1984, contributions are fixed before the period of coverage and taxable cash is not available until the end of such period of coverage.

(C) PLANS FOR WHICH SUBSTANTIAL IMPLEMENTATION COSTS WERE INCURRED.—For purposes of this paragraph, any plan with respect to which substantial implementation costs had been incurred before February 10, 1984, shall be treated as in existence on February 10, 1984.

(6) STUDY OF EFFECTS OF CAFETERIA PLANS ON HEALTH CARE COSTS.—

(A) STUDY.—The Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, shall conduct a study of the effects of cafeteria plans (within the meaning of section 125 of the Internal Revenue Code of 1954) on the containment of health care costs.

(B) REPORT.—The Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, shall submit a report on the study conducted under subparagraph (A) to the Committee on Ways and Means of the House of Representatives and the Committee in Finance of the Senate by no later than April 1, 1985.

(c) CLARIFICATION THAT FRINGE BENEFITS NOT COVERED BY STATUTORY EXCLUSION INCLUDED IN GROSS INCOME.—Paragraph (1) of section 61(a) (defining gross income) is amended by striking out "commissions, and similar items" and inserting in lieu thereof "commissions, fringe benefits, and similar items".

(d) CONFORMING AMENDMENTS TO EMPLOYMENT TAXES.—

(1) SOCIAL SECURITY TAXES.—

(A) Subsection (a) of section 3121 (defining wages) is amended—

(i) by striking out "all remuneration paid in any medium" in the material preceding paragraph (1) and inserting in lieu thereof "all remuneration (including benefits) paid in any medium", and

(ii) by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by inserting after paragraph (19) the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(B) Section 209 of the Social Security Act is amended—

(i) by striking out "all remuneration paid in any medium" in the material preceding subsection (a) and inserting in lieu thereof "all remuneration (including benefits) paid in any medium", and

(ii) by striking out "or" at the end of subsection (q), by striking out the period at the end of subsection (r) and inserting in lieu thereof "; or", and by inserting after subsection (r) the following new subsection:

"(s) Any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132 of the Internal Revenue Code of 1954."

(2) RAILROAD RETIREMENT TAX.—Subsection (e) of section 3231 (defining compensation) is amended by adding at the end thereof the following new paragraph:

"(5) The term 'compensation' shall not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(3) UNEMPLOYMENT TAX.—Subsection (b) of section 3306 (defining wages) is amended—

(A) by striking out "all remuneration paid in any medium" in the material preceding paragraph (1) and inserting in lieu thereof "all remuneration (including benefits) paid in any medium", and

(B) by striking out "or" at the end of paragraph (14), by striking out the period at the end of paragraph (15) and inserting in lieu thereof "; or", and by inserting after paragraph (15) the following new paragraph:

"(16) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(4) WITHHOLDING.—Subsection (a) of section 3401 (defining wages) is amended—

(A) by striking out "all remuneration paid in any medium" in the material preceding paragraph (1) and inserting in lieu thereof "all remuneration (including benefits) paid in any medium", and

(B) by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(5) METHOD OF COLLECTING TAX FROM NONCASH FRINGE BENEFITS.—Section 3501 (relating to collection and payment of taxes) is amended—

(A) by striking out "The taxes" and inserting in lieu thereof the following:

"(a) GENERAL RULE.—The taxes", and

(B) by adding at the end thereof the following new subsection:

"(b) TAXES WITH RESPECT TO NON-CASH FRINGE BENEFITS.—The taxes imposed by this subtitle with respect to non-cash fringe benefits shall be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations."

(e) ELECTION WITH RESPECT TO CERTAIN EXISTING LINES OF BUSINESS.—

(1) IN GENERAL.—Chapter 43 (relating to qualified pension, etc., plans), as amended by this Act, is amended by adding at the end thereof the following new section:

"SEC. 4977. TAX ON CERTAIN FRINGE BENEFITS PROVIDED BY AN EMPLOYER.

"(a) IMPOSITION OF TAX.—In the case of an employer to whom an election under this section applies for any calendar year, there is hereby imposed a tax for such calendar year equal to 30 percent of the excess fringe benefits.

"(b) EXCESS FRINGE BENEFITS.—For purposes of subsection (a), the term 'excess fringe benefits' means, with respect to any calendar year—

"(1) the aggregate value of the fringe benefits provided by the employer during the calendar year which were not includible in gross income under paragraphs (1) and (2) of section 132(a), over

"(2) 1 percent of the aggregate amount of compensation—

"(A) which was paid by the employer during such calendar year to employees, and

* Probably should read "(h)."

"(B) was includible in gross income for purposes of chapter 1.

"(c) EFFECT OF ELECTION ON SECTION 132(a).—If—

"(1) an election under this section is in effect with respect to an employer for any calendar year, and

"(2) as of January 1, 1984, substantially all of the employees of the employer were entitled to employee discounts or services provided by the employer in 1 line of business, for purposes of paragraphs (1) and (2) of section 132(a) (but not for purposes of section 132(g)(2)), all employees of any line of business of the employer which was in existence on January 1, 1984, shall be treated as employees of the line of business referred to in paragraph (2).

"(d) PERIOD OF ELECTION.—An election under this section shall apply to the calendar year for which made and all subsequent calendar years unless revoked by the employer.

"(e) TREATMENT OF AFFILIATED GROUPS.—For purposes of this section, all members of the same affiliated group of corporations (as defined in section 1504) shall be treated as 1 corporation."

(2) CLERICAL AMENDMENT.—The table of sections for chapter 43 is amended by adding at the end thereof the following new item:

"Sec. 4977. Tax on certain fringe benefits provided by an employer."

(f) DETERMINATION OF LINE OF BUSINESS IN CASE OF AFFILIATED GROUP OPERATING RETAIL DEPARTMENT STORES.—If—

(1) as of October 5, 1983, the employees of one member of an affiliated group (as defined in section 1504 of the Internal Revenue Code of 1954 without regard to subsections (b)(2) and (b)(4) thereof) were entitled to employee discounts at the retail department stores operated by another member of such affiliated group, and

(2) the primary business of the affiliated group is the operation of retail department stores,

then, for purpose of applying section 132(a)(2) of the Internal Revenue Code of 1954, with respect to discounts provided for such employees at the retail department stores operated by such other member, the employer shall be treated as engaged in the same line of business as such other member.

(g) MORATORIUM ON ISSUANCE OF REGULATIONS RELATING TO FACULTY HOUSING.—

(1) IN GENERAL.—Any regulation providing for the inclusion in gross income under section 61 of the Internal Revenue Code of 1954 of the excess (if any) of the fair market value of qualified campus lodging over the greater of—

(A) the operating costs paid or incurred in furnishing such lodging, or

(B) the rent received for such lodging,

shall not be issued before January 1, 1986.

(2) QUALIFIED CAMPUS LODGING.—For purposes of this subsection, the term "qualified campus lodging" means lodging which is—

(A) located on (or in close proximity to) a campus of an educational institution (described in section 170(b)(1)(A)(ii) of the Internal Revenue Code of 1954), and

(B) provide by such institution to an employee of such institution, or to a spouse or dependent (within the meaning of section 152 of such Code) of such employee.

(3) APPLICATION OF SUBSECTION.—This subsection shall apply with respect to lodging furnished after December 31, 1983, and before January 1, 1986.

(h) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1985.

SEC. 532. EXCLUSION OF CERTAIN REDUCTIONS IN TUITION FROM GROSS INCOME.

(a) IN GENERAL.—Section 117 (relating to scholarships and fellowship grants) is amended by adding at the end thereof the following new subsection:

"(d) QUALIFIED TUITION REDUCTIONS.—

"(1) IN GENERAL.—Gross income shall not include any qualified tuition reduction.

"(2) QUALIFIED TUITION REDUCTION.—For purposes of this subsection, the term 'qualified tuition reduction' means the amount of any reduction in tuition provided to an employee of an organization described in section 170(b)(1)(A)(ii) for the education (below the graduate level) at such organization (or another organization described in section 170(b)(1)(A)(ii)) of—

"(A) such employee, or

"(B) any person treated as an employee (or whose use is treated as an employee use) under the rules of section 132(f).

"(3) REDUCTION MUST NOT DISCRIMINATE IN FAVOR OF HIGHLY COMPENSATED, ETC.—Paragraph (1) shall apply with respect to any qualified tuition reduction provided with respect to any officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to qualified tuition reductions (as defined in section 117(d)(2) of the Internal Revenue Code of 1954) for education furnished after June 30, 1985, in taxable years ending after such date.

Subtitle D—Employee Stock Ownership Plans

SEC. 541. NONRECOGNITION OF GAIN ON STOCK SOLD TO EMPLOYEE STOCK OWNERSHIP PLANS OR CERTAIN COOPERATIVES IF QUALIFIED REPLACEMENTS PROPERTY ACQUIRED.

(a) IN GENERAL.—Part III of subchapter O of chapter 1 (relating to nontaxable exchanges), as amended by this Act, is amended by adding at the end thereof the following new section:

"SEC. 1042. SALES OF STOCK TO STOCK OWNERSHIP PLANS OR CERTAIN COOPERATIVES.

"(a) NONRECOGNITION OF GAIN.—If—

"(1) the taxpayer elects the application of this section with respect to any sale of qualified securities.

"(2) the taxpayer purchases qualified replacement property within the replacement period, and

"(3) the requirements of subsection (b) are met with respect to such sale,

then the gain (if any) on such sale shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property.

"(b) REQUIREMENTS TO QUALIFY FOR NONRECOGNITION.—A sale of qualified securities meets the requirements of this subsection if—

"(1) SALE OF EMPLOYEE ORGANIZATIONS.—The qualified securities are sold to—

"(A) an employee stock ownership plan (as defined in section 4975(e)(7)), or

"(B) an eligible worker-owned cooperative.

"(2) EMPLOYEES MUST OWN 30 PERCENT OF STOCK AFTER SALE.—The plan or cooperative referred to in paragraph (1) owns, immediately after the sale, at least 30 percent of the total value of the qualified securities outstanding as of such time.

"(3) PLAN MAINTAINED FOR BENEFIT OF EMPLOYEES.—No portion of the assets of the plan or cooperative attributable to qualified securities acquired by the plan or cooperative described in paragraph (1) accure under such plan, or are allocated by such cooperative, for the benefit of—

"(A) the taxpayer,

"(B) any person who is a member of the family of the taxpayer (within the meaning of section 267(c)(4)), or

"(C) any othr person who owns (after application of section 318(a)) more than 25 percent in value of any class of outstanding qualified securities.

"(4) WRITTEN STATEMENT REQUIRED.—

"(A) IN GENERAL.—The taxpayer files with the Secretary the written statement described in subparagraph (B).

"(B) STATEMENT.—A statement is described in this subparagraph if it is a verified written statement of—

"(i) the employer whose employees are covered by the plan described in paragraph (1), or

"(ii) any authorized officer of the cooperative described in paragraph (1),

consenting to the application of section 4978(a) with respect to such employer or cooperative.

"(c) DEFINITIONS; SPECIAL RULES.—For purposes of this section.—

"(1) QUALIFIED SECURITIES.—The term 'qualified securities' means employer securities (as defined in section 409A(l)) which—

"(A) are issued by a domestic corporation that has no securities outstanding that are readily tradable on an established securities market,

"(B) at the time of the sale described in subsection (a)(1), have been held by the taxpayer for more than 1 year, and

"(C) were not received by the taxpayer in—

"(i) a distribution from a plan described in section 401(a), or

"(ii) a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

"(2) ELIGIBLE WORKER-OWNED COOPERATIVE.—The term 'eligible worker-owned cooperative' means any organiztion—

"(A) to which part I of subchapter T applies,

"(B) a majority of the membership of which is composed of employees of such organization,

"(C) a majority of the voting stock of which is owned by members,

"(D) a majority of the board of directors of which is elected by the members on the basis of 1 person 1 vote, and

"(E) a majority of the allocated earnings and losses of which are allocated to members on the basis of—

"(i) patronage,

"(ii) capital contributions, or

"(iii) some combination of clauses (i) and (ii).

"(3) REPLACEMENT PEROID.—The term 'replacement period' means the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale.

"(4) QUALIFIED REPLACMENT PROPERTY.—The term 'qualified replacement property' means any securities (as defined in section 165(g)(2)) issued by a domestic corporation which does not, for the taxable year in which such stock is issued, have passive investment income (as defined in section 1362(d)(3)(D)) that exceeds 25 percent of the gross receipts of such corporation for such taxable year.

"(5) SECURITIES ACQUIRED BY UNDERWRITER.—No acquisition of securities by an underwriter in the ordinary course of his trade or business as an underwriter, whether or not guaranteed, shall be treated as a sale for purposes of subsection (a).

"(6) TIME FOR FILING ELECTION.—An election under subsection (a) shall be filed not later than the last day prescribed by law (including extensions thereof) for filing the return

of tax imposed by this chapter for the taxable year in which the sale occurs.

"(d) BASIC OF QUALIFIED REPLACEMENT PROPERTY.—The basis of the taxpayer in qualified replacement property purchased by the taxpayer during the replacement period shall be reduced by the amount of gain not recognized by reason such purchase and the application of subsection (a). If more than one item of qualified replacement property is purchased, the basic of each of such items shall be reduced by an amount determined by multiplying the total gain not recognized by reason of such purchase and the application of subsection (a) by a fraction—

"(1) the numerator of which is the cost of such item of property, and

"(2) the denominator of which is the total cost of all such items of property.

"(e) STATUTE OF LIMITATIONS.—If any gain is realized by the taxpayer on the sale or exchange of any qualified securities and there is in effect an election under subsection (a) with respect to such gain, then—

"(1) the statutory period for the assessment of any deficiency with respect to such gain shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of—

"(A) the taxpayer's cost of purchasing qualified replacement property which the taxpayer claims results in nonrecognition of any part of such gain,

"(B) the taxpayer's intention not to purchase qualified replacement property within the replacement period, or

"(C) a failure to make such purchase within the replacement period, and

"(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment."

(b) CONFORMING AMENDMENTS.—

(1) Section 1223 (relating to holding period of property) is amended by redesignating paragraph (13) as paragraph (14) and by inserting after paragraph (12) the following:

"(13) In determining the period for which the taxpayer has held qualified replacement property (within the meaning of section 1042(b)) the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale of qualified securities (within the meaning of section 1042(b)), there shall be included the period for which such qualified securities had been held by the taxpayer."

(2) Subsection (a) of section 1016 (relating to adjustments to basis), as amended by this Act, is amended—

(A) by striking out "and" at the end of paragraph (25),

(B) by striking out the period at the end of paragraph (26) and inserting in lieu thereof ", and", and

(C) by adding at the end thereof the following new paragraph:

"(27) in the case of qualified replacement property, the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale or exchange of any property, to the extent provided in section 1042(c)."

(3) The table of sections for part III of subchapter O of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 1042. Sales of stock to employees."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales of securities in taxable years beginning after the date of enactment of this Act.

SEC. 542. DEDUCTIBILITY OF CERTAIN DIVIDEND DISTRIBUTIONS FROM EMPLOYEE STOCK OWNERSHIP PLANS.

(a) DEDUCTION.—Section 404 (relating to deductions for employer contributions to an employees' trust) is amended by adding at the end thereof the following new subsection:

"(k) DIVIDENDS PAID DEDUCTIONS.—In addition to the deductions provided under subsection (a), there shall be allowed as a deduction to a corporation the amount of any dividend paid in cash by such corporation during the taxable year with respect to the stock of such corporation if—

"(1) such stock is held on the record date for the dividend by a tax credit employee stock ownership plan (as defined in section 409A) or an employee stock ownership plan (as defined in section 4975(e)(7)) which is maintained by such corporation or by any other corporation that is a member of a controlled group of corporations (within the meaning of section 409A(1)(4)) that includes such corporation, and

"(2) in accordance with the plan provisions—

"(A) the dividend is paid in cash to the participants in the plan, or

"(B) the dividend is paid to the plan and is distributed in cash to participants in the plan not later than 90 days after the close of the plan year in which paid."

(b) DENIAL OF PARTIAL EXCLUSION.—Section 116 (relating to partial exclusion of dividends) is amended by adding at the end thereof the following new subsection:

"(e) DIVIDENDS FROM EMPLOYEE STOCK OWNERSHIP PLANS.—Subsection (a) shall not apply to any dividend described in section 404(k)."

(c) NO WITHHOLDING ON DIVIDEND DISTRIBUTION.—Subparagraph (B) of section 3405(d)(1) (relating to designated distributions) is amended—

(1) by striking out "and" at the end of clause (i),

(2) by striking out the period at the end of clause (ii) and inserting in lieu thereof ", or", and

(3) by adding at the end thereof the following new clause:

"(iii) any distribution described in section 404(k)(2)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of enactment of this Act.

SEC. 543. EXCLUSION OF INTEREST ON LOANS USED TO FINANCE ACQUISITION OF EMPLOYER SECURITIES BY AN ESOP.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items excluded from gross income), as amended by this Act, is amended by redesignating section 133 as section 134 and by inserting after section 131 the following new section:

"SEC. 133. INTEREST ON CERTAIN LOANS USED TO ACQUIRE EMPLOYER SECURITIES.

"(a) IN GENERAL.—Gross income does not include 50 percent of the interest received by—

"(1) a bank (within the meaning of section 581),

"(2) an insurance company to which subchapter L applies, or

"(3) a corporation actively engaged in the business of lending money,

with respect to a securities acquisition loan.

"(b) SECURITIES ACQUISITION LOAN.—

"(1) IN GENERAL.—For purposes of this section, the term 'securities acquisition loan' means any loan to a corporation, or to an employee stock ownership plan, to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409A(1)) for the plan.

"(2) LOANS BETWEEN RELATED PERSONS.—The term 'securities acquisition loan' shall not include—

"(A) any loan made between corporations which are members of the same controlled group of corporations, or

"(B) any loan made between an employee stock ownership plan and any person that is—

"(i) the employer of any employees who are covered by the plan; or

"(ii) a member of a controlled group of corporations which includes such employer.

"(3) CONTROLLED GROUP OF CORPORATIONS.—For purposes of this paragraph, the term 'controlled group of corporations' has the meaning given such term by section 409A(l)(4).

"(c) EMPLOYEE STOCK OWNERSHIP PLAN.—For purposes of this section, the term 'employee stock ownership plan' has the meaning given to such term by section 4975(e)(7)."

(b) CONFORMING AMENDMENT.—The table of sections for part III of subchapter B of chapter I is amended by striking out the item relating to section 133 and inserting in lieu thereof the following:

"Sec. 133. Interest on certain loans used to acquire employer securities.
"Sec. 134. Cross references to other Act."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to loans used to acquire employer securities after the date of the enactment of this Act.

SEC. 544. ASSUMPTION OF ESTATE TAX LIABILITY BY EMPLOYER STOCK OWNERSHIP PLAN OR COOPERATIVE RECEIVING EMPLOYER SECURITIES

(a) IN GENERAL.—Subchapter C of chapter 11 (relating to miscellaneous estate tax provisions) is amended by adding at the end thereof the following new section:

"SEC. 2210. LIABILITY FOR PAYMENT IN CASE OF TRANSFER OF EMPLOYER SECURITIES TO AN EMPLOYEE STOCK OWNERSHIP PLAN OR A WORKER-OWNED COOPERATIVE.

"(a) IN GENERAL.—If—

"(1) employer securities—

"(A) are acquired from the decedent by an employee stock ownership plan or by an eligible worker-owned cooperative from any decedent,

"(B) pass from the decedent to such a plan or cooperative, or

"(C) are transferred by the executor to such a plan or coopertive, and

"(2) the executor elects the application of this section and files the agreements described in subsection (e) before the due date (including extensions) for filing the return of tax imposed by section 2001,

then the executor is relieved of liability for payment of that portion of the tax imposed by section 2001 which such employee stock ownership plan or cooperative is required to pay under subsection (b).

"(b) PAYMENT OF TAX BY EMPLOYEE STOCK OWNERSHIP PLAN OR COOPERATIVE.—

"(1) IN GENERAL.—An employee stock ownership plan or eligible worker-owned cooperative—

"(A) which has acquired employer securities from the decedent, or to which such securities have passed from the decedent or been transferred by the executor, and

"(B) with respect to which an agreement described in subsection (e)(1) is in effect,

shall pay that portion of the tax imposed by section 2001 with respect to the taxable estate of the decedent which is described in paragraph (2).

"(2) AMOUNT OF TAX TO BE PAID.—The portion of the tax imposed by section 2001 with respect to the taxable estate of the decedent

that is referred to in paragraph (1) is equal to the lesser of—

"(A) the value of the employer securities described in subsection (a)(1) which is included in the gross estate of the decedent, or

"(B) the tax imposed by section 2001 with respect to such taxable estate reduced by the sum of the credits allowable against such tax.

"(c) INSTALLMENT PAYMENTS.—

"(1) IN GENERAL.—If—

"(A) the executor of the estate of the decedent (without regard to this section) elects to have the provisions of section 6166 (relating to extensions of time for payment of estate tax where estate consists largely of interest in closely held business) apply to payment of that portion of the tax imposed by section 2001 with respect to such estate which is attributable to employer securities, and

"(B) the plan administrator or the cooperative provides to the executor the agreement described in subsection (e)(1),

then the plan administrator or the cooperative may elect, before the due date (including extensions) for filing the return of such tax, to pay all or part of the tax described in subsection (b)(2) in installments under the provisions of section 6166.

"(2) INTEREST ON INSTALLMENTS.—In determining the 4-percent portion for purposes of section 6601(j)—

"(A) the portion of the tax imposed by section 2001 with respect to an estate for which the executor is liable, and

"(B) the portion of such tax for which an employee stock ownership plan or an eligible worker-owned cooperative is liable,

shall be aggregated.

"(d) GUARANTEE OF PAYMENTS.—Any employer—

"(1) whose employees are covered by an employee stock ownership plan, and

"(2) who has entered into an agreement described in subsection (e)(2) which is in effect,

shall guarantee (in such manner as the Secretary may prescibe) the payment of any amount such plan is required to pay under subsection (b), including any interest payable under section 6601 which is attributable to such amount.

"(e) AGREEMENTS.—The agreements described in this subsection are as follows:

"(1) A written agreement signed by the plan administrator, or by any authorized officer of the eligible worker-owned cooperative, consenting to the application of subsection (b) to such plan or cooperative.

"(2) A written agreement signed by the employer whose employees are covered by the plan described in subsection (b) consenting to the application of subsection (d).

"(f) EXEMPTION FROM TAX ON PROHIBITED TRANSACTIONS.—The assumption under this section by an employee stock onwership plan of any portion of the liability for the tax imposed by section 2001 shall be treated as a loan described in section 4975(d)(3).

"(g) DEFINITIONS.—For purposes of this section—

"(1) EMPLOYER SECURITIES.—The term 'employer securities' has the meaning given such term by section 409A(1).

"(2) EMPLOYEE STOCK OWNERSHIP PLAN.—The term 'employee stock ownership plan' has the meaning given such term by section 4975(e)(7).

"(3) ELIGIBLE WORKER-OWNED COOPERATIVE.—The term 'eligible worker-owned cooperative' has the meaning given to such term by section 1041(b)(2).

"(4) PLAN ADMINISTRATOR.—The term 'plan administrator' has the meaning given such term by section 414(g)."

(b) CONFORMING AMENDMENTS.—

(1) Section 2002 (relating to liability for payment of estate tax) is amended to read as follows:

"SEC. 2002. LIABILITY FOR PAYMENT.

"Except as provided in section 2210, the tax imposed by this chapter shall be paid by the executor."

(2) The table of sections for subchapter C of chapter 11 is amended by adding at the end thereof the following:

"Sec. 2210. Liability for payment in case of transfer of employer securities to an employee stock ownership plan or a worker-owned cooperative."

(3) Section 6018 (relating to estate tax returns) is amended by adding at the end thereof the following new subsection:

"(c) ELECTION UNDER SECTION 2210.—In all cases in which subsection (a) requires the filing of a return, if an executor elects the applications of section 2210—

"(1) RETURN BY EXECUTOR.—The return which the executor is required to file under the provisions of subsection (a) shall be made with respect to that portion of estate tax imposed by subtitle B which the executor is required to pay.

"(2) RETURN BY PLAN ADMINISTRATOR.—The plan administrator of an employee stock ownership plan or the eligible worker-owned cooperative, as the case may be, shall make a return with respect to that portion of the tax imposed by section 2001 which such plan or cooperative is required to pay under section 2210(b)."

(4) Subsection (j) of section 6166 (relating to cross references) is amended by adding at the end thereof the following new paragraph:

"(6) PAYMENT OF ESTATE TAX BY EMPLOYEE STOCK OWNERSHIP PLAN OR ELIGIBLE WORKER-OWNED COOPERATIVE.—For provision allowing plan administrator or eligible worker-owned cooperative to elect to pay a certain portion of the estate tax in installments under the provisions of this section, see section 2210(c)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to those estates of decedents which are required to file returns on a date (including any extensions) after the date of enactment of this Act.

SEC. 545. EXCISE TAX ON CERTAIN DISPOSITIONS OF EMPLOYER SECURITIES BY EMPLOYEE STOCK OWNERSHIP PLANS AND CERTAIN COOPERATIVES.

(a) IN GENERAL.—Chapter 43 (relating to excise taxes on qualified pension plans), as amended by this Act, is amended by adding at the end thereof the following new section:

"SEC. 4978. TAX ON CERTAIN DISPOSITIONS BY EMPLOYEE STOCK OWNERSHIP PLANS AND CERTAIN COOPERATIVES.

"(a) TAX ON DISPOSITIONS OF SECURITIES TO WHICH SECTION 1042 APPLIES BEFORE CLOSE OF MINIMUM HOLDING PERIOD.—If, during the 3-year period after the date on which the employee stock ownership plan or eligible worker-owned cooperative acquired any qualified securities in a sale to which section 1042 applied, such plan or cooperative disposes of any qualified securities and—

"(1) the total number of shares held by such plan or cooperative after such disposition is less then the total number of qualified securities held immediately after such sale, or

"(2) except to the extent provided in regulations, the value of qualified securities held by such plan or cooperative after such disposition is less than 30 percent of the total value of all qualified securities as of such disposition,

there is hereby imposed a tax on the disposition equal to the amount determined under subsection (b).

"(b) AMOUNT OF TAX.—

"(1) IN GENERAL.—The amount of the tax imposed by paragraph (1) shall be equal to 10 percent of the amount realized on the disposition.

"(2) LIMITATION.—The amount realized taken into account under paragraph (1) shall not exceed that portion allocable to qualified securities acquired in the sale to which section 1042 applied (determined as if such securities were disposed of before any other securities).

"(3) DISTRIBUTIONS TO EMPLOYEES.—The amount realized on any distribution to an employee for less than fair market value shall be determined as if the qualified security had been sold to the employee at fair market value.

"(c) LIABILITY FOR PAYMENT OF TAXES.—The tax imposed by this subsection shall be paid by—

"(1) the employer, or

"(2) the eligible worker-owned cooperative, that made the written statement described in section 1042(a)(2)(B).

"(d) SECTION NOT TO APPLY TO CERTAIN DISPOSITIONS.—

"(1) CERTAIN DISTRIBUTIONS TO EMPLOYEES.—This section shall not apply with respect to any distribution of qualified securities (or sale of such securities) which is made by reason of—

"(A) the death of the employee,

"(B) the retirement of the employee after the employee has attained 59½ years of age,

"(C) the disability of the employee (within the meaning of section 72(m)(5)), or

"(D) the separation of the employee from service for any period which results in a 1-year break in service (within the meaning of section 411(a)(6)(A)).

"(2) CERTAIN REORGANIZATIONS.—In the case of any exchange of qualified securities in any reorganization described in section 368(a)(1) for stock of another corporation, such exchange shall not be treated as a disposition for purposes of this section.

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) EMPLOYEE STOCK OWNERSHIP PLAN.—

"(A) IN GENERAL.—The term 'employee stock ownership plan' has the meaning given to such term by section 4975(e)(7).

"(B) TAX CREDIT EMPLOYEE STOCK OWNERSHIP PLANS.—The term 'employee stock ownership plan' includes any tax credit employee stock ownership plan (within the meaning of section 409A).

"(2) QUALIFIED SECURITIES.—The term 'qualified securities' has the meaning given to such term by section 1042(b)(1).

"(3) ELIGIBLE WORKER-OWNED COOPERATIVE.—The term 'eligible worker-owned cooperative' has the meaning given to such term by section 1042(b)(1).

"(4) DISPOSITION.—The term 'disposition' includes any distribution."

(b) CONFORMING AMENDMENT.—The table of sections for chapter 43 is amended by adding at the end thereof the following new item:

"Sec. 4978. Tax on certain dispositions and allocations by employee stock ownership plans and certain cooperatives."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of enactment of this Act.

Subtitle E—Miscellaneous

SEC. 551. TREATMENT OF CERTAIN DISTRIBUTIONS FROM A QUALIFIED TERMINATED PLAN.

(a) IN GENERAL.—For purposes of the Internal Revenue Code 1954, if—

(1) a distribution was made from a qualified terminated plan to an employee on De-

cember 16, 1976, and on January 6, 1977, such employee transferred all of the property received in such distribution to an individual retirement account (within the meaning of section 408(a) of such Code) established for the benefit of such employee, and

(2) the remaining balance to the credit of such employee in such qualified terminated plan was distributed to such employee on January 21, 1977, and all the property received by such employee in such distribution was transferred by such employee to such individual retirement account on January 21, 1977,

then such distributions shall be treated as qualifying rollover distributions (within the meaning of section 402(a)(5) of such Code) and shall not be includible in the gross income of such employee for the taxable year in which paid.

(b) QUALIFIED TERMINATED PLAN.—For purposes of this section, the term "qualified terminated plan" means a pension plan—

(1) with respect to which a notice of sufficiency was issued by the Pension Benefit Guaranty Corporation on December 2, 1976, and

(2) which was terminated by corporate action on February 20, 1976.

(c) REFUND OR CREDIT OF OVERPAYMENT BARRED BY STATUTE OF LIMITATIONS.—Notwithstanding section 6511(a) of the Internal Revenue Code of 1954 or any other period of limitation or lapse of time, a claim for credit or refund of overpayment of the tax imposed by such Code which arises by reason of this section may be filed by any person at any time within the 1-year period beginning on the date of enactment of this Act. Sections 6511(b) and 6514 of such Code shall not apply to any claim for credit or refund filed under this subsection within such 1-year period.

SEC. 552. PARTIAL TERMINATION FOR CERTAIN PENSION PLANS.

For purposes of section 411(d)(3) of the Internal Revenue Code of 1954 (relating to minimum vesting standards in the case of partial terminations), a partial termination shall not be treated as occurring if—

(1) the partial termination is a result of a decline in plan participation which—

(A) occurs by reason of the completion of the Trans-Alaska Oil Pipeline construction project, and

(B) occurred after December 31, 1975, and before January 1, 1980, with respect to participants employed in Alaska,

(2) no discrimination prohibited by section 401(a)(4) of such Code occurred with respect to such partial termination, and

(3) the plan administrator establishes to the satisfaction of the Secretary of the Treasury or his delegate that the benefits of this section will not accrue to the employers under the plan.

SEC. 553. DISTRIBUTION REQUIREMENTS FOR ACCOUNTS AND ANNUITIES OF AN INSURER IN A REHABILITATION PROCEEDING.

(a) IN GENERAL.—For purposes of sections 401(a)(9), 408(a) (6) and (7), and 408(b) (3) and (4) of the Internal Revenue Code of 1954—

(1) a trust, custodial account, or annuity or other contract forming part of a pension or profit-sharing plan, or a retirement annuity, or

(2) a grantor of an individual retirement account or an individual retirement annuity,

shall not be treated as failing to meet the requirements of such sections if such account, annuity, or contract was issued by an insurance company which, on March 15, 1984, was a party to a rehabilitation proceeding under the applicable State insurance law.

(b) LIMITATION.—Subsection (a) shall apply only during the period during which—

(1) the insurance company continues to be a party to the proceeding described in subsection (a), and

(2) distributions under the trust, custodial account, or annuity or other contract may not be made by reason of such proceeding.

SEC. 554. EXTENSION OF TIME FOR REPAYMENT OF QUALIFIED REFUNDING LOANS.

Paragraph (2) of section 236(c) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new subparagraph:

"(D) SPECIAL RULE FOR NON-KEY EMPLOYEES.—In the case of a non-key employee (within the meaning of section 416(i)(2) of the Internal Revenue Code of 1954), this paragraph shall be applied by substituting 'January 1, 1985' for 'August 14, 1983' each place it appears."

SEC. 555. TECHNICAL AMENDMENTS TO THE INCENTIVE STOCK OPTION PROVISIONS.

(a) DETERMINATION OF FAIR MARKET VALUE.—

(1) IN GENERAL.—Subsection (c) of section 422A (relating to special rules) is amended by adding at the end thereof of the following new paragraph:

"(10) FAIR MARKET VALUE.—For purposes of this section, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.".

(2) INCENTIVE STOCK OPTION AS AN ITEM OF TAX PREFERENCE.—Paragraph (10) of section 57(a) (relating to items of tax preference) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the fair market value of a share of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse."

(b) MODIFICATION OF INCENTIVE STOCK OPTIONS.—Subparagraph (B) of section 425(h)(3) (relating to modifications) is amended by striking out "422A(b)(5),".

(c) EFFECTIVE DATES.—

(1) FAIR MARKET VALUE.—The amendment made by subsection (a) shall apply to options granted after March 20, 1984, except that such subsection shall not apply to any incentive stock option granted before September 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

(2) ITEMS OF TAX PREFERENCE.—The amendment made by subsection (b) shall apply to options exercised after March 20, 1984. In the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the preceding sentence shall be applied by substituting "December 31, 1984" for "March 20, 1984".

(3) MODIFICATIONS.—The amendment made by subsection (c) shall apply with respect to modifications of options after March 20, 1984.

SEC. 556. TIME FOR MAKING CERTAIN SECTION 83(b) ELECTIONS.

In the case of any transfer of property in connection with the performance of services after June 30, 1978, and on or before November 18, 1982, the election permitted by section 83(b) of the Internal Revenue Code of 1954 may be made, notwithstanding paragraph (2) of such section 83(b), with the income tax return for the first taxable year ending after the date of the enactment of this Act, if—

(1) the amount paid for such property was not less than its fair market value at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), and

(2) the election is consented to by the person transferring such property.

The election shall contain that information required by the Secretary of the Treasury or his delegate for elections permitted by such section 83(b). The period for assessing any tax attributable to a transfer of property which is the subject of an election made pursuant to this section shall not expire before the date which is 3 years after the date such election was made.

SEC. 557 EMPLOYER AND EMPLOYEE BENEFIT ASSOCIATION TREATED AS RELATED PERSONS UNDER SECTION 1239.

(a) GENERAL RULE.—Section 1239 (relating to gain from sale of depreciable property between certain related taxpayers) is amended by adding at the end thereof the following new subsection:

"(d) EMPLOYER AND RELATED EMPLOYEE ASSOCIATION.—For purposes of subsection (a), the term 'related person' also includes—

"(1) an employer and any person related to the employer (within the meaning of subsection (b)), and

"(2) a welfare benefit fund (within the meaning of section 419(e)) which is controlled directly or indirectly by persons referred to in paragraph (1)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to sales or exchanges after the date of the enactment of this Act in taxable years ending after such date.

SEC. 558. ELIMINATION OF RETROACTIVE APPLICATION OF AMENDMENTS MADE BY MULTIEMPLOYER PENSION PLAN AMENDMENTS ACT OF 1980.

(a) IN GENERAL.—

(1) LIABILITY.—Any withdrawal liability incurred by an employer pursuant to part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1381 et seq.) as a result of the complete or partial withdrawal of such employer from a multiemployer plan before September 26, 1980, shall be void.

(2) REFUNDS.—Any amounts paid by an employer to a plan sponsor as a result of such withdrawal liability shall be refunded by the plan sponsor to the employer with interest (in accordance with section 401(a)(2)), less a reasonable amount for administrative expenses incurred by the plan sponsor (other than legal expenses incurred with respect to the plan) in calculating, assessing, and refunding such amounts.

(b) CONFORMING AMENDMENTS.—

(1) EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.—

(A) Sections 4211 (b) and (c), 4217(a), and 4235(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1391 (b) and (c), 1397(a), and 1415(a)) are amended by striking out "April 28, 1980" each place it appears and inserting in lieu thereof "September 25, 1980".

(B) Sections 4211 (b) and (c), 4217(a), 4219(c)(1)(C)(iii), and 4402(e) of such Act (29 U.S.C. 1391 (b) and (c), 1397(a), 1399(c)(1)(C)(iii), and 1461(e)) are amended by striking out "April 29, 1980" each place it appears and inserting in lieu thereof "September 26, 1980".

"(C) Section 4402(f)(1) of such Act (29 U.S.C. 1461(f)(1)) is amended by striking out "April 29, 1985" and inserting in lieu thereof "September 26, 1985".

(2) MULTIEMPLOYER PENSION PLAN AMENDMENTS ACT OF 1980.—Section 108(d) of the Multiemployer Pension Plan Amendments Act of 1980 (29 U.S.C. 1385 note) is amended—

(A) by striking out "April 29, 1982" in paragraph (1) and inserting in lieu thereof "September 26, 1982"; and

(B) by striking out "April 29, 1980" each place it appears in paragraphs (2) and (3) and inserting in lieu thereof "September 26, 1980".

(c) NO INCREASE IN LIABILITY.—The amendments made by this section shall not be construed to increase the liability incurred by any employer pursuant to part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1381 et seq.), as in effect immediately before the amendments made by subsection (b), as a result of the complete or partial withdrawal of such employer from a multiemployer plan prior to September 26, 1980.

(d) SPECIAL RULE FOR CERTAIN BINDING AGREEMENTS.—In the case of an employer who, on September 26, 1980, has a binding agreement to withdraw from a multiemployer plan, subsection (a)(1) shall be applied by substituting "December 31, 1980" for "September 26, 1980".

SEC. 558. TELECOMMUNICATION EMPLOYEES.

(a) EMPLOYEE PROTECTION.—Notwithstanding any provisions of the divestiture interchange agreement to the contrary, in the case of any change in employment on or after January 1, 1985, by a covered employee, the recognition of service credit, and enforcement of such recognition, shall be governed in the same manner and to same extent as provided under the divestiture interchange agreement for a change in employment by a covered employee during calendar year 1984.

(b) EMPLOYEES COVERED.—For purposes of this section, a covered employee is an individual—

(1) who is an employee of an entity subject to the modified final judgment,

(2) who is serving in an eligible position, and

(3) who—

(A) on December 31, 1983, was an employee of any such entity serving in an eligible position, or

(B) was a former employee with rehire or recall rights on such date and is rehired during the period of the employee's rehire or recall rights.

(c) DEFINITIONS.—For purposes of this section—

(1) The term "service credit" means service credit for benefit accrual, vesting, and eligibility for benefits under any pension plan, or any other employee benefits, including the interchange and treatment of associated benefit obligations and assets.

(2) The term "change in employment" means the commencement of employment of a covered employee by an entity subject to the modified final judgment after the termination of employment (with or without break in service) of such individual from an eligible position within another entity subject to the modified final judgment.

(3) The term "eligible position" means any position (A) which is not a supervisory position, within the meaning of section 2(11) of the National Labor Relations Act (29 U.S.C. 152(11)) or (B) the annual base pay rate for which is not more than $50,000, adjusted by the percentage increase in the consumer price index since December 31, 1983.

(4) The term "modified final judgment" means the judgment of the United States District Court for the District of Columbia in the case, United States against Western Electric, et alia, No. 82-0192, as modified.

(5) The term "entity subject to the modified final judgment" means—

(A) any carrier divested as a result of the modified final judgment,

(B) the corporation owning such carrier before divestiture,

(C) any other communications common carrier owned, in whole or in part, by such corporation on December 31, 1983, or

(D) any Interchange Company (as defined in the divestiture interchange agreement) excluding any subsidiary of such company other than any such subsidiary—

(i) which was established as of December 31, 1983, and

(ii) which participates in a defined benefit pension plan maintained by such Interchange Company.

(6) The term "divestiture interchange agreement" refers to the agreement between entities subject to the modified final judgment which was executed as of November 1, 1983, and which provides for mutual reciprocal recognition of service credit.

(7) The term "consumer price index" means the Consumer Price Index (all items—United States city average) published monthly by the Bureau of Labor Statistics.

(d) COORDINATION WITH OTHER BENEFIT-RELATED PROVISIONS.—Nothing in this section shall be construed to limit benefits which would otherwise be available to any individual, whether provided under the modified final judgment, under applicable law, or otherwise.

SEC. 559. STUDY OF EMPLOYEE WELFARE BENEFIT PLANS.

(a) IN GENERAL.—The Secretary of the Treasury shall make a study of the problems relating to the use of employee welfare benefit plans for the provision of benefits to current and retired employees. Such study shall include a study of the need for participation, vesting, and funding standards.

(b) REPORT.—A report of the study conducted under subsection (a), together with such recommendations for legislation as the Secretary deems appropriate, shall be made to the Congress by not later than February 1, 1985.

TITLE VI—TAX-EXEMPT BOND PROVISIONS

Subtitle A—Mortgage Subsidy Bonds

SEC. 611. 4-YEAR EXTENSION OF MORTGAGE SUBSIDY BOND AUTHORITY.

(a) GENERAL RULE.—Subparagraph (B) of section 103A(c)(1) (defining qualified mortgage bond) is amended by striking out "December 31, 1983" each place it appears and inserting in lieu thereof "December 31, 1987".

(b) REPORTING, ETC., REQUIREMENTS FOR MORTGAGE SUBSIDY BONDS.—

(1) IN GENERAL.—Subsection (j) of section 103A (relating to other requirements) is amended by adding at the end thereof the following new paragraphs:

"(3) INFORMATION REPORTING REQUIREMENT.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if the issuer submits to the Secretary, not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the issue is issued, a statement concerning the issue which contains—

"(i) the name and address of the issuer,

"(ii) the date of the issue, the amount of the lendable proceeds of the issue, and the stated interest rate, term, and face amount of each obligation which is part of the issue,

"(iii) such information as the Secretary may require in order to determine whether such issue meets the requirements of this section and the extent to which proceeds of such issue have been made available to low-income individuals, and

"(iv) such other information as the Secretary may require.

"(B) EXTENSION OF TIME.—The Secretary may grant an extension of time for the filing of any statement under subparagraph (A) if there is reasonable cause for the failure to file such statement in a timely fashion.

"(4) STATE CERTIFICATION REQUIREMENTS.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if, before the issue, a State official designated by State law (or, where there is no such State official, the governor) certifies that the issue meets the requirements of subsection (g).

"(B) CERTIFICATION FURNISHED TO SECRETARY.—Any certification under subparagraph (A) shall be submitted to the Secretary at the same time as the statement with respect to such issue is submitted under paragraph (3).

"(C) SPECIAL RULE FOR CONSTITUTIONAL HOME RULE CITIES.—In the case of constitutional home rule cities (as defined in subsection (g)(5)(C)), the certification under subparagraph (A) shall be made by the chief executive officer of such city.

"(5) POLICY STATEMENT.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if the applicable elected representative of the governmental unit—

"(i) which is the issuer, or

"(ii) on whose behalf such issue was issued,

has published (after a public hearing following reasonable public notice) a report described in subparagraph (B) by the last day of the year preceding the year in which such issue is issued and a copy of such report has been submitted to the Secretary on or before such last day.

"(B) REPORT.—The report referred to in subparagraph (A) which is published by the applicable elected representative of the governmental unit shall include—

"(i) a statement of the housing, development, and income distribution policies which such governmental unit is to follow in issuing mortgage subsidy bonds and mortgage credit certificates, and

"(ii) an assessment of the compliance of such governmental unit during the preceding 1-year period preceding the date of the report with—

"(I) the statement of policy on qualified mortgage bonds and mortgage credit certificates that was set forth in the previous report, if any, of an applicable elected representative of such governmental unit, and

"(II) the intent of Congress that State and local governments are expected to use their authority to issue qualified mortgage bonds and mortgage credit certificates to the great extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford home ownership before assisting higher income families."

(c) TREATMENT OF QUALIFIED VETERANS' MORTGAGE BONDS.—

(1) Subparagraph (C) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "subsection (j)(1)" and inserting in lieu thereof "subsection (d), paragraphs (1) and (3) of subsection (j), and subsection (o)".

(2) Section 103A is amended by adding at the end thereof the following new subsection:

"(o) ADDITIONAL REQUIREMENTS FOR QUALIFIED VETERANS' MORTGAGE BONDS.—

"(1) VETERANS TO WHOM FINANCING MAY BE PROVIDED.—An obligation meets the requirements of this subsection only if each mortgagor to whom financing is provided under the issue is a qualified veteran.

"(2) REQUIREMENT THAT STATE PROGRAM BE IN EFFECT BEFORE JUNE 22, 1984.—An issue meets the requirements of this subsection only if it is a general obligation of a State which issued qualified veterans' mortgage bonds before June 22, 1984.

"(3) VOLUME LIMITATION.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if the aggregate amount of bonds issued pursuant thereto (when added to the aggregate

amount of qualified veterans' mortgage bonds previously issued by the state during the calendar year) does not exceed the State veterans limit for such calendar year.

"(B) STATE VETERANS LIMIT.—A State's veterans limit for any calendar year is one-fifth of the aggregate amount of qualified veterans' bonds issued by such State during the period beginning on January 1, 1979, and ending on June 22, 1984.

"(4) QUALIFIED VETERAN.—For purposes of this subsection, the term 'qualified veteran' means any veteran—

(A) who served on active duty at some time before January 1, 1977, and

"(B) who applied for the financing before the later of—

"(i) the date 30 years after the last date on which such veteran left active service, or

"(ii) January 1, 1985.

"(5) GOOD FAITH EFFORT RULES MADE APPLICABLE.—Rules similar to the rules of subparagraphs (B) and (C) of subsection (c)(2) shall apply to the requirements of this subsection.

"(6) SPECIAL RULE FOR CERTAIN SHORT-TERM OBLIGATIONS.—In the case of any obligation which has a term of 1 year or less and which was issued to provide financing for property taxes, the amount taken into account under this subsection with respect to such obligation shall be 1/15 of its principal amount."

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply with respect to obligations issued after December 31, 1983.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to obligations issued after December 31, 1984.

(3) SUBSECTION (c).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendment made by subsection (c) shall apply to obligations issued after the date of the enactment of this Act.

(B) VOLUME LIMITATION.—The requirements of paragraph (3) of section 103A(o) of the Internal Revenue Code of 1954 (as added by this section) shall apply to obligations issued after June 22, 1984. In applying such requirements to obligations issued after such date, obligations issued on or before such date shall not be taken into account under such paragraph (3).

(C) QUALIFIED VETERANS' MORTGAGE BONDS AUTHORIZED BEFORE OCTOBER 18, 1983, NOT TAKEN INTO ACCOUNT.—The requirements of section 103(o)(3) of the Internal Revenue Code of 1954 shall not apply to any qualified veterans' mortgage bond if—

(i) the issuance of such bond was authorized by a State referendum before October 18, 1983, or

(ii) the issuance of such bond is authorized pursuant to a State referendum before December 1, 1983, where such referendum was authorized by action of the State legislature before October 18, 1983.

(4) TRANSITIONAL RULE WHERE STATE FORMULA FOR ALLOCATING STATE CEILING EXPIRES.—

(A) IN GENERAL.—If a State law which provided a formula for allocating the State ceiling under section 103A(g) of the Internal Revenue Code of 1954 for calendar year 1983 expires as of the close of calendar year 1983, for purposes of section 103A(g) of such Code, such State law shall be treated as remaining in effect after 1983. In any case to which the preceding sentence applies, where the State's expiring allocation formula requires action by a State official to allocate the State ceiling among issuers, actions of such State official in allocating such ceiling shall be effective.

(B) TERMINATION.—Subparagraph (A) shall not apply on or after the effective date of any State legislation enacted after the date of the enactment of this Act with respect to the allocation of the State ceiling.

(C) SPECIAL RULE FOR TEXAS.—In the case of Texas, the Governor of such State may take the action described in suparagraph (A) pursuant to procedures established by the Governor consistent with the State laws of Texas.

(5) SPECIAL RULE FOR DETERMINATIONS OF STATISTICAL AREA.—For purposes of applying section 103A of the Internal Revenue Code of 1954 and any other provision of Federal law—

(A) RESCISSION.—The Director of the Office of Management and Budget shall rescind the designation of the Kansas City, Missouri primary metropolitan statistical area (KCMO PMSA) and the designation of the Kansas City, Kansas primary metropolitan statistical area (Kansas City, KS PMSA), and shall not take any action to designate such two primary metropolitan statistical areas as a consolidated metropolitan statistical area.

(B) DESIGNATION.—The Director of the Office of Management and Budget shall designate a single metropolitan statistical area which includes the following:

(i) Kansas City, Kansas.

(ii) Kansas City, Missouri.

(iii) The counties of Johnson, Wyandotte, Leavenworth, and Miami in Kansas.

(iv) The counties of Cass, Clay, Jackson, Platte, Ray, and Lafayette in Missouri.

The metropolitan statistical area designation pursuant to this subsection shall be known as the "Kansas City Missouri-Kansas Metropolitan Statistical Area".

(6) TRANSITIONAL RULE FOR KENTUCKY AND NEVADA.—For purposes of section 103A(g) of the Internal Revenue Code of 1954, in the case of Kentucky and Nevada, subclause (I) of section 103A(g)(6)(B)(ii) of such Code shall be applied as if the first day referred to in such subclause were January 1, 1987.

(7) ANNUAL REPORT TO CONGRESS.—The Secretary of the Treasury, in consultation with the Secretary of Housing and Urban Development, shall submit an annual report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives regarding the performance of issuers of qualified mortgage bonds and mortgage credit certificates relative to the intent of Congress described in section 103A(j) of the Internal Code of 1954.

SEC. 612. MORTGAGE CREDIT CERTIFICATES.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to credits against tax) is amended by redesignating section 25 as section 26 and by inserting after section 24 the following new section:

"SEC 25. INTEREST ON CERTAIN HOME MORTGAGES.

"(a) ALLOWANCE OF CREDIT.—

"(1) IN GENERAL.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the product of—

"(A) the certificate credit rate, and

"(B) the interest paid or incurred by the taxpayer during the taxable year on the remaining principal of the certificated indebtedness amount.

"(2) LIMITATION WHERE CREDIT RATE EXCEEDS 20 PERCENT.—

"(A) IN GENERAL.—If the certificate credit rate exceeds 20 percent, the amount of the credit allowed to the taxpayer under paragraph (1) for any taxable year shall not exceed $2,000.

"(B) SPECIAL RULE WHERE 2 OR MORE PERSONS HOLD INTERESTS IN RESIDENCE.—If 2 or more persons hold interests in any residence, the limitation of subparagraph (A) shall be allocated among such persons in proportion to their respective interests in the residence.

"(b) CERTIFICATE CREDIT RATE; CERTIFIED INDEBTEDNESS AMOUNT.—For purposes of this section—

"(1) CERTIFICATE CREDIT RATE.—The term 'certificate credit rate' means the rate of the credit allowable by this section which is specified in the mortgage credit certificate.

"(2) CERTIFIED INDEBTEDNESS AMOUNT.—The term 'certified indebtedness amount' means the amount of indebtedness which is—

"(A) incurred by the taxpayer—

"(i) to acquire the principal residence of the taxpayer,

"(ii) as a qualified home improvement loan (as defined in section 103A(l)(6)) with respect to such residence, or

"(iii) as a qualified rehabilitation loan (as defined in section 103A(l)(7)) with respect to such residence, and

"(B) specified in the mortgage credit certificate.

"(c) MORTGAGE CREDIT CERTIFICATE; QUALIFIED MORTGAGE CREDIT CERTIFICATE PROGRAM.—For purposes of this section—

"(1) MORTGAGE CREDIT CERTIFICATE.—The term 'mortgage credit certificate' means any certificate which—

"(A) is issued under a qualified mortgage credit certificate program by the State or political subdivision having the authority to issue a qualified mortgage bond to provide financing on the principal residence of the taxpayer,

"(B) is issued to the taxpayer in connection with the acquisition, qualified rehabilitation, or qualified home improvement of the taxpayer's principal residence,

"(C) specifies—

"(i) the certificate credit rate, and

"(ii) the certified indebtedness amount, and

"(D) is in such form as the Secretary may prescribe.

"(2) QUALIFIED MORTGAGE CREDIT CERTIFICATE PROGRAM.—

"(A) IN GENERAL.—The term 'qualified mortgage credit certificate program' means any program—

"(i) which is established by a State or political subdivision thereof for any calendar year for which it is authorized to issue qualified mortgage bonds,

"(ii) under which the issuing authority elects (in such manner and form as the Secretary may prescribe) not to issue an amount of qualified mortgage bonds which it may otherwise issue during such calendar year under section 103A,

"(iii) under which the indebtedness certified by mortgage credit certificates meets the requirements of the following subsections of section 103A (as modified by subparagraph (B) of this paragraph):

"(I) subsection (d) (relating to residence requirements),

"(II) subsection (e) (relating to 3-year requirement),

"(III) subsection (f) (relating to purchase price requirement),

"(IV) subsection (h) (relating to portion of loans required to be placed in targeted areas), and

"(V) paragraph (1) of subsection (j) (relating to other requirements),

"(iv) under which no mortgage credit certificate may be issued with respect to any residence any of the financing of which is provided from the proceeds of a qualified mortgage bond or a qualified veterans' mortgage bond,

"(v) except to the extent provided in regulations, which is not limited to indebtedness incurred from particular lenders,

"(vi) except to the extent provided in regulations, which provides that a mortgage credit certificate is not transferrable, and

"(vii) if the issuing authority allocates a block of mortgage credit certificates for use in connection with a particular development, which requires the developer to fur-

nish to the issuing authority and the homebuyer a certificate that the price for the residence is no higher than it would be without the use of a mortgage credit certificate.

"(B) MODIFICATIONS OF SECTION 103A.—Under regulations prescribed by the Secretary, in applying section 103A for purposes of subclauses (II) and (IV) of subparagraph (A)(iii)—

"(i) each qualified mortgage certificate credit program shall be treated as a separate issue,

"(ii) the product determined by multiplying—

"(I) the certified indebtedness amount of each mortgage credit certificate issued under such program, by

"(II) the certificate credit rate specified in such certificate,

shall be treated as proceeds of such issue and the sum of such products shall be treated as the total proceeds of such issue, and

"(iii) paragraph (1) of section 103A(e) shall be applied by substituting '100 percent' for '90 percent or more'.

Clause (iii) shall not apply if the issuing authority submits a plan to the Secretary for administering the 90-percent requirement of section 103A(e)(1) and the Secretary is satisfied that such requirement will be met under such plan.

"(d) DETERMINATION OF CERTIFICATE CREDIT RATE.—For purposes of this section—

"(1) IN GENERAL.—The certificate credit rate specified in any mortgage credit certificate shall not be less than 10 percent or more than 50 percent.

"(2) AGGREGATE LIMIT ON CERTIFICATE CREDIT RATES.—

"(A) IN GENERAL.—In the case of each qualified mortgage credit certificate program, the sum of the products determined by multiplying—

"(i) the certified indebtedness amount of each mortgage credit certificate issued under such program, by

"(ii) the certificate credit rate with respect to such certificate,

shall not exceed 20 percent of the nonissued bond amount or, if lesser, the aggregate amount of certified indebtedness referred to in clause (i).

"(B) NONISSUED BOND AMOUNT.—For purposes of subparagraph (A), the term 'nonissued bond amount' means, with respect to any qualified mortgage credit certificate program, the amount of qualified mortgage bonds which the issuing authority is otherwise authorized to issue and elects not to issue under subsection (c)(2)(A)(ii).

"(e) SPECIAL RULES AND DEFINITIONS.—For purposes of this section——

"(1) CARRYFORWARD OF UNUSED CREDIT.—

"(A) IN GENERAL.—If the credit allowable under subsection (a) for any taxable year exceeds the applicable tax limit for such taxable year, such excess shall be a carryover to each of the 3 succeeding taxable years and, subject to the limitations of subparagraph (B), shall be added to the credit allowable by subsection (a) for such succeeding taxable year.

"(B) LIMITATION.—The amount of the unused credit which may be taken into account under subparagraph (A) for any taxable year shall not exceed the amount by which the applicable tax limit for such taxable year exceeds the sum of the amounts which, by reason of this paragraph, are carried to such taxable year and are attributable to taxable years before the unused credit year.

"(C) APPLICABLE TAX LIMIT.—For purposes of this paragraph, the term 'applicable tax limit' means the limitation imposed by section 26(a) for the taxable year reduced by the sum of the credits allowable under this subpart (other than this section).

"(2) INDEBTEDNESS NOT TREATED AS CERTIFIED WHERE CERTAIN REQUIRMENTS NOT IN FACT MET.—Subsection (a) shall not apply to any indebtedness if all the requirements of subsection (d)(1), (e), (f), (g), and (j) of section 103A were not in fact met with respect to such indebtedness. Except to the extent provided in regulations, the requirements described in the preceding sentence shall be treated as met if there is a certification, under penalty of perjury, that such requirements are met.

"(3) PERIOD FOR WHICH CERTIFICATE IN EFFECT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a mortgage credit certificate shall be treated as in effect with respect to interest attributable to the period—

"(i) beginning on the date such certificate is issued, and

"(ii) ending on the earlier of the date on which—

"(I) the certificate is revoked by the issuing authority, or

"(II) the residence to which such certificate relates ceases to be the principal residence of the individual to whom the certificate relates.

"(B) CERTIFICATE INVALID UNLESS INDEBTEDNESS INCURRED WITHIN CERTAIN PERIOD.—A certificate shall not apply to any indebtedness which is incurred after the close of the second calendar year following the calendar year for which the issuing authority made the applicable election under subsection (c)(2)(A)(ii).

"(C) NOTICE TO SECRETARY WHEN CERTIFICATE REVOKED.—An issuing authority which revokes any mortgage credit certificate shall notify the Secretary of such revocation at such time and in such manner as the Secretary shall prescribe by regulations.

(4) CERTAIN REFINANCING PERMITTED.—In applying subsection (c)(2)(A)(iii), under regulations, the requirements of section 103A(j)(1) may be treated as met if a mortgage credit certificate is issued with respect to a mortgage which is used to replace an existing mortgage for which such a certificate has already been issued if such replacement mortgage does not extend the term, alter the amortization schedule, or increase the principal amount, of the original mortgage.

"(5) PUBLIC NOTICE THAT CERTIFICATES WILL BE ISSUED.—At least 90 days before any mortgage crdit certificate is to be issued after a qualified mortgage credit certificate program, the issuing authority shall provide reasonable public notice of—

"(A) the eligibility requirements for such certificate,

"(B) the methods by which such certificates are to be issued, and

"(C) such other information as the Secretary may require.

"(6) INTEREST PAID OR ACCRUED TO RELATED PERSONS.—No credit shall be allowed under subsection (a) for any interest paid or accrued to a person who is a related person to the taxpayer (within the meaning of section 103(b)(6)(C)(i)).

(7) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 1034.

"(8) QUALIFIED REHABILITATION AND HOME IMPROVEMENT.—

"(A) QUALIFIED REHABILITATION.—The term 'qualified rehabilitation' has the meaning given such term by section 103A(l)(7)(B).

"(B) QUALIFIED HOME IMPROVEMENT.—The term 'qualified home improvement' means an alteration, repair, or improvement described in section 103A(l)(6).

(9) QUALIFIED MORTGAGE BOND.—The term 'qualified mortgage bond' has the meaning given such term by section 103A(c)(1).

"(10) MANUFACTURED HOUSING.—For purposes of this section, the term 'single family residence' includes any manufactured home which has a minimum of 400 square feet of living space and a minimum width in excess of 102 inches and which is of a kind customarily used at a fixed location. Nothing in the preceding sentence shall be construed as providing that such a home will be taken into account in making determinations under section 103A.

"(f) REDUCTION IN AGGREGATE AMOUNT OF QUALIFIED MORTGAGE BONDS WHICH MAY BE ISSUED WHERE CERTAIN REQUIREMENTS NOT MET.—

"(1) IN GENERAL.—If for any calendar year any mortgage credit certificate program fails to meet the requirements of—

"(A) clause (iv), (v), or (vi) of subsection (c)(2)(A), or

"(B) paragraph (2) of subsection (d),

the applicable State ceiling under paragraph (4) of section 103A(g) for the State in which such program operates shall be reduced by 1.25 times the correction amount with respect to such failure. Such reduction shall be applied to such State ceiling for the calendar year following the calendar year in which the Secretary determines the correction amount with respect to such failure.

"(2) CORRECTION AMOUNT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'correction amount' means, in the case of a failure to meet a requirement referred to in—

"(i) paragraph (1)(A), the amount of indebtedness involved, or

"(ii) paragraph (1)(B), the amount equal to the excess credit amount divided by 0.20.

"(B) EXCESS CREDIT AMOUNT.—

"(I) IN GENERAL.—For purposes of subparagraph (A)(ii), the term 'excess credit amount' means the excess of—

"(I) the credit amount for any mortgage credit certificate program, over

"(II) the amount which would have been the credit amount for such program had such program met the requirements of paragraph (2) of subsection (d).

"(ii) CREDIT AMOUNT.—For purposes of clause (i), the term 'credit amount' means the sum of the products determined under clauses (i) and (ii) of subsection (d)(2)(A).

"(3) SPECIAL RULE FOR STATES HAVING CONSTITUTIONAL HOME RULE CITIES.—In the case of a State having one or more constitutional home rule cities (within the meaning of section 103A(g)(5)(C)), the reduction in the State ceiling by reason of paragraph (1) shall be allocated to the constitutional home rule city, or to the portion of the State not within such city, or to the portion of the State not within such city, whichever caused the reduction.

"(4) EXCEPTION WHERE CERTIFICATION PROGRAM.—The provisions of this subsection shall not apply in any case in which there is a certification program which is designed to insure that the requirements of this section are met and which meets such requirements as the Secretary may be regulations prescribe.

"(5) WAIVER.—The Secretary may waive the application of paragraph (1) in any case in which he determines that the failure is due to reasonable cause.

"(g) REPORTING REQUIREMENTS.—Each person who makes a loan which is a certified indebtedness amount under any mortgage credit certificate shall file a report with the Secretary containing—

"(1) the name, address, and social security account number of the individual to which the certificate was issued,

"(2) the certificate's issuer, date of issue, certified indebtedness amount, and certificate credit rate, an

"(3) such other information as the Secretary may require by regulations.

Each person who issues a mortgage credit certificate shall file a report showing such information as the Secretary shall by regulations prescribe. Any such report shall be filed at such time and in such manner as the Secretary may require by regulations.

"(h) TERMINATION.—No election may be made under subsection (c)(2)(A)(ii) for any calendar year after 1978.

(i) REGULATIONS; CONTRACTS.—

"(1) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations which may require recipients of mortgage credit certificates to pay a reasonable processing fee to defray the expenses incurred in administering the program.

"(2) CONTRACTS.—The Secretary is authorized to enter into contracts with any person to provide services in connection with the administration of this section."

(b) APPLICATION WITH SECTION 103A.—Subsection (g) of section 103A (relating to limitation on aggregate amount of qualified mortgage bonds issued during any calendar year) is amended by adding at the end thereof the following new paragraph:

"(8) REDUCTION FOR MORTGAGE CREDIT CERTIFICATES.—The applicable limit of any issuing authority for any calendar year shall be reduced by the sum of—

"(A) the amount of qualified mortgage bonds which such authority elects not to issue under section 25(c)(2)(A)(ii) during such year, plus

"(B) the amount of any reduction in such ceiling under section 25(f) applicable to such authority for such year."

(c) DISALLOWANCE OF PORTION OF DEDUCTION FOR INTEREST WHERE CREDIT TAKEN.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) REDUCTION OF DEDUCTION WHERE SECTION 25 CREDIT TAKEN.—The amount of the deduction under this section for interest paid or accured during any taxable year on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to seciton 26)."

(d) CIVIL PENALTIES.—

(1) Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6708. PENALTIES WITH RESPECT TO MORTGAGE CREDIT CERTIFICATES.

"(a) NEGLIGENCE.—If—

"(1) any person makes a misstatement in any verified written statement made under penalties of perjury with respect to the issuance of a mortgage credit certificate, and

"(2) such misstatement is due to the negligence of such person,

such person shall pay a penalty of $1,000 for each mortgage credit certificate with respect to which such a misstatement was made.

"(b) FRAUD.—If a misstatement described in subsection (a)(1) is due to fraud on the part of the person making such misstatement, in addition to any criminal penalty, such person shall pay a penalty of $10,000 for each mortgage credit certificate with respect to which such a misstatement is made.

"(c) REPORTS.—Any person required by section 25(g) to file a report with the Secretary who fails to file to the report with respect to any mortgage credit certificate at the time and in the manner required by the Secretary shall pay a penalty of $200 for such failure unless it is shown that such failure is due to reasonable cause and not to willful neglect.

"(d) MORTGAGE CREDIT CERTIFICATE.—The term 'mortgage credit certificate' has the meaning given to such term by section 25(c)."

(2) The table of sections for subchapters B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6708. Penalties with respect to mortgage credit certificates."

(e) TECHNICAL AMENDMENTS.—

(1) Sections 28(d)(2), 29(b)(5), 30(g)(1)(A), 38(c)(2), and 901(a), as amended by this Act, are each amended by striking out "section 25(b)" and inserting in lieu thereof "section 26(b)".

(2) Section 23(b)(5), as amended by this Act, is amended by striking out "section 25(a)" and inserting in lieu thereof "section 26(a)" and by striking out "(other than this section)" and inserting in lieu thereof "(other than this section and section 25)".

(3) Paragraph (3) of section 55(c) is amended—

(A) by striking out "25" each place it appears and inserting in lieu thereof "26", and

(B) by striking out "section 23, 30, or 38" and inserting in lieu thereof "section 23, 25, 30, or 38".

(4) Clause (iii) of section 168(l)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982 and amended by this Act, is amended by striking out "section 25(b)(2)" and inserting in lieu thereof "section 26(b)(2)".

(5) Clause (iii) of section 168(l)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982 and amended by this Act, is amended by striking out "section 25(b)(2)" and inserting in lieu thereof "section 26(b)(2)".

(g) CONFORMING AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 25 and inserting in lieu thereof the following:

"Sec. 25. Interest on certain home mortgages.

"Sec. 26. Limitation based on tax liability; definition of tax liability."

(h) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to interest paid or accrued after December 31, 1984, on indebtedness incurred after December 31, 1984.

(2) ELECTIONS.—The amendments made by this section shall apply to elections under section 25(c)(2)(A)(ii) of the Internal Revenue Code of 1954 (as added by this section) for calendar years after 1983.

SEC. 613. AUTHORITY TO BORROW FROM FEDERAL FINANCING BANK.

(a) GENERAL RULE.—Upon application by the appropriate State Housing Agency of Oregon, the Federal Financing Bank shall make qualified cash flow loans to such Agency. Such loans shall bear interest at a rate equal to the average rate on the applicable mortgage bonds with respect to which such loans were made.

(b) QUALIFIED CASH FLOW LOANS.—For purposes of this section, the term "qualified cash flow loan" means any loan with respect to an applicable mortgage bond reasonably necessary to cover any excess determined under subsection (c)(2) on the basis of actual payments. The aggregate amount of such loans which may be outstanding at any 1 time shall not exceed $300,000,000.

(c) APPLICABLE MORTGAGE BONDS.—For purposes of this section, the term "applicable mortgage bond" means any qualified veterans' mortgage bond issued as part of an issue—

(1) which was outstanding on December 5, 1980,

(2) with respect to which the excess of—

(A) the projected aggregate payments of principal on the applicable mortgage bonds during the 15-fiscal year period beginning with fiscal year 1984, over

(B) the projected aggregate payments during such period of principal on mortgages financed by the applicable mortgage bonds,

exceeds 12 percent of the aggregate principal amount of such bonds outstanding on July 1, 1983,

(3) with respect to which the amount of the average annual prepayments during fiscal years 1981, 1982, and 1983 was less than 2 percent of the average of the loan balances as of the beginning of each of such fiscal years, and

(4) which, for fiscal year 1983, had a prepayment experience rate that did not exceed 20 percent of the prepayment experience rate of the Federal Housing Administration in the State or region in which the issuer is located.

(d) DEFINITIONS.—

(1) ASSUMPTIONS USED IN MAKING PROJECTION.—The computation under subsection (c)(2) shall be made by using the following percentage of the prepayment experience of the Federal Housing Administration in the State or region in which the issuer of the applicable mortgage bonds is located:

Fiscal Year:	*Percentage:*
1984	*15*
1985	*20*
1986	*25*
1987 and thereafter	*30.*

(2) QUALIFIED VETERANS' MORTGAGE BONDS.—The term "qualified veterans' mortgage bonds" has the meaning given to such term by section 103A(c)(3) of the Internal Revenue Code of 1954.

SEC. 614. ELIMINATION OF CERTAIN EXCEPTIONS TO THE APPLICATION OF THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980.

Section 1104 of the Mortgage Subsidy Bond Tax Act of 1980 is amended by adding at the end thereof the following new subsections:

"(p) MOST EXCEPTIONS NOT TO APPLY TO BONDS ISSUED AFTER DECEMBER 31, 1984.—In addition to any obligations to which the amendments made by section 1102 apply by reason of the provisions of this section, the amendments made by section 1102 shall apply, notwithstanding any other provision of this section (other than subsection (n)), to obligations issued after December 31, 1984, all or a major portion of the proceeds of which are used to finance new mortgages on single-family residences that are owner occupied.

"(q) REDUCTION OF STATE CEILING BY AMOUNT OF SPECIAL MORTGAGE BONDS ISSUED BEFORE 1985.—

"(1) IN GENERAL.—Notwithstanding any other provision of this section (other than subsections (n) and (r)), any obligation—

"(A) which is part of an issue all or a major portion of the proceeds of which are used to finance new mortgages in single-family residences that are owner occupied,

"(B) which were issued by issuing authorities in such State after June 15, 1984, and before January 1, 1985, and

"(C) to which the amendments made by section 1102 do not apply by reason of any provision of this section other than subsection (n),

shall, for purposes of applying the Internal Revenue Code of 1954, be treated as an obligation which is not described in section 103(a) of such Code if the aggregate face amount of such issue exceeds the portion of the State ceiling that is allocated by the State to such issue prior to the date of issuance of such issue.

"(2) APPLICATION OF SECTION 103A(g).—For purposes of applying section 103A(g) of such Code, the State ceiling for calendar year 1984 shall be reduced by the aggregate amount allocated by the State to any issues described in paragraph (1).

"(3) STATE CEILING.—For purposes of this subsection, the term 'State ceiling' has the meaning given to such term by section 103A(g)(4) of the Internal Revenue Code of 1954.

"(r) EXCEPTIONS TO SUBSECTION (q).—Subsection (q) shall not apply with respect to—

"(1) obligations—

"(A) the proceeds of which are used to finance the River Place Project located in Minneapolis, Minnesota, and

"(B) the aggregate face amount of which does not exceed $55,000,000, or

"(2) obligations—

"(A) the proceeds of which are used to finance the Waseca, Minnesota project, and

"(B) the aggregate face amount of which does not exceed $7,800,000.".

Subtitle B—Private Activity Bonds

PART I—GENERAL RESTRICTIONS

SEC. 621 LIMITATION ON AGGREGATE AMOUNT OF PRIVATE ACTIVITY BONDS.

Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) LIMITATION ON AGGREGATE AMOUNT OF PRIVATE ACTIVITY BONDS ISSUED DURING ANY CALENDAR YEAR.—

"(1) IN GENERAL.—A private activity bond issued as part of an issue shall be treated as an obligation not described in subsection (a) if the aggregate amount of private activity bonds issued pursuant to such issue, when added to the aggregate amount of private activity bonds previously issued by the issuing authority during the calendar year, exceeds such authority's private activity bond limit for such calendar year.

"(2) PRIVATE ACTIVITY BOND LIMIT FOR STATE AGENCIES.—For purposes of this subsection—

"(A) IN GENERAL.—The private activity bond limit for any agency of the State authorized to issue private activity bonds for any calendar year shall be 50 percent of the State ceiling for such calendar year.

"(B) SPECIAL RULE WHERE STATE HAS MORE THAN 1 AGENCY.—If more than 1 agency of the State is authorized to issue private activity bonds, all such agencies shall be treated as a single agency.

"(3) PRIVATE ACTIVITY BOND LIMIT FOR OTHER ISSUERS.—For purposes of this subsection—

"(A) IN GENERAL.—The private activity bond limit for any issuing authority (other than a State agency) for any calendar year shall be an amount which bears the same ratio to 50 percent of the State ceiling for such calendar year as—

"(i) the population of the jurisdiction of such issuing authority, bears to

"(ii) the population for the entire State.

"(B) OVERLAPPING JURISDICTIONS.—For purposes of subparagraph (A)(i), the rules of section 103A(g)(3)(B) shall apply.

"(4) STATE CEILING.—For purposes of this subsection—

"(A) IN GENERAL.—The State ceiling applicable to any State for any calendar year shall be the greater of

"(i) an amount equal to $150 multiplied by the State's population, or

"(ii) $200,000,000.

"(B) PHASEIN OF LIMITATION WHERE AMOUNT OF 1983 PRIVATE ACTIVITY BONDS EXCEEDS THE CEILING.—

"(i) IN GENERAL.—In the case of any State which has an excess bond amount for 1983, the State ceiling for calendar year 1984 shall be the sum of the State ceiling determined under subparagraph (A) plus 50 percent of the excess bond amount for 1983.

"(ii) EXCESS BOND AMOUNT FOR 1983.—For purposes of clause (i), the excess bond amount for 1983 in any State is the excess (if any) of—

"(I) the aggregate amount of private activity bonds issued by issuing authorities in such State during the first 9 months of calendar year 1983 multiplied by 4/3, over

"(II) the State ceiling determined under subparagraph (A) for calendar year 1984.

"(C) ADJUSTMENT OF CEILING TO REFLECT TERMINATION OF SMALL ISSUE EXEMPTION.—In the case of calendar year after 1986, subparagraph (A) shall be applied by substituting '$100' for '$150'.

"(5) SPECIAL RULE FOR STATES WITH CONSTITUTIONAL HOME RULE CITIES.—In the case of any State with 1 or more constitutional home rule cities (as defined in section 103A(g)(5)(C)), the rules of paragraph (5) of section 103A(g) shall apply for purposes of this subsection.

"(6) STATE MAY PROVIDE FOR DIFFERENT ALLOCATION.—

"(A) IN GENERAL.—A State may, by law provide a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(B) INTERIM AUTHORITY FOR GOVERNOR.—

"(i) IN GENERAL.—The Governor of any State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(ii) TERMINATION OF AUTHORITY.—The authority provided in clause (i) shall not apply after the earlier of—

"(I) the first day of the first calendar year beginning after the legislature has met in regular session for more than 60 days after the date of the enactment of this paragraph, or

"(II) the effective date of any State legislation with respect to the allocation of the State ceiling.

"(C) STATE MAY NOT ALTER ALLOCATION TO CONSTITUTIONAL HOME RULE CITIES.—The rules of paragraph (6)(C) of section 103A(g) shall apply for purposes of this paragraph.

"(7) PRIVATE ACTIVITY BOND.—For purposes of this subsection—

"(A) IN GENERAL.—Except as otherwise provided in the paragraph, the term 'private activity bond' means any obligation the interest on which is exempt from tax under subsection (a) and which is—

"(i) an industrial development bond, or

"(ii) a student loan bond.

"(B) EXCEPTION FOR MULTIFAMILY HOUSING.—The term 'private activity bond' shall not include any obligation described in subsection (b)(4)(A) nor any housing program obligation under section 11(b) of the United States Housing Act of 1937.

"(C) EXCEPTION FOR CERTAIN FACILITIES DESCRIBED IN SECTION 103(b)(4) (C) OR (D).—

"(i) IN GENERAL.—The term 'private activity bond' shall not include any obligation described in subparagraph (C) or (D) of section 103(b)(4), but only if the property described in such subparagraph is owned by or on behalf of a governmental unit.

"(ii) EXCEPTION NOT TO APPLY TO CERTAIN PARKING FACILITIES.—This subparagraph shall not apply to any obligation described in subparagraph (D) of section 103(b)(4) (determined by not taking into account any parking facilities unless such facilities are related to another facility described in such subparagraph (D)).

"(iii) DETERMINATION OF WHETHER PROPERTY OWNED BY GOVERNMENTAL UNIT.—For purposes of clause (i), property shall not be treated as not owned by a governmental unit solely by reason of the length of the lease to which it is subject if the lessee makes an irrevocable election (binding on the lessee and all successors in interest under the lease) not to claim depreciation or an investment credit with respect to such property.

"(iv) Restriction where significant front end loading.—Under regulations prescribed by the Secretary, clause (i) shall not apply in any case where the property is leased under a lease which has significant front end loading of rental accruals or payments.

"(D) REFUNDING ISSUES.—The term 'private activity bond' shall not include any obligation which is issued to refund another obligation to the extent that the amount of such obligation does not exceed the amount of the refunded obligation. In the case of any student loan bond, the preceding sentence shall apply only if the maturity date of the refunding obligation is not later than the later of—

"(i) the maturity of the obligation to be refunded, or

"(ii) the date 17 years after the date on which the refunded obligation was issued (or in the case of a series of refunding, the date on which the original obligation was issued).

"(8) STUDENT LOAN BONDS.—For purposes of this subsection, the term 'student loan bond' means an obligation which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly to finance loans to individuals for educational expenses.

"(9) POPULATION.—For purposes of this subsection, determinations of the population of any State (or issuing authority) shall be made with respect to any calendar year on the basis of the most recent census estimate of the resident population of such State (or issuing authority) published by the Bureau of the Census before the beginning of such calendar year.

"(10) ELECTIVE CARRYFORWARD OF UNUSED LIMITATION FOR SPECIFIED PROJECT.—

"(A) IN GENERAL.—If—

"(i) an issuing authority's private activity bond limit for any calendar year after 1983, exceeds

"(ii) the aggregate amount of private activity bonds issued during such calendar year by such authority,

such authority may elect to treat all (or any portion) of such excess as a carryforward for 1 or more carryforward projects.

"(B) ELECTION MUST SPECIFY PROJECT.—In any election under subparagraph (A), the issuing authority shall—

"(i) specify the project (or projects) for which the carryforward is elected, and

"(ii) specify the portion of the excess described in subparagraph (A) which is to be a carryforward for each such project.

"(C) USE OF CARRYFORWARD.—

"(i) IN GENERAL.—If any issuing authority elects a carryforward under subparagraph (A) with respect to any carryforward project, any private activity bonds issued by such authority with respect to such project during the 3 calendar years (or, in the case of a project described in subsection (b)(4)(F), 6 calendar years) following the calendar year in which the carryforward arose shall not be taken into account under paragraph (1) to the extent the amount of such bonds do not exceed the amount of the carryforward elected for such project.

"(ii) ORDER IN WHICH CARRYFORWARD USED.—Carryforwards elected with respect to any project shall be used in the order of the calendar years in which they arose.

"(D) ELECTION.—Any election made under this paragraph shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Any such election

(and any specification contained therein), once made, shall be irrevocable.

"(E) CARRYFORWARD PROJECT.—For purposes of this paragraph, the term 'carryforward project' means—

"(i) any project described in paragraph (4) or (5) of subsection (b), and

"(ii) the purpose of issuing student loan bonds.

"(11) TREATMENT OF QUALIFIED SCHOLARSHIP FUNDING BONDS.—In the case of a qualified scholarship funding bond (as defined in subsection (e)), such bond shall be treated for purposes of this subsection as issued by a State or local issuing authority (whichever is appropriate).

"(12) Certification of no consideration for allocation.

"(A) In general.—Any private activity bond allocated any portion of the State limit shall not be exempt from tax under subsection (a) unless the public official if any responsible for such allocation certifies under penalty of perjury that the allocation was not made in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign.

"(B) Any criminal penalty made applicable.—Any person willfully making an allocation described in subparagraph (A) in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign shall be subject to criminal penalty to the same extent as if such allocation were a willful attempt to evade tax imposed by this title."

SEC. 622. TAX EXEMPTION DENIED WHERE OBLIGATION DIRECTLY OR INDIRECTLY GUARANTEED BY FEDERAL GOVERNMENT.

Subsection (h) of section 103 (relating to certain obligations must not be guaranteed or subsidized under a energy program) is amended to read as follows:

"(h) OBLIGATION MUST NOT BE GUARANTEED, ETC.—

"(1) IN GENERAL.—An obligation shall not be treated as an obligation described in subsection (a) if such obligation is federally guaranteed.

"(2) FEDERALLY GUARANTEED DEFINED.—For purposes of paragraph (1), an obligation is federally guaranteed if—

"(A) the payment of principal or interest with respect to such obligation is guaranted (in whole or in part) by the United States (or any agency or instrumentality thereof),

"(B) such obligation is issued as part of an issue and a significant portion of the proceeds of such issue are to be—

"(i) used in making loans the payment of principal or interest with respect to which are to be guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or

"(ii) invested (directly or indirectly) in federally insured deposits or accounts, or

"(C) the payment of principal or interest on such obligation is otherwise indirectly guaranteed (in whole or in part) by the United States (or an agency or instrumentality thereof).

"(3) EXCEPTIONS.—

"(A) CERTAIN INSURANCE PROGRAMS.—An obligation shall not be treated as federally guaranteed by reason of—

"(i) any guarantee by the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association,

"(ii) any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans,

"(iii) any guarantee by the Small Business Administration with respect to qualified contracts for pollution control facilities (within the meaning of section 404(a) of the Small Business Investment Act of 1958, as in effect on the date of the enactment of the Tax Reform Act of 1984) if—

"(I) the Administrator of the Small Business Administration charges a fee for making such guarantee, and

"(II) the amount of such fee equals or exceeds 1 percent of the amount guaranteed, or

"(iv) any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. 839d) as in effect on the date of the enactment of the Tax Reform Act of 1984.

"(B) DEBT SERVICE, ETC.—Paragraph (1) shall not apply to—

"(i) proceeds of the issue invested for an initial temporary period until such proceeds are needed for the purpose for which such issue was issued,

"(ii) investments of a bona fide debt service fund,

"(iii) investments of a reserve which meet the requirements of subsection (c)(4)(B),

"(iv) investments in obligations issued by the United States Treasury, or

"(v) other investments permitted under regulations.

"(C) EXCEPTION FOR HOUSING PROGRAMS.—

"(i) IN GENERAL.—Except as provided in clause (ii), paragraph (1) shall not apply to—

"(I) an obligation described in subsection (b)(4)(A) or a housing program obligation under section 11(b) of the United States Housing Act of 1937,

"(II) a qualified mortgage bond (as defined in section 103A(c)(1)), or

"(III) a qualified veterans' mortgage bond (as defined in section 103A(c)(3)).

"(ii) EXCEPTION NOT TO APPLY WHERE OBLIGATION INVESTED IN FEDERALLY INSURED DEPOSITS OR ACCOUNTS.—Clause (i) shall not apply to any obligation which is federally guaranteed within the meaning of paragraph (2)(B)(ii).

"(D) LOANS TO, OR GUARANTEES BY, FINANCIAL INSTITUTIONS.—Except as provided in paragraph (2)(B)(ii), an obligation which is issued as part of an issue shall not be treated as federally guaranteed merely by reason of the fact that the proceeds of such issue are used in making loans to a financial institution or there is a guarantee by a financial institution.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) TREATMENT OF CERTAIN ENTITIES WITH AUTHORITY TO BORROW FROM UNITED STATES.—To the extent provided in regulations prescribed by the Secretary, any entity with statutory authority to borrow from the United States shall be treated as an instrumentality of the United States. Except in the case of a private activity bond (as defined in subsection (n)(7)), nothing in the preceding sentence shall be construed as treating the District of Columbia or any possession of the United States as an instrumentality of the United States.

"(B) FEDERALLY INSURED DEPOSIT OR ACCOUNT.—The term 'federally insured deposit or account' means any deposit or account in a financial institution to the extent such deposit or account is insured under Federal law by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Administration, or any similar federally chartered corporation.

"(5) CERTAIN OBLIGATIONS SUBSIDIZED UNDER ENERGY PROGRAM.—

"(A) IN GENERAL.—An obligation to which this paragraph applies shall be treated as an obligation not described in subsection (a) if the payment of the principal or interest with respect to such obligation is to be made (in whole or in part) under a program of the United States, a State, or a political subdivision of a State the principal purpose of which is to encourage the production or conservation of energy.

"(B) OBLIGATIONS TO WHICH PARAGRAPH APPLIES.—This paragraph shall apply to any obligations to which paragraph (1) of subsection (b) does not apply by reason of—

"(i) subsection (b)(4)(H) (relating to qualified hydroelectric generating facilities), or

"(ii) subsection (g) (relating to qualified steam-generating or alcohol-producing facilities)."

SEC. 623. AGGREGATE LIMIT PER TAXPAYER FOR SMALL ISSUE EXCEPTION.

Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(15) AGGREGATE LIMIT PER TAXPAYER FOR SMALL ISSUE EXCEPTION.—

"(A) IN GENERAL.—Paragraph (6) of this subsection shall not apply to any issue if the aggregate authorized face amount of such issue allocated to any test-period beneficiary (when increased by the outstanding tax-exempt IDB's of such beneficiary) exceeds $40,000,000.

"(B) OUTSTANDING TAX-EXEMPT IDB'S OF ANY PERSON.—For purposes of applying subparagraph (A) with respect to any issue, the outstanding tax-exempt IDB's of any person who is a test-period beneficiary with respect to such issue is the aggregate face amount of all industrial development bonds the interest on which is excempt from tax under subsection (a)—

"(i) which are allocated to such beneficiary, and

"(ii) which are outstanding at the time of such later issue (not including as outstanding any obligation which is to be redeemed from the proceeds for the later issue).

"(C) ALLOCATIONS.—The amount of any issue shall be allocated—

"(i) in the case of any test-period beneficiary who is the owner of any facilities being financed, on the basis of ownership, and

"(ii) in the case of any test-period beneficiary who is a principal user of the facilities, on the basis of the use.

"(D) TEST-PERIOD BENEFICIARY.—For purposes of this paragraph, except as provided in regulations, the term 'test-period beneficiary' means any person who was an owner or principal user of facilities being financed by the issue at any time during the 3-year period beginning on the later of—

"(i) the date such facilities were placed in service, or

"(ii) the date of the issue.

"(E) TREATMENT OF RELATED PERSONS.—For purposes of this paragraph, all persons who are related (within the meaning of paragraph (6)(C)) to each other shall be treated as one person."

PART II—ARBITRAGE LIMITATIONS

SEC. 624. ARBITRAGE ON NONPURPOSE OBLIGATIONS.

(a) IN GENERAL.—Subsection (c) of section 103 (relating to arbitrage bonds) is amended by redesignating paragraph (6) as paragraph (7) and inserting after paragraph (5) the following new paragraph:

"(6) INVESTMENTS IN NONPURPOSE OBLIGATIONS.—

"(A) IN GENERAL.—For purposes of this title, any obligation which is part of an issue of industrial development bonds which does not meet the requirements of subparagraphs (C) and (D) shall be treated as an obligation which is not described in subsection (a).

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to any obligation described in subsection (b)(4)(A) or to any housing pro-

gram obligation under section 11(b) of the Housing Act of 1937.

"(C) LIMITATION ON INVESTMENT IN NONPURPOSE OBLIGATIONS.—

"(i) IN GENERAL.—An issue meets the requirements of this subparagraph only if—

"(I) at no time during any bond year, the amount invested in nonpurpose obligations with a yield higher than the yield on the issue exceeds 150 percent of the debt service on the issue for the bond year, and

"(II) the aggregate amount invested as provided in subclause (I) is promptly and appropriately reduced as the amount of outstanding obligations of the issue is reduced.

"(ii) EXCEPTION FOR TEMPORARY PERIODS.—Clause (i) shall not apply to—

"(I) proceeds of the issue invested for an initial temporary period until such proceeds are needed for the governmental purpose of the issue, and

"(II) temporary investment periods related to debt service.

"(iii) DEBT SERVICE DEFINED.—For purposes of this subparagraph, the debt service on the issue for any bond year is the scheduled amount of interest and amortization of principal payable for such year with respect to such issue. For purposes of the preceding sentence, there shall not be taken into account amounts scheduled with respect to any bond which has been retired before the beginning of the bond year.

"(iv) NO DISPOSITION IN CASE OF LOSS.—This subparagraph shall not require the sale or disposition of any investment if such sale or disposition would result in a loss which exceeds the amount which would be paid to the United States (but for such sale or disposition) at the time of such sale or disposition.

"(D) REBATE TO UNITED STATES.—An issue shall be treated as meeting the requirements of this subparagraph only if an amount equal to the sum of—

"(i) the excess of—

"(I) the aggregate amount earned on all nonpurpose obligations (other than investments attributable to an excess described in this clause), over

"(II) the amount which would have been earned if all nonpurpose obligations were invested at a rate equal to the yield on the issue, plus

"(ii) any income attributable to the excess described in clause (i),

is paid to the United States by the issuer in accordance with the requirements of subparagraph (E).

"(E) DUE DATE OF PAYMENTS UNDER SUBPARAGRAPH (D).—The amount which is required to be paid to the United States by the issuer shall be paid in installments which are made at least once every 5 years. Each installment shall be in an amount which insures that 90 percent of the amount described in subparagraph (D) with respect to the issue at the time payment of such installment is required will have been paid to the United States. The last installment shall be made no later than 30 days after the day on which the last obligation of the issue is redeemed and shall be in an amount sufficient to pay the remaining balance of the amount described in subparagraph (D) with respect to such issue.

"(F) SPECIAL RULES FOR APPLYING SUBPARAGRAPH (D).—

"(i) IN GENERAL.—In determining the aggregate amount earned on nonpurpose obligations for purposes of subparagraph (D)—

"(I) any gain or loss on the disposition of a nonpurpose obligation shall be taken into account, and

"(II) unless the issuer otherwise elects, any amount earned on a bona fide debt service fund shall not be taken into account if the gross earnings on such fund for the bond year is less than $100,000.

"(ii) TEMPORARY INVESTMENTS.—Notwithstanding subparagraph (D), an issue shall, for purposes of this paragraph, be treated as meeting the requirements of subparagraph (D) if the gross proceeds of such issue are expended for the governmental purpose for which the bond was issued by no later than the day which is 6 months after the date of issuance of such issue. Gross proceeds which are held in a bona fide debt service fund shall not be considered gross proceeds for purposes of this paragraph only.

"(G) EXEMPTION FROM GROSS INCOME OF SUM REBATED.—Gross income does not include the sum described in subparagraph (D). Notwithstanding any other provision of this title, no deduction shall be allowed for any amount paid to the United States under subparagraph (D).

"(H) DEFINITIONS.—For purposes of this paragraph—

"(i) NONPURPOSE OBLIGATIONS.—The term 'nonpurpose obligation' means any security (within the meaning of subparagraph (A) or (B) of section 165(g)(2)) or any obligation not described in subsection (a) which—

"(I) is acquired with the gross proceeds of an issue, and

"(II) is not acquired in order to carry out the governmental purpose of the issue.

"(ii) GROSS PROCEEDS.—The gross proceeds of an issue include—

"(I) amounts received (including repayments of principal) as a result of investing the original proceeds of the issue, and

"(II) amounts used to pay debt service on the issue.

"(iii) YIELD.—The yield on the issue shall be determined on the basis of the issue price (within the meaning of section 1273 or 1274."

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (1) of section 103A(i) (relating to arbitrage) is amended by striking out "section 103(c)" and inserting in lieu thereof "section 103(c) (other than section 103(c)(6))".

(2) Subsection (c) of section 103 is amended by striking out "Bonds" in the heading.

(3) Paragraph (1) of section 103(c) is amended by inserting "to arbitrage bonds" in the heading.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply with respect to bonds issued after December 31, 1984.

(2) EXCEPTION.—The amendments made by this section shall not apply to obligations issued by the Essex County Port Authority of New York and New Jersey as part of an issue approved by Essex County, New Jersey, on July 7, 1981, and approved by the State of New Jersey on December 31, 1981. The aggregate face amount of bonds to which this paragraph applies shall not exceed $350,000,000.

SEC. 625. STUDENT LOAN BOND

(a) ARBITRAGE REGULATIONS.—

(1) IN GENERAL.—The Secretary shall prescribe regulations which specify the circumstances under which a qualified student loan bond shall be treated as an arbitrage bond for purposes of section 103 of the Internal Revenue Code of 1954. Such regulations may provide that—

(A) paragraphs (4) and (5) of section 103(c) of such Code shall not apply, and

(B) rules similar to section 103(c)(6) shall apply,

to qualified student loan bonds.

(2) DEFINITIONS.—For purposes of this subsection—

(A) QUALIFIED STUDENT LOAN BOND.—The term 'qualified student loan bond' has the meaning given to such term by section 103(o)(3) of the Internal Revenue Code of 1954 (as amended by this Act).

(B) ARBITRAGE BOND.—The term "arbitrage bond" has the meaning given to such term by section 103(c)(2).

(3) EFFECTIVE DATE.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, any regulations prescribed by the Secretary under paragraph (1) shall apply to obligations issued after the qualified date.

(B) QUALIFIED DATE.—

(i) IN GENERAL.—For purposes of this paragraph, the term "qualified date" means the earlier of—

(I) the date on which the Higher Education Act of 1965 expires, or

(II) the date, after the date of enactment of this Act, on which the Higher Education Act of 1965 is reauthorized.

(ii) PUBLICATION OF REGULATIONS.—Notwithstanding clause (i), the qualified date shall not be a date which is prior to the date that is 6 months after the date on which the regulations prescribed under paragraph (1) are published in the Federal Register.

(C) REFUNDING OBLIGATIONS.—Regulations prescribed by the Secretary under paragraph (1) shall not apply to any obligation issued exclusively to refund any qualified student loan bond which was issued before the qualified date, except that the requirements of subparagraphs (A) and (B) of section 625(c)(5) of this Act must be met with respect to such refunding.

(D) FULFILLMENT OF COMMITMENTS.—Regulations prescribed by the Secretary under paragraph (1) shall not apply to any obligations which are needed to fulfill written commitments to acquire or finance student loans which are originated after June 30, 1984, and before the qualified date, but only if—

(i) such commitments are binding on the qualified date, and

(ii) the amount of such commitments is consistent with practices of the issuer which were in effect on March 15, 1984, with respect to establishing secondary markets for student loans.

(b) ARBITRAGE LIMITATION ON STUDENT LOAN BONDS WHICH ARE NOT QUALIFIED STUDENT LOAN BONDS.—Under regulations prescribed by the Secretary of the Treasury or his delegate, any student loan bond (other than a qualified student loan bond) issued after December 31, 1985, shall be treated as an obligation not described in subsection (a) (1) or (2) of section 103 of the Internal Revenue Code of 1954 unless the issue of which such obligation is a part meets requirements similar to those of sections 103(c)(6) and 103A(i) of such Code.

(c) ISSUANCE OF STUDENT LOAN BONDS WHICH ARE NOT TAX-EXEMPT.—Any issuer who may issue obligations described in section 103(a) of the Internal Revenue Code of 1954 may elect to issue student loan bonds which are not described in such section 103(a) of such Code without prejudice to—

(1) the status of any other obligations issued, or to be issued, by such issuer as obligations described in section 103(a) of such Code, or

(2) the status of the issuer as an organization exempt from taxation under such Code.

(d) FEDERAL EXECUTIVE BRANCH JURISDICTION OVER TAX-EXEMPT STATUS.—For purposes of Federal law, any determination by the executive branch of the Federal Government of whether interest on any obligation is exempt from taxation under the Internal Revenue Code of 1954 shall be exclusively within the jurisdiction of the Department of the Treasury.

(e) STUDY ON TAX EXEMPT STUDENT LOAN BONDS.—

(1) IN GENERAL.—The Comptroller General of the United States and the Director of the

Congressional Budget Office, shall conduct studies of—

(A) the appropriate role of tax-exempt bonds which are issued in connection with the guaranteed student loan program and the PLUS program established under the Higher Education Act of 1965, and

(B) the appropriate arbitrage rules for such bonds.

(2) REPORT.—The Comptroller General of the United States and the Director of the Congressional Budget Office, shall submit to the Committee on Finance and the Committee on Labor and Human Resources of the Senate and the Committee on Ways and Means and the Committee on Education and Labor of the House of Representatives reports on the studies conducted under paragraph (1) by no later than 9 months after the date of enactment of this Act.

PART III—OTHER RESTRICTIONS

SEC. 626. DENIAL OF TAX EXEMPTION TO CONSUMER LOAN BONDS.

(a) IN GENERAL.—Section 103 (relating to interest on certain governmental obligations) is amended by adding at the end thereof the following new subsection:

"(o) CONSUMER LOAN BONDS.—

"(1) DENIAL OF TAX EXEMPTION.—For purposes of this title, any consumer loan bond shall be treated as an obligation which is not described in subsection (a).

"(2) CONSUMER LOAN BONDS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'consumer loan bond' means any obligation which is issued as part of an issue all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans (other than loans described in subparagraph (C)) to persons who are not exempt persons (within the meaning of subsection (b)(3)).

"(B) EXCLUDED OBLIGATIONS.—The term 'consumer loan bond' shall not include any—

"(i) qualified student loan bond,

"(ii) industrial development bond, or

"(iii) qualified mortgage bond or qualified veterans' mortgage bond.

"(C) EXCLUDED LOANS.—A loan is described in this subparagraph if the loan—

"(i) enables the borrower to finance any governmental tax or assessment of general application for an essential governmental function, or

"(ii) is used to acquire or carry nonpurpose obligations (within the meaning of subsection (c)(6)(G)(i)).

"(3) QUALIFIED STUDENT LOANS.—For purposes of this subsection, the term 'qualified student loan bond' means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance student loans under a program of general application to which the Higher Education Act of 1965 applies if—

"(A) limitations are imposed under the program on—

"(i) the maximum amount of loans outstanding to any student, and

"(ii) the maximum rate of interest payable on any loan,

"(B) the loans are directly or indirectly guaranteed by the Federal Government,

"(C) the financing of loans under the program is not limited by Federal law to the proceeds of obligations the interest on which is exempt from taxation under this title, and

"(D) special allowance payments under section 438 of the Higher Education Act of 1965—

"(i) are authorized to be paid with respect to loans made under the program, or

"(ii) would be authorized to be made with respect to loans under the program if such loans were not financed with the proceeds of obligations the interest on which is exempt from taxation under this title.

Such term shall not include any obligation issued under a State program which discriminates on the basis of the location (in the United States) at which the educational institution is located.

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection the amendment made by subsection (a) shall apply to obligations issued after the date of enactment of this Act.

(2) EXCEPTIONS FOR CERTAIN STUDENT LOAN PROGRAMS.—

(A) IN GENERAL.—The amendments made by this section shall not apply to obligations issued by a program described in the following table to the extent the aggregate face amount of such obligations does not exceed the amount of allowable obligations specified in the following table with respect to such program:

Program	Amount of Allowable Obligations
Colorado Student Obligation Bond Authority.	$60 million
Connecticut Higher Education Supplementary Loan Authority.	$15.5 million
District of Columbia	$50 million
Illinois Higher Education Authority.	$11 million
State of Iowa	$16 million
Louisiana Public Facilities Authority.	$75 million
Maine Health and Higher Education Facilities Authority.	$5 million
Maryland Higher Education Supplemental Loan Program.	$24 million
Massachusetts College Student Loan Authority.	$90 million
Minnesota Higher Education Coordinating Board.	$60 million
New Hampshire Higher Education and Health Facilities Authority.	$39 million
New York Dormitory Authority	$120 million
Pennsylvania Higher Education Assistance Agency.	$300 million
Georgia Private Colleges and University Authority.	$31 million
Wisconsin State Building Commission.	$60 million
South Dakota Health and Educational Facilities Authority.	$6 million

(B) PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY.—Subparagraph (A) shall apply to obligations issued by the Pennsylvania Higher Education Assistance Agency only as such obligations are issued solely for the purpose of refunding student loan bonds outstanding on March 15, 1984.

(4) CERTAIN TAX-EXEMPT MORTGAGE SUBSIDY BONDS.—For purposes of applying section 103(o) of the Internal Revenue Code of 1954, the term "consumer loan bond" shall not include any mortgage subsidy bond (within the meaning of section 103A(b) of such Code) to which the amendments made by section 1102 of the Mortgage Subsidy Bond Tax Act of 1980 do not apply.

(5) REFUNDING EXCEPTION.—The amendments made by this section shall not apply to any obligation or series of obligations the proceeds of which are used exclusively to refund obligations issued before March 15, 1984, except that—

(A) the amount of the refunding obligations may not exceed 101 percent of the aggregate face amount of the refunded obligations, and

(B) the maturity date of any refunding obligation may not be later than the date which is 17 years after the date on which the refunded obligation was issued (or, in the case of a series of refundings, the date on which the original obligation was issued).

(6) EXCEPTION FOR CERTAIN ESTABLISHED PROGRAMS.—The amounts made by this section shall not apply to any obligation substantially all of the proceeds of which are used to carry out a program established under State law which has been in effect in substantially the same form during the 30-year period ending on the date of enactment of this Act, but only if such proceeds are used to make loans or to fund similar obligations—

(A) in the same manner in which,

(B) in the same (or lesser) amount per participant, and

(C) for the same purposes for which,

such program was operated on March 15, 1984. This subparagraph shall not apply to obligations issued on or after March 15, 1987.

(7) CERTAIN BONDS FOR RENEWABLE ENERGY PROPERTY.—The amendments made by this section shall not apply to any obligations described in section 243 of the Crude Oil Windfall Profit Tax Act of 1980.

SEC. 627. LIMITATIONS ON ACQUISITIONS OF LAND, EXISTING FACILITIES, ETC.

(a) LIMITATION ON USE FOR LAND ACQUISITION.—Subsection (b) of section 103 is amended by adding at the end thereof the following new paragraph:

"(16) LIMITATION ON USE FOR LAND ACQUISITION.—

"(A) IN GENERAL.—Paragraphs (4), (5), and (6) shall not apply with respect to any obligation issued as part of an issue if—

"(i) any portion of the proceeds of such issue are to be used (directly or indirectly) for the acquisition of land (or an interest therein) to be used for farming purposes, or

"(ii) 25 percent or more of the proceeds of such issue are to be used (directly or indirectly) for the acquisition of land not described in clause (i) (or an interest therein).

In the case of an obligation described in paragraph (5) (relating to industrial parks), clause (i) shall be applied by substituting '50 percent' for '25 percent'.

"(B) EXCEPTION FOR FIRST-TIME FARMERS.—

"(i) IN GENERAL.—If the requirements of clause (ii) are met with respect to any land, subparagraph (A) shall not apply to such land, and paragraph (17) shall not apply to property located thereon or to property to be acquired within 1 year to be used in farming, but only to the extent of expenditures (financed with the proceeds of the issue) not in excess of $250,000.

"(ii) ACQUISITION BY FIRST-TIME FARMERS.—The requirements of this clause are met with respect to any land if—

"(I) such land is to be used for farming purposes, and

"(II) such land is to be acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who will materially and substantially participate on the farm of which such land is a part in the operation of such farm.

"(iii) FIRST-TIME FARMER.—For purposes of this subparagraph, the term 'first-time farmer' means any individual if such individual has not at any time had any direct or indirect ownership interest in substantial farmland in the operation of which such individual materially participated. For purposes of this subparagraph, any ownership or material participation by an individual's spouse or minor child shall be treated as ownership and material participation by the individual.

"(iv) FARM.—For purposes of this subparagraph, the term 'farm' has the meaning given such term by section 6420(c)(2).

"(v) SUBSTANTIAL FARMLAND.—The term 'substantial farmland' means any parcel of land unless—

"(I) such parcel is smaller than 15 percent of the median size of a farm in the county in which such parcel is located, and

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(II) the fair market value of the land does not at any time while held by the individual exceed $125,000.

"(C) EXCEPTION FOR CERTAIN LAND ACQUIRED FOR ENVIRONMENTAL PURPOSES.—Any land acquired by a public agency in connection with an airport, mass transit, or port development project shall not be taken into account under subparagraph (A) if—

"(i) such land is acquired for a noise abatement, wetland preservation, future use, or other public purpose, and

"(ii) there is not other significant use of such land."

(b) ACQUISITION OF EXISTING PROPERTY NOT PERMITTED.—Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(17) ACQUISITION OF EXISTING PROPERTY NOT PERMITTED.—

"(A) IN GENERAL.—Paragraphs (4), (5), (6), and (7) shall not apply to any obligation issued as part of an issue if any portion of the procedds of such issue is to be used for the acquisition of any property (or an interest therein) unless the first use of such property is pursuant to such acquisition.

"(B) EXCEPTION FOR CERTAIN REHABILITATIONS.—Subparagraphs (A) shall not apply with respect to any building (and the equipment therefor) if—

"(i) the rehabilitation expenditures with respect to such building equals or exceeds

"(ii) 15 percent of the portion of the cost of acquiring such building (and equipment) financed with the proceeds of the issue.

A rule similar to the rule of the preceding sentence shall apply in the case of facilities other than an building except that clause (ii) shall be applied by substituting '10v percent' for '15 percent'.

"(C) REHABILITATION EXPENDITURES.—

For purposes of this paragraph—

"(i) IN GENERAL.—Except as provided in this subparagraph, the term 'rehabilitation expenditures' means any amount properly chargeable to capital account which is incurred by the person acquiring the building for property (or additions or improvements to property) in connection with the rehabilitation of a building. In the case of an integrated operation contained in a building before its acquisition, such term includes rehabilitating existing equipment in such building or replacing it with equipment having substantially the same function. For purposes of this clause, any amount incurred by a successor to the person acquiring the building or by the seller under a sales contract with such person shall be treated as incurred by such person.

"(ii) CERTAIN EXPENDITURES NOT INCLUDED.—The term 'rehabilitation expenditures' does not include any expenditure described in section 48(g)(2)(B) (other than clause (i) thereof).

"(iii) PERIOD DURING WHICH EXPENDITURES MUST BE INCURRED.—The term 'rehabilitation expenditures' shall not include any amount which is incurred after the date 2 years after the later of—

"(I) the date on which the building was acquired, or

"(II) the date on which the obligation was issued."

(c) USE OF TAX-EXEMPT BONDS PROHIBITED FOR SKYBOXES, AIRPLANES, GAMBLING ESTABLISHMENTS, ETC.—Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(18) NO PORTION OF BONDS MAY BE ISSUED FOR SKYBOXES, AIRPLANES, GAMBLING ESTABLISHMENTS, ETC.—Paragraphs (4), (5), and (6) shall not apply to any obligation issued as part of an issue if any portion of the proceeds of such issue is to be used to provide any airplane, skybox, or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

SEC. 628. MISCELLANEOUS INDUSTRIAL DEVELOPMENT BOND PROVISIONS.

(a) CERTAIN RESTRICTIONS APPLY TO EXEMPTIONS NOT CONTAINED IN INTERNAL REVENUE CODE OF 1954.—

(1) Paragraph (1) of section 103(m) (relating to obligations exempt other than under this title) is amended by adding at the end thereof the following new sentence: "In the case of an obligation issued after December 31, 1983, such obligation shall not be treated as described in this paragraph unless the appropriate requirements of subsections (b), (c), (h), (k), (l), and (n) of this section and section 103A are met with respect to such obligation. For purposes of applying such requirements, a possession of the United States shall be treated as a State; except that clause (ii) of subsection (o)(4)(A) shall not apply."

(2) Subparagraph (B) of section 103(m)(2) is amended to read as follows:

"(B) is exempt from tax under this title without regrd to any provision of law not contained in this title."

(3) Subsection (m) of section 103 is amended by adding at the end thereof the following new paragraph:

"(3) EXCEPTIONS.—The following obligations shall be treated as obligations described in paragraph (1) (without regard to the second sentence thereof):

"(A) Any obligation issued pursuant to the Northwest Power Act.

"(B) Any obligation issued pursuant to section 608(6)(A) of Public Law 97-468.

"(C) Any obligation described in section 243 of the Crude Oil Windfall Profits Tax Act of 1980.

(b) EXPANSION OF TAX-EXEMPT BOND FINANCED PROPERTY REQUIRED TO BE DEPRECIATED ON STRAIGHT-LINE BASIS.—

(1) IN GENERAL.—Subparagraph (C) of section 168(f)(12) (relating to limitations on property financed with tax-exempt bonds) is amended to read as follows:

"(C) EXCEPTION FOR PROJECTS FOR RESIDENTIAL RENTAL PROPERTY.—Subparagraph (A) shall not apply to any recovery property which is placed in service in connection with projects for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A)."

(2) CONFORMING AMENDMENT.—Paragraph (12) of section 168(f) is amended by striking out subparagraph (D) and by redesignating subparagraph (E) as subparagraph (D).

(c) AGGREGATION OF ISSUES FOR SINGLE PROJECT.—Paragraph (6) of section 103(b) (relating to exemption for small issues) is amended by adding at the end thereof the following new subparagraph:

"(P) AGGREGATION OF ISSUES WITH RESPECT TO SINGLE PROJECT.—For purposes of this paragraph, 2 or more issues part or all of which are to be used with respect to a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses using substantial common facilities shall be treated as 1 issue (and any person who is a principal user with respect to any of such issues shall be treated as a principal user with respect to the aggregated issue)."

(d) DEFINITION OF RELATED PERSONS IN THE CASE OF PARTNERSHIPS.—Paragraph (13) of section 103(b) (relating to exception where bond held by substantial user) is amended by adding at the end thereof the following new sentences: "For purposes of this paragraph—

"(A) a partnership and each of its partners (and their spouses and minor children) shall be treated as related persons, and

"(B) an S corporation and each of its shareholders (and their spouses and minor children) shall be treated as related persons.".

(e) RESIDENTIAL RENTAL PROPERTY MAY BE IN MIXED USE STRUCTURE.—Paragraph (4) of section 103(b) (relating to certain exempt activities) is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (A), any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes."

(f) PUBLIC APPROVAL REQUIREMENT IN THE CASE OF PUBLIC AIRPORT.—If—

(1) the proceeds of any issue are to be used to finance a facility or facilities located on a public airport, and

(2) the governmental unit issuing such obligations is the owner or operator of such airport,

such governmental unit shall be deemed to be the only governmental unit having jurisdiction over such airport for purposes of subsection (k) of section 103 of the Internal Revenue Code of 1954 (relating to public approval for industrial development bonds).

(g) REPEAL OF ADVANCE REFUNDING OF QUALIFIED PUBLIC FACILITIES.—Paragraph (7) of section 103(b) (relating to advance refunding of qualified public facilities) is hereby repealed.

SEC. 629. CERTAIN PUBLIC UTILITIES TREATED AS EXEMPTED PERSONS UNDER SECTION 103(B); SPECIAL RULES FOR CERTAIN RAILROADS.

(a) CERTAIN PUBLIC UTILITIES.—For purposes of applying section 103(b)(3) of the Internal Revenue Code with respect to—

(1) any obligations issued after the date of enactment of this Act, and

(2) any obligations issued after December 31, 1969, which were treated as obligations described in section 103(a) of such Code on the day on which such obligations were issued,

the term "exempt person" shall include a regulated public utility having any customer service area within a State served by a public power authority which was required as a condition of a Federal Power Commission license specified by an Act of Congress enacted prior to the enactment of section 107 of the Revenue and Expenditure Control Act of 1968 (Public Law 90-364) to contract to sell power to one such utility and which is authorized by State law to sell power to other such utilities, but only with respect to the purchase by any such utility and resale to its customers of any output of any electrical generation facility or any portion thereof or any use of any electrical transmission facility or any portion thereof financed by such power authority and owned by it or by such State, and provided that by agreement between such power authority and any such utility there shall be no markup in the resale price charged by such utility of that component of the resale price which represents the price paid by such utility for such output or use.

(b) CERTAIN RAILROADS.—Section 103(b)(1) of the Internal Revenue Code of 1954 shall not apply to any obligation which is described in section 103(b)(6)(A) of such Code if—

(1) substantially all of the proceeds of such obligation are used to acquire railroad track and right-of-way from a railroad involved in a title 11 or similar proceeding (within

the meaning of section 368(a)(3)(A) of such Code), and

(2) the Federal Railroad Administration provides joint financing for such acquisitions.

(c) SPECIAL RULES FOR SUBSECTION (a).—

(1) OBLIGATIONS SUBJECT TO CAP.—Any obligation described in subsection (a) shall be treated as a private activity bond for purposes of section 103(n) of the Internal Revenue Code of 1954.

(2)(b) LIMITATION ON AMOUNT OF OBLIGATIONS TO WHICH SUBSECTION (a)(1) APPLIES.—The aggregate amount of obligations to which subsection (a)(1) applies shall not exceed $625,000,000.

(3) LIMITATION ON PURPOSES.—Subsection (a)(1) shall only apply to obligations issued as part of an issue substantially all the proceeds of which are used to provide 1 or more of the following:

(A) Cable facilities.

(B) Small hydroelectric facilities.

(C) The acquisition of an interest in an electrical generating facility.

SEC. 630. EXTENSION OF SMALL ISSUE INDUSTRIAL DEVELOPMENT BOND EXCEPTION.

Subparagraph (N) of section 103(D)(6) (relating to termination date) is amended to read as follows:

"(N) TERMINATION DATES.—

"(i) IN GENERAL.—This paragraph shall not apply to any obligation issued after December 31, 1986 (including any obligations issued to refund an obligation issued on or before such date).

"(ii) OBLIGATIONS USED TO FINANCE MANUFACTURING FACILITIES.—In the case of any obligation which is part of an issue substantially all of the proceeds of which are to be used to provide a manufacturing facility, clause (i) shall be applied by substituting '1988' for '1986'.

"(iii) MANUFACTURING FACILITY.—For purposes of this subparagraph, the term 'manufacturing facility' means any facility which is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property).

SEC. 631. EFFECTIVE DATES.

(a) PRIVATE ACTIVITY BOND CAP.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by section 621 shall apply to obligations issued after December 31, 1983.

(2) INDUCEMENT RESOLUTION BEFORE JUNE 19, 1984.—The amendment made by section 621 shall not apply to any issue of obligations if—

(A) there was an inducement resolution (or other comparable preliminary approval) for the issue before June 19, 1984, and

(B) the issue is issued before January 1, 1985.

(3) CERTAIN PROJECTS PRELIMINARILY APPROVED BEFORE OCTOBER 19, 1983, GIVEN APPROVAL.—If—

(A) there was an inducement resolution (or other comparable preliminary approval) for a project before October 19, 1983, by any issuing authority,

(B) a substantial user of such project notifies the issuing authority within 30 days after the date of the enactment of this Act that it intends to claim its rights under this paragraph, and

(C) construction of such project began before October 19, 1983, or the substantial user was under a binding contract on such date to incur significant expenditures with respect to such project,

such issuing authority shall allocate its share of the limitation under section 103(n) of such Code for the calendar year during which the obligations were to be issued pursuant to such resolution (or other approval) first to such project. If the amount of obligations required by all projects which meet the requirements of the preceding sentence exceeds the issuing authority's share of the limitation under section 103(n) of such Code, priority under the preceding sentence shall be provided first to those projects for which substantial expenditures were incurred before October 19, 1983. If any issuing authority fails to meet the requirements of this paragraph, the limitation under section 103(n) of such Code for the issuing authority for the calendar year following such failure shall be reduced by the amount of obligations with respect to which such failure occurred.

(3) EXCEPTION FOR CERTAIN BONDS FOR A CONVENTION CENTER AND RESOURCE RECOVERY PROJECT.—In the case of any city, if—

(A) the city council of such city authorized a feasibility study for a convention center on June 10, 1982, and

(B) on November 4, 1983, a municipal authority acting for such city accepted a proposal for the construction of a facility that is capable of generating steam and electricity through the combustion of municipal waste,

the amendment made by section 621 shall not apply to any issue, issued during 1984, 1985, 1986, or 1987 and substantially all of the proceeds of which are to be used to finance the convention center (or access ramps and parking facilities therefor) described in subparagraph (A) or the facility described in subparagraph (B).

(b) PROPERTY FINANCED WITH TAX-EXEMPT BONDS REQUIRED TO BE DEPRECIATED ON STRAIGHT-LINE BASIS.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amendments made by section 628(b) shall apply to property placed in service after December 31, 1983, to the extent such property is financed by the proceeds of an obligation (including a refunding obligation) issued after October 18, 1983.

(2) EXCEPTIONS.—

(A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by section 628(b) shall not apply with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

(B) REFUNDING.—

(i) IN GENERAL.—Except as provided in clause (ii), in the case of property placed in service after December 31, 1983, which is financed by the proceeds of an obligation which is issued solely to refund another obligation which was issued before October 19, 1983, the amendments made by section 628(b) shall apply only with respect to an amount equal to the basis in such property which has not been recovered before the date such refunded obligation is issued.

(ii) SIGNIFICANT EXPENDITURES.—In the case of facilities the original use of which commences with the taxpayer and with respect to which significant expenditures are made before January 1, 1984, the amendments made by section 628(b) shall not apply with respect to such facilities to the extent such facilities are financed by the proceeds of an obligation issued solely to refund another obligation which was issued before October 19, 1983.

(C) FACILITIES.—In the case of an inducement resolution or other comparable preliminary approval adopted by an issuing authority before October 19, 1983, for purposes of applying subparagraphs (A)(i) and (B)(ii) with respect to obligations described in such resolution, the term "facilities" means the facilities described in such resolution.

(c) OTHER PROVISIONS RELATING TO TAX-EXEMPT BONDS.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amendments made by this subtitle shall apply to obligations issued after December 31, 1983.

(2) OBLIGATIONS INVESTED IN FEDERALLY INSURED DEPOSITS.—Notwithstanding any other provision of this section, clause (ii) of section 103(h)(2)(B) of the Internal Revenue Code of 1954 (as amended by this subtitle) shall apply to obligations issued after April 14, 1983; except that such clause shall not apply to any obligation issued pursuant to a binding contract in effect on March 4, 1983.

(3) EXCEPTIONS.—

(A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by this subtitle (other than section 621) shall not apply to obligations with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditure was entered into before October 19, 1983.

(B) FACILITIES.—Subparagraph (C) of subsection (b)(2)(A) shall apply for purposes of subparagraph (A) of this paragraph.

(4) REPEAL OF ADVANCE REFUNDING OF QUALIFIED PUBLIC FACILITIES.—The amendment made by section 628(j) shall apply to refunding obligations issued after the date of the enactment of this Act; except that if substantially all the proceeds of the refunded issue were used to provide airports or docks, such amendment shall only apply to refunding obligations issued after December 31, 1984. In the case of any refunding obligation with respect to the Alabama State Docks Department or the Dade County Florida Airport, the preceding sentence shall be applied by substituting "December 31, 1985" for "December 31, 1984".

(d) PROVISIONS OF THIS SUBTITLE NOT TO APPLY TO CERTAIN PROPERTY.—The amendments made by this subtitle shall not apply to any property (and shall not apply to obligations issued to finance such property) if such property is described in any of the following paragraphs:

(1) Any property described in paragraph (5), (6), or (7) of section 32(g) of this Act.

(2) any property described in paragraph (4) of section 32(g) of such Act but only if the obligation is issued before January 1, 1985.

(3) Any property described in paragraph (3) of section 216(b) of the Tax Equity and Fiscal Responsibility Act of 1982.

(4) Any solid waste disposal facility described in section 103(b)(4)(E) of the Internal Revenue Code of 1954 if—

(A) a State public authority created pursuant to State legislation which took effect on June 18, 1973, took formal action before October 19, 1983, to commit development funds for such facility.

(B) such authority issues obligations for any such facility before January 1, 1987, and

(C) expenditures have been made for the development of any such facility before October 19, 1983.

(e) DETERMINATION OF SIGNIFICANT EXPENDITURE.—

(1) IN GENERAL.—For purposes of this section, the term "significant expenditures" means expenditures which equal or exceed the lesser of—

(A) $15,000,000, or

(B) 20 percent of the estimated cost of the facilities.

(A) CERTAIN GRANTS TREATED AS EXPENDITURES.—For purposes of paragraph (1), amount of any UDAG grant preliminary ap-

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proved on May 5, 1981, or April 4, 1983, shall be treated as an expenditure with respect to the facility for which such grant was so approved.

(f) EXCEPTION FOR CERTAIN OTHER AMENDMENTS.—If—

(1) there was an inducement resolution (or other comparable preliminary approval) for an issue before June 1, 1984, by any issuing authority, and

(2) such issues is issued before January 1, 1985, the following amendments shall not apply:

(A) the amendments made by section 623,

(B) the amendments made by subsections (a) and (b) of section 627 (except to the extent such amendments relate to farm land),

(C) in the case of a race track, the amendment made by section 627(c), and

(D) the amendments made by section 628(c).

SEC. 632. MISCELLANEOUS EXCEPTIONS AND SPECIAL RULES.

(a) EXCEPTION FROM PROVISIONS OTHER THAN ARBITRAGE AND FEDERAL GUARANTEES.—Notwithstanding any other provision of this title, the amendments made by this title (other than by section 622 (relating to Federal guarantees) and section 623 (relating to arbitrage)) shall not apply to the following obligations:

(1) Obligations issued with respect to any waste-to-energy facility authorized by official action on April 10, 1980 and with respect to which a subsequent agreement was signed, between a city government and the Department of the Army on December 27, 1982, to jointly pursue construction and operation of such facility.

(2) Obligations issued to finance a redevelopment program on 9 city blocks adjacent to a transit station but only if such program was approved on October 25, 1983.

(3) Obligations issued pursuant to an inducement resolution adopted on August 8, 1978, for a redevelopment plan for which a redevelopment trust fund was established on September 7, 1977.

(4) Obligations issued to finance a UDAG project which was preliminarily approved on December 29, 1982, and which received final approval on May 3, 1984.

(5) Obligations issued to finance a parking garage pursuant to an inducement resolution adopted on March 9, 1984, in connection with a project for which a UDAG grant application was made on January 31, 1984.

(6) Obligations which—

(A) are issued to finance a downtown development project with respect to which an urban development action grant is made but only if such grant—

(i) was preliminarily approved on November 23, 1983, and

(ii) received final approval before June 1, 1984, and

(B) are issued pursuant to inducment resolution that were adopted on December 21, 1982, July 5, 1983, and March 1, 1983, But only to the extent the aggregate face amount of such obligations does not exceed $34,000,000.

(7) Obligations with respect to which an inducement resolution was adopted on March 5, 1984, for the purpose of acquiring existing airport facilities at more than 12 locations in 1 State but—

(A) only if the Civil Aeronautics Board certifies that such transaction would reduce the amount of Federal subsidies provided under section 419 of the Airline Deregulation Act of 1978, and

(B) only to the extent the aggregate face amount of such obligations does not exceed $25,000,000.

(8) Obligations described in subsection (b).

(b) CERTAIN PARKING FACILITY BONDS.—For purposes of the Internal Revenue Code of 1954, any obligation issued with respect to a parking facility approved by an agency of a county government on December 1, 1982, as part of an urban revitalization plan shall be treated as an obligation described in section 103(b)(4)(D) of such Code.

(c) EXCEPTION TO CERTAIN BOND LIMITATIONS.—The amendments made by section 621 (relating to the limitations on amount of private activity bonds) and section 626(a) (relating to the prohibition on acquiring existing facilities) shall not apply to obligations issued before January 1, 1987, in connection with the Claymont, Delaware regeneration plant of the Delaware Economic Development Authority, but only to the extent the aggregate face amount of such obligation does not exceed $30,000,000.

(d) CERTAIN OBLIGATIONS TREATED AS NOT FEDERALLY GUARANTEED.—For purposes of section 103(h) of the Internal Revenue Code of 1954, obligations (including refunding obligations) shall not be treated as federally guaranteed if—

(A) such obligations were issued with respect to any facility, and

(B) any obligation was issued on June 3, 1982 in the principal amount of $11,312,125 for the purpose of financing the development, study, or related costs incurred with respect to such facility or any facility related to such facility.

(e) CERTAIN EXPENDITURES TREATED AS SIGNIFICANT EXPENDITURES.—For purposes of this title, expenditures of $850,000 incurred with respect to any project involving $15,000,000 shall be treated as significant expenditures if such expenditures were incurred pursuant to an agreement entered into on July 13, 1982, relating to the discharge of industrial waste after January 1, 1986.

(f) CERTAIN ORDINANCES TREATED AS INDUCEMENT RESOLUTIONS.—For purposes of this title, any ordinance passed on May 3, 1982, with respect to a planned development district shall be treated as an inducement resolution with respect to obligations issued in 1984 in connection with a mall project for such district.

(g) DELAYED EFFECTIVE DATE WITH RESPECT TO CERTAIN IDBS.—

(1) FERC PROJECTS.—Notwithstanding any other provision of this title, any amendments made by this title (other than the amendments to section 103(c) of the Internal Revenue Code of 1954) which, but for this paragraph, would apply to industrial development bonds issued after December 31, 1984, shall not apply to any of the following obligations issued before January 1, 1986:

(A) obligations issued with respect to Federal Energy Regulatory Commission project 4657, but only to the extent the aggregate face amount of such obligations does not exceed $12,900,000;

(B) obligations issued with respect to Federal Energy Regulatory Commission project 2853, but only to the extent the aggregate face amount of such obligations does not exceed $28,600,000; or

(C) obligations issued with respect to Federal Energy Regulatory Commission project 4700, but only to the extent the aggregate face amount of such obligations does not exceed $3,850,000.

(2) PARK CENTRAL NEW TOWN IN TOWN PROJECT.—Notwithstanding any other provision of this title, any amendments made by this title (other than the amendments to section 103(c) of the Internal Revenue Code of 1954) which, but for this paragraph, would apply to industrial development bonds issued after December 31, 1984, shall not apply to any obligation issued before January 1, 1988, with respect to Park Central New Town In Town Project located in Port Arthur, Texas, but only to the extent the aggregate face amount of such obligations does not exceed $80,000,000.

Subtitle C—Miscellaneous Provisions

SEC. 641. CLARIFICATION OF TREATMENT OF CERTAIN EXEMPTIONS FOR PURPOSES OF THE FEDERAL ESTATE AND GIFT TAXES.

(a) GENERAL RULE.—Nothing in any provision of law exempting any property (or interest therein) from taxation shall exempt the transfer of such property (or interest therein) from Federal estate, gift, and generation-skipping transfer taxes. In the case of any provision of law enacted after the date of the enactment of this Act, such provision shall not be treated as exempting the transfer of property from Federal estate, gift, and generation-skipping transfer taxes unless it refers to the appropriate provisions of the Internal Revenue Code of 1954.

(b) EFFECTIVE DATE.—

"(1) IN GENERAL.—The provisions of subsection (a) shall apply to the estates of decedents dying, gifts made, and transfers made on or after June 19, 1984.

"(2) TREATMENT OF CERTAIN TRANSFERS TREATED AS TAXABLE.—The provisions of subsection (a) shall also apply in the case of any transfer of property (or interest therein) if at any time there was filed an estate or gift tax return showing such transfer as subject to Federal estate or gift tax.

"(3) NO INFERENCE.—No inference shall arise from paragraphs (1) and (2) that any transfer of property (or interest therein) before June 19, 1984, is exempt from Federal estate and gift taxes.

SEC. 642. REPORTS WITH TRANSFERS OF PUBLIC HOUSING BONDS.

(a) GENERAL RULE.—With respect to transfers of public housing bonds occurring after December 31, 1983, and before June 19, 1984, the taxpayer shall report the date and amount of such transfer and such other information as the Secretary of the Treasury or his delegate shall prescribe by regulations to allow the determination of the tax and interest due if it is ultimately determined that such transfers are subject to estate, gift, or generation-skipping tax.

(b) PENALTY FOR FAILURE TO REPORT.—Any taxpayer failing to provide the information required by subsection (a) shall be liable for a penalty equal to 25 percent of the excess of (1) the estate, gift, or generation-skipping tax that is payable assuming that such transfers are subject to tax, over (2) the tax payable assuming such transfers are not so subject.

SEC. 643. TAX-EXEMPT STATUS OF OBLIGATIONS OF CERTAIN EDUCATIONAL ORGANIZATIONS.

(a) IN GENERAL.—For purposes of section 103 of the Internal Revenue Code of 1954, a qualified educational organization shall be treated as a State governmental unit, but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business (determined by applying section 513(a) of such Code to such organization).

(b) QUALIFIED EDUCATIONAL ORGANIZATION.—For purposes of subsection (a), the term "qualified educational organization" means a college or university created on Februdry 22, 1855, by specific act of the legislature of the State within which such college or university is located.

(c) EFFECTIVE DATE.—This section shall apply to obligations issued after December 31, 1953.

SEC. 644. LOCAL FURNISHING OF ELECTRICITY OR GAS.

(a) GENERAL RULE.—For the purposes of section 103(b)(4)(E), facilities for the local furnishing of electric energy also shall include a facility that is part of a sysem providing service to the general populace (i) if at least 97 percent (measured both by total number of metered customers and by their annual consumption on a kilowatt hour basis) of the retail customers of such system are located in two contiguous counties, and (ii) if the remainder of such customers are located in a portion of a third contiguous county which portion is located on a peninsula not directly connected by land to the rest of the county of which it is a part.

(b) ELECTION TO ALLOCATE TO 1984 ONE-HALF OF STATE LIMIT FOR 1985, 1986, AND 1987.—Solely for purposes of issuing obligations described in subsection (a), the issuing authorities of a State may elect (at such time and in such manner as the Secretary of the Treasury shall by regulations prescribe) to take into account in 1984 one-half of the amount which would have been the State limit for the calendar years 1985, 1986, and 1987.

SEC. 645. LOCAL FURNISHING WHERE FACILITY INITIALLY AUTHORIZED BY FEDERAL GOVERNMENT.

For the purpose of section 103(b)(4)(E), facilities for the local furnishing of electric energy also shall include a facility that is part of a system providing service to the general populace—

(i) if the facility was initially authorized by the Federal Government in 1962;

(ii) if the facility receives financing of at least 25 percent by an exempt person;

(iii) if the electric energy generated by the facility is purchased by an electric cooperative qualified as a rural electric borrower under 7 U.S.C. section 901 et seq.; and

(iv) if the facility is located in a noncontiguous State.

SEC. 646. TREASURY DEPARTMENT DECISIONS AFFECTING TAX-EXEMPT BONDS.

(a) The Secretary of Education and the Secretary of the Treasury shall within 90 days of the date of enactment of this provision, establish procedures under which issuers affected by any decision of the Secretary of Education or his delegate under section 7 of the Student Loan Consolidation and Technical Amendments Act of 1983 may request and obtain a hearing and a review of such decision by the Secretary of the Treasury or his delegate followed by a written report to the Secretary of Education and to such person with respect to such review to be filed no later than 60 days of the request for review (unless the person requesting such review consents to an extension of time).

(b) Nothing in this section shall affect the exemption from income taxation of interest on any student loan bond or any issuer of such bonds.

SEC. 647. SPECIAL RULE FOR POSSESSIONS AND DISTRICT OF COLUMBIA.

Notwithstanding any other provision of law—

(1) the Virgin Islands and American Samoa shall have authority to issue industrial development bonds (within the meaning of section 103(b)(2) of the Internal Revenue Code of 1954), and

(2) the District of Columbia housing finance agency shall have the authority to issue obligations described in section 103(b)(4)(A) of such Code and to issue mortgage subsidy bonds (as defined in section 103A of such Code).

SEC. 648. SPECIAL ARBITRAGE RULE.

Securities or obligations are not described in section 103(c)(2)(A) or (B) of the Internal Revenue Code of 1954 and are not subject to yield restrictions to the extent that on the date of issue of a bond issue which is payable from the investment earnings on such securities or obligations—

(1) such securities or obligations are held in a fund which, except to the extent of the investment earnings on such securities or obligations, cannot be used, under State constitutional or statutory restrictions continuously in effect since October 9, 1969, to pay debt service on the bond issue or to finance the facilities that are to be financed with the proceeds of the bonds,

, (2) the fund has received no substantial discretionary contributions after October 9, 1969,

(3) the issuer (A) had a practice of issuing bonds secured by the investment earnings of the fund during the period commencing January 1, 1960, and ending on October 9, 1969, and (B) has had a continuous practice of issuing bonds secured by the investment earnings of the fund at least once during each 5-year period beginning on October 9, 1969, and

(4) the amount of securities or obligations benefitting from this rule cannot exceed the principal amount of bonds (to which such securities or other obligations would, but for this rule, be allocated) which could be issued under applicable laws restricting the amount of bonds that can be issued (but not restrictions on the purposes for which bonds can be issued) in effect on October 9, 1969, as applied to the facts on the day of issue.

TITLE VII—TECHNICAL CORRECTIONS

SEC. 701. COORDINATION WITH OTHER TITLES.

For purposes of applying the amendments made by any title of this Act other than this title, the provisions of this title shall be treated as having been enacted immediately before the provisions of such other titles.

Subtitle A—Amendments Related to the Tax Equity and Fiscal Responsibility Act of 1982

SEC. 711. TECHNICAL CORRECTIONS OF PROVISIONS RELATING TO INDIVIDUALS.

(a) AMENDMENTS RELATED TO SECTION 201.—

(1) DEFINITION OF REGULAR TAX.—Paragraph (2) of section 55(f) (defining regular tax) is amended by striking out "sections 72(m)(5)(B)" and inserting in lieu thereof "sections 47(a), 72(m)(5)(B)".

(2) SPECIAL ELECTION FOR INTANGIBLE DRILLING AND DEVELOPMENT COSTS LIMITED TO WELLS LOCATED IN THE UNITED STATES.—Subparagraph (A) of section 58(i)(4) (relating to special election for intangible drilling and development cost not allocable to interest as limited partner) is amended by inserting "(with respect to wells located in the United States)" after "intangible drilling costs".

(3) 3-YEAR AMORTIZATION FOR CIRCULATION EXPENSES.—

(A) Subparagraph (B) of section 57(a)(6) (relating to circulation and research and experimental expenditures) is amended to read as follows:

"(B) the amount which would have been allowable for the taxable year with respect to expenditures paid or incurred during such taxable year if—

"(i) the circulation expenditures described in section 173 had been capitalized and amortized ratably over the 3-year period beginning with the taxable year in which such expenditures were made, or

"(ii) the research and experimental expenditures described in section 174 had been capitalized and amortized ratably over the 10-year period beginning with the taxable year in which such expenditures were made."

(B) Paragraph (1) of section 58(i) (relating to optional 10-year writeoff of certain tax preferences) is amended by striking out "10-year period" and inserting in lieu thereof "10-year period (3-year period in the case of circulation expenditures described in section 173)".

(C) Subsection (b) of section 173 is amended by striking out "10-year" and inserting in lieu thereof "3-year".

(4) LOSSES TREATED AS INVESTMENT LOSSES.—Subparagraph (B) of section 55(e)(8) is amended to read as follows:

"(B) INCOME AND LOSSES TAKEN INTO ACCOUNT IN COMPUTING QUALIFIED NET INVESTMENT INCOME.—Any income or loss derived from a limited business interest shall be taken into account in computing qualified net investment income."

(5) TREATMENT OF ALCOHOL FUELS CREDIT.—Subparagraph (c) of section 55(b)(1) (defining alternative minimum taxable income) is amended by striking out "section 667" and inserting in lieu thereof "section 87 or 667".

(b) AMENDMENT RELATED TO SECTION 202.—Paragraph (5) of section 213(d) (relating to definitions) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (4)".

(c) AMENDMENTS RELATED TO SECTION 203.—

(1) CLARIFICATION OF ADJUSTED GROSS INCOME IN THE CASE OF ESTATES AND TRUSTS.—Paragraph (2) of section 165(h) (relating to casualty and theft losses) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of paragraph (1), the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income."

(2) COORDINATION OF SECTION 165(h) WITH SECTION 1231.—

(A) COORDINATION FOR 1984 AND SUBSEQUENT YEARS.—

(i) CLARIFICATION OF LOSSES TO WHICH SECTION 165(c)(3) APPLIES.—Paragraph (3) of section 165(c) (relating to limitation on loss of individuals) is amended by striking out "trade or business" and inserting in lieu thereof "trade or business or a transaction entered into for profit".

(ii) AMENDMENT OF SECTION 165(h).—Subsection (h) of section 165 (relating to casualty and theft losses) is amended to read as follows:

"(h) TREATMENT OF CASUALTY GAINS AND LOSSES.—

"(1) $100 LIMITATION PER CASUALTY.—Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds $100.

"(2) NET CASUALTY LOSS ALLOWED ONLY TO THE EXTENT IT EXCEEDS 10 PERCENT OF ADJUSTED GROSS INCOME.—

"(A) IN GENERAL.—If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of—

"(i) the amount of the personal casualty gains for the taxable year, plus

"(ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.

"(B) SPECIAL RULE WHERE PERSONAL CASUALTY GAINS EXCEED PERSONAL CASUALTY LOSSES.—If the personal casualty gains for any taxable year exceed the personal casualty losses for such taxable year—

"(i) all such gains shall be treated as gains from sales or exchanges of capital assets, and

"(ii) all such losses shall be treated as losses from sales or exchanges of capital assets.

"(3) DEFINITIONS OF PERSONAL CASUALTY GAIN AND PERSONAL CASUALTY LOSS.—For purposes of this subsection—

"(A) PERSONAL CASUALTY GAIN.—The term 'personal casualty gain' means the recognized gain from any involuntary conversion of property which is described in subsection (c)(3) arising from fire, storm, shipwreck, or other casualty, or from theft.

"(B) PERSONAL CASUALTY LOSS.—The term 'personal casualty loss' means any loss described in subsection (c)(3). For purposes of paragraph (2), the amount of any personal casualty loss shall be determined after the application of paragraph (1).

"(4) SPECIAL RULES.—

"(A) PERSONAL CASUALTY LOSSES ALLOWABLE IN COMPUTING ADJUSTED GROSS INCOME TO THE EXTENT OF PERSONAL CASUALTY GAINS.—In any case to which paragraph (2)(A) applies, the deduction for personal casualty losses for any taxable year shall be treated as a deduction allowable in computing adjusted gross income to the extent such losses do not exceed the personal casualty gains for the taxable year.

"(B) JOINT RETURNS.—For purposes of this subsection, a husband and wife making a joint return for the taxable year shall be treated as 1 individual.

"(C) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of paragraph (2), the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income.

"(D) COORDINATION WITH ESTATE TAX.—No loss described in subsection (c)(3) shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return."

(iii) SECTION 1231 NOT TO APPLY TO PERSONAL CASUALTY GAINS OR LOSSES.—Subsection (a) of section 1231 (relating to property used in the trade or business and involuntary conversions) is amended to read as follows:

"(a) GENERAL RULE.—

"(1) GAINS EXCEED LOSSES.—If—

"(A) the section 1231 gains for any taxable year, exceed

"(B) the section 1231 losses for such taxable year,

such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be.

"(2) GAINS DO NOT EXCEED LOSSES.—If—

"(A) the section 1231 gains for any taxable year, do not exceed

"(B) the section 1231 losses for such taxable year,

such gains and losses shall not not be treated as gains and losses from sales or exchanges of capital assets.

"(3) SECTION 1231 GAINS AND LOSSES.—For purposes of this subsection—

"(A) SECTION 1231 GAIN.—The term 'section 1231 gain' means—

"(i) any recognized gain on the sale or exchange of property used in the trade or business, and

"(ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of—

"(I) property used in the trade or business, or

"(II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

"(B) SECTION 1231 LOSS.—The term 'section 1231 loss' means any recognized loss from a sale or exchange or conversion described in subparagraph (A).

"(4) SPECIAL RULES.—For purposes of this subsection—

"(A) In determining under this subsection whether gains exceed losses—

"(i) the section 1231 gains shall be included only if and to the extent taken into account in computing gross income, and

"(ii) the section 1231 losses shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply.

"(B) Losses (including losses not compensated for by insurance or otherwise) on the destruction, in whole or in part, theft or seizure, or requisition or condemnation of—

"(i) property used in the trade or business, or

"(ii) capital assets which are held for more than 1 year and are held in connection with a trade or business or a transaction entered into for profit,

shall be treated as losses from a compulsory or involuntary conversion.

"(C) In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any—

"(i) property used in the trade or business, or

"(ii) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit,

this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions."

(iv) Sections 873(b)(1) and 931(d)(2)(B) are each amended by striking out ", for losses of property not connected with the trade or business if arising from certain casualties or theft," and inserting in lieu thereof "for losses".

(v) EFFECTIVE DATE.—The amendments made by this subparagraph shall apply to taxable years beginning after December 31, 1983.

(B) TRANSITIONAL RULE.—In the case of taxable years beginning before January 1, 1984—

(i) For purposes of paragraph (1)(B) of section 165(h) of the Internal Revenue Code of 1954, adjusted gross income shall be determined without regard to the application of section 1231 of such Code to any gain or loss from an involuntary conversion of property described in subsection (c)(3) of section 165 of such Code arising from fire, storm, shipwreck, or other casualty or from theft.

(ii) Section 1231 of such Code shall be applied after the application of paragraph (1) of section 165(h) of such Code.

(3) CLERICAL AMENDMENT.—Subsection (d) of section 6405 (relating to refunds attributable to certain disaster losses) is amended by striking out "section 165(h)" and inserting in lieu thereof "section 165(i)".

SEC. 712. TECHNICAL CORRECTIONS OF PROVISIONS PRIMARILY RELATING TO BUSINESSES.

(a) AMENDMENTS RELATED TO SECTION 204.—

(1) CLARIFICATION OF ADDITIONAL AMOUNT TREATED AS ORDINARY INCOME UNDER SECTION 1250.—

(A) Paragraph (1) of section 291(a) (relating to section 1250 capital gain treatment) is amended—

(i) by striking out "under section 1250" in subparagraph (B) and inserting in lieu thereof "under section 1250 (determined without regard to this paragraph)", and

(ii) by striking out "which is ordinary income" and inserting in lieu thereof "which is ordinary income under section 1250".

(B) Subsection (a) of section 1250 is amended by adding at the end thereof the following new paragraph:

"(4) CROSS REFERENCE.—

"For reduction in the case of corporations on capital gain treatment under this section, see section 291(a)(1)."

(2) INVESTMENT TAX CREDIT ALLOWED ONLY FOR MINERAL EXPLORATION AND DEVELOPMENT COSTS FOR DEPOSITS LOCATED IN THE UNITED STATES.—Clause (ii) of section 291(b)(2)(B) is amended by inserting "in the case of a deposit located in the United States," after "(ii)".

(3) CLARIFICATION OF COORDINATION WITH COST DEPLETION.—Paragraph (6) of section 291(b) (relating to coordination with cost depletion) is amended to read as follows:

"(6) COORDINATION WITH COST DEPLETION.—The portion of the adjusted basis of any property which is attributable to amounts to which paragraph (1) applied shall not be taken into account for purposes of determining depletion under section 611."

(4) CLARIFICATION OF DEFINITION OF INTEREST.—Subparagraph (B) of section 291(e)(1) (relating to interest on debt to carry tax-exempt obligations acquired after December 31, 1982) is amended by adding at the end thereof the following new clause:

"(iii) INTEREST.—For purposes of this subparagraph, the term 'interest' includes amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares."

(b) AMENDMENT RELATED TO SECTION 205.—Subsection (q) of section 48 (relating to basis adjustment to section 38 property) is amended by adding at the end thereof the following new paragraph:

"(6) ADJUSTMENT IN BASIS OF INTEREST IN PARTNERSHIP OR S CORPORATION.—The adjusted basis of—

"(A) a partner's interest in a partnership, and

"(B) stock in an S corporation,

shall be appropriately adjusted to take into account adjustments made under this subsection in the basis of property held by the partnership or S corporation (as the case may be)."

(c) AMENDMENT RELATED TO SECTION 207.—Paragraph (4) of section 189(e) (defining residential real property) is amended by striking out "or" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or", and by adding at the end thereof the following new subparagraph:

"(C) real property held by a cooperative housing corporation (as defined in section 216(b)) and used for dwelling purposes."

(d) AMENDMENTS RELATED TO SECTION 210.—

(1) SPECIAL RULE WHERE DEALER-LESSEE REQUIRED TO PURCHASE VEHICLE.—Paragraph (2) of section 210(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining terminal rental adjustment clause) is amended by adding at the end thereof the following new sentence: "Such term also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provision achieves substantially the same results as a provision described in the preceding sentence."

(2) EXCEPTION WHERE LESSEE TOOK POSITION ON RETURN THAT HE WAS OWNER.—Section 210 of the Tax Equity and Fiscal Responsibility

Act of 1982 is amended by adding at the end thereof the following new subsection:

"(c) EXCEPTION WHERE LESSEE TOOK POSITION ON RETURN.—Subsection (a) shall not apply to deny a deduction for interest paid or accrued claimed by a lessee with respect to a qualified motor vehicle agreement on a return of tax imposed by chapter 1 of the Internal Revenue Code of 1954 which was filed before the date of the enactment of this Act or to deny a credit for investment in depreciable property claimed by the lessee on such a return pursuant to an agreement with the lessor that the lessor would not claim the credit."

(e) AMENDMENT RELATED TO SECTION 211.—Subparagraph (A) of section 211(e)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to retention of old sections 907(b) and 904(f)(4) where taxpayer had separate basket foreign loss) is amended by striking out "the 8-year period" and inserting in lieu thereof "the 8-year period (or such shorter period as the taxpayer may select)".

(f) AMENDMENT RELATED TO SECTION 212.—Paragraph (1) of section 954(h) (defining foreign base company oil-related income) is amended by striking out "section 907(c)(2)" and inserting in lieu thereof "paragraphs (2) and (3) of section 907(c)".

(g) AMENDMENT RELATED TO SECTION 213.—The table contained in subparagraph (C) of section 936(a)(2) is amended by striking out "The percentage tax is:" and inserting in lieu thereof "The percentage is:".

(h) AMENDMENT RELATED TO SECTION 217.—Subsection (e) of section 217 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to effective date) is amended by adding at the end thereof the following new sentence: "For purposes of applying section 168(f)(8)(D)(v) of the Internal Revenue Code of 1954, the amendments made by subsection (c) shall apply to agreements entered into after the date of the enactment of this Act."

(i) AMENDMENTS RELATED TO SECTION 222.—(1) Sections 301(e)(2) and 302(f)(3) are each amended by striking out "partial or complete liquidation" and inserting in lieu thereof "complete liquidation".

(2) The paragraph heading of paragraph (1) of section 306(b) (relating to exceptions) is amended by striking out "INTEREST." and inserting in lieu thereof "INTEREST, ETC.".

(3) Paragraph (1) of section 543(a) (defining personal holding company income) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (A), and by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period.

(j) AMENDMENT RELATED TO SECTION 223.—Paragraph (1) of section 311(e) (defining qualified stock) is amended by adding at the end thereof the following new subparagraph:

"(C) RULES FOR PASSTHRU ENTITIES.—In the case of an S corporation, partnership, trust, or estate—

"(i) the determination of whether subparagraph (A) is satisfied shall be made at the shareholder, partner, or beneficiary level (rather than at the entity level), and

"(ii) the distribution shall be treated as made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity."

(k) AMENDMENTS RELATED TO SECTION 224.—(1) ASSETS TREATED AS SOLD AT FAIR MARKET VALUE.—

(A) IN GENERAL.—Paragraph (1) of section 338(a) (relating to general rule) is amended by inserting "at fair market value" after "acquisition date".

(B) BASIS OF ASSETS AFTER DEEMED PURCHASE.—Subsection (b) of section 338 (relating to price at which deemed sale made) is amended to read as follows:

"(b) BASIS OF ASSETS AFTER DEEMED PURCHASE.—

"(1) IN GENERAL.—For purposes of subsection (a), the assets of the target corporation shall be treated as purchased for an amount equal to the sum of—

"(A) the grossed-up basis of the purchasing corporation's recently purchased stock, and

"(B) the basis of the purchasing corporation's nonrecently purchased stock.

"(2) ADJUSTMENT FOR LIABILITIES AND OTHER RELEVANT ITEMS.—The amount described in paragraph (1) shall be adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items.

"(3) ELECTION TO STEP-UP THE BASIS OF CERTAIN TARGET STOCK.—

"(A) IN GENERAL.—Under regulations prescribed by the Secretary, the basis of the purchasing corporation's nonrecently purchased stock shall be the basis amount determined under subparagraph (B) of this paragraph if the purchasing corporation makes an election to recognize gain as if such stock were sold on the acquisition date for an amount equal to the basis amount determined under subparagraph (B).

"(B) DETERMINATION OF BASIS AMOUNT.—For purposes of subparagraph (A), the basis amount determined under this subparagraph shall be an amount equal to the grossed-up basis determined under subparagraph (A) of paragraph (1) multiplied by a fraction—

"(i) the numerator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

"(ii) the denominator of which is 100 percent minus the percentage referred to in clause (i).

"(4) GROSSED-UP BASIS.—For purposes of paragraph (1), the grossed-up basis shall be an amount equal to the basis of the corporation's recently purchased stock, multiplied by a fraction—

"(A) the numerator of which is 100 percent, minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

"(B) the denominator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.

"(5) ALLOCATION AMONG ASSETS.—The amount determined under paragraphs (1) and (2) shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.

"(6) DEFINITIONS OF RECENTLY PURCHASED STOCK AND NONRECENTLY PURCHASED STOCK.—For purposes of this subsection—

"(A) RECENTLY PURCHASED STOCK.—The term 'recently purchased stock' means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which was purchased by such corporation during the 12-month acquisition period.

"(B) NONRECENTLY PURCHASED STOCK.—The term 'nonrecently purchased stock' means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which is not recently purchased stock."

(2) COORDINATION WITH SECTION 333.—The last sentence of paragraph (1) of section 338(c) (relating to coordination with section 337 where purchasing corporation holds less than 100 percent of stock) is amended by striking out "such 1-year period" and inserting in lieu thereof "such 1-year period and section 333 does not apply to such liquidation".

(3) EXCEPTIONS TO DEEMED ELECTION RULE.—Paragraph (2) of section 338(e) (relating to exceptions) is amended—

(A) by striking out "(in whole or in part)" in subparagraph (B) and inserting in lieu thereof "wholly",

(B) by inserting "and" at the end of subparagraph (C), and

(C) by striking out subparagraphs (D) and (E) and inserting in lieu thereof the following:

"(D) such acquisition is described in regulations prescribed by the Secretary and meets such conditions as such regulations may provide."

(4) TIME FOR MAKING ELECTION.—Paragraph (1) of section 338(g) (relating to election) is amended to read as follows:

"(1) WHEN MADE.—Except as otherwise provided in regulations, an election under this section shall be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs."

(5) DEFINITION OF PURCHASE.—

(A) Subparagraph (B) of section 338(h)(3) (defining purchase) is amended to read as follows:

"(B) DEEMED PURCHASE UNDER SUBSECTION (a).—The term 'purchase' includes any deemed purchase under subsection (a)(2). The acquisition date for a corporation which is deemed purchased under subsection (a)(2) shall be determined under regulations prescribed by the Secretary."

(B) Paragraph (3) of section 338(h) is amended by adding at the end thereof the following new subparagraph:

"(C) CERTAIN STOCK ACQUISITIONS FROM RELATED CORPORATIONS.—

"(i) IN GENERAL.—Clause (ii) of subparagraph (A) shall not apply to an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase (within the meaning of subparagraph (A) and (B)).

"(ii) CERTAIN DISTRIBUTIONS.—Clause (i) of subparagraph (A) shall not apply to an acquisition of stock described in clause (i) of this subparagraph if the corporation acquiring such stock—

"(I) made a qualified stock purchase of stock of the related corporation, and

"(II) made an election under this section (or is treated under subsection (e) as having made such an election) with respect to such qualified stock purchase.

"(iii) RELATED CORPORATION DEFINED.—For purposes of this subparagraph, a corporation is a related corporation if stock owned by such corporation is treated (under section 318(a) other than paragraph (4) thereof) as owned by the corporation acquiring the stock."

(C) Paragraph (1) of section 338(h) (defining 12-month acquisition period) is amended by inserting before the period at the end thereof the following: "(or, if any of such stock was acquired in an acquisition which is a purchase by reason of subparagraph (C) of paragraph (3), the date on which the acquiring corporation is first considered under section 318(a) (other than paragraph (4) thereof) as owning stock owned by the corporation from which such acquisition was made)."

(D) clause (ii) of section 338(h)(3)(A) (defining purchase) is amended to read as follows:

"(ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and".

(E) Paragraph (4) of section 318(b) (relating to cross references) is amended to read as follows: "(4) section 338(h)(3) (defining purchase);".

(6) SPECIAL RULES FOR APPLYING SECTION 338.—

(A) Subsection (h) of section 338 (relating to definitions and special rules) is amended by striking out paragraph (7), by redesignating paragraphs (8) and (9) as paragraphs (9) and (10), respectively, and by inserting after paragraph (6) the following new paragraphs:

"(7) ADDITIONAL PERCENTAGE MUST BE ATTRIBUTABLE TO PURCHASE, ETC.—For purposes of subsection (c)(1), any increase in the maximum percentage of stock taken into account over the percentage of stock (by value) of the target corporation held by the purchasing corporation on the acquisition date shall be taken into account only to the extent such increase is attributable to—

"(A) purchase, or

"(B) a redemption of stock of the target corporation—

"(i) to which section 302(a) applies, or

"(ii) in the case of a shareholder who is not a corporation, to which section 301 applies.

"(8) ACQUISITIONS BY AFFILIATED GROUP TREATED AS MADE BY 1 CORPORATION.—Except as provided in regulations prescribed by the Secretary, stock and asset acquisitions made by members of the same affiliated group shall be treated as made by 1 corporation."

(B) Paragraph (9) of section 338(h), as redesignated by subparagraph (A), is amended by striking out "paragraph (9)" and inserting in lieu thereof "paragraph (10)".

(C) Subsection (h) of section 338 is amended by adding at the end thereof the following new paragraphs:

"(11) ELECTIVE FORMULA FOR DETERMINING FAIR MARKET VALUE.—For purposes of subsection (a)(1), fair market value may be determined on the basis of a formula provided in regulations prescribed by the Secretary which takes into account liabilities and other relevant items.

"(12) SECTION 337 TO APPLY WHERE TARGET HAD ADOPTED PLAN FOR COMPLETE LIQUIDATION.—If—

"(A) during the 12-month period ending on the acquisition date the target corporation adopted a plan of complete liquidation,

"(B) such plan was not rescinded before the close of the acquisition date, and

"(C) the purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election) with respect to the target corporation,

then, subject to rules similar to the rules of section 337 subsection (c)(1), for purposes of section 337 (and other provisions which relate to section 337), the target corporation shall be treated as having distributed all of its assets as of the close of the acquisition date.

"(13) TAX ON DEEMED SALE NOT TAKEN INTO ACCOUNT FOR ESTIMATED TAX PURPOSES.—For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account.

"(14) COORDINATION WITH SECTION 341.—For purposes of determining whether section 341 applies to a disposition within 1 year after the acquisition date of stock by a shareholder (other than the acquiring corporation) who held stock in the target corporation on the acquisition date, section 341 shall be applied without regard to this section.

"(15) COMBINED DEEMED SALE RETURN.—Under regulations prescribed by the Secretary, a combined deemed sale return may be filed by all target corporations acquired by a purchasing corporation on the same acquisition date if such target corporations were members of the same selling consolidated group (as defined in subparagraph (B) of paragraph (10)).".

(7) Subsection (i) of section 338 (relating to regulations) is amended to read as follows:

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including—

"(1) regulations to ensure that the purpose of this section to require consistency of treatment of stock and asset sales and purchases may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations) and

"(2) regulations providing for the coordination of the provisions of this section with the provision of this title relating to foreign corporations and their shareholders."

(8) TREATMENT OF CERTAIN LIQUIDATIONS.—

(A) IN GENERAL.— Section 269 (relating to acquisitions made to evade or avoid income tax) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) CERTAIN LIQUIDATIONS AFTER QUALIFIED STOCK PURCHASES.—

"(1) IN GENERAL.—If—

"(A) there is a qualified stock purchase by a corporation of another corporation,

"(B) an election is not made under section 338 with respect to such purchase,

"(C) the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than 2 years after the acquisition date, and

"(D) the principal purpose for such liquidation is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring corporation would not otherwise enjoy,

then the Secretary may disallow such deduction, credit, or other allowance.

"(2) MEANING OF TERMS.—For purposes of paragraph (1), the terms 'qualified stock purchase' and 'acquisition date' have the same respective meanings as when used in section 338."

(B) CONFORMING AMENDMENT.—Subsection (c) of section 269 (as redesignated by subparagraph (A)) is amended by striking out "subsection (a)" and inserting in lieu thereof "subsection (a) or (b)".

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to liquidations after October 20, 1983, in taxable years ending after such date.

(9) AMENDMENTS NOT TO APPLY TO ACQUISITIONS BEFORE SEPTEMBER 1, 1982.—

(A) IN GENERAL.—The amendments made by this subsection shall not apply to any qualified stock purchase (as defined in section 338(d)(3) of the Internal Revenue Code of 1954) where the acquisition date (as defined in section 338(h)(2) of such Code) is before September 1, 1982.

(B) EXTENSION OF TIME FOR MAKING ELECTION.—In the case of any qualified stock purchase described in subparagraph (A), the time for making an election under section 338 of such Code shall not expire before the close of the 60th day after the date of the enactment of this Act.

(10) SPECIAL RULES FOR DEEMED PURCHASES UNDER PRIOR LAW.—If, before October 20, 1983, a corporation was treated as making a qualified stock purchase (as defined in section 338(d)(3) of the Internal Revenue Code of 1954), but would not be so treated under the amendments made by paragraphs (5) and (6) of this subsection, the amendments made by such paragraphs shall not apply to such purchase unless such corporation elects (at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe) to have the amendments made by such paragraphs apply.

(l) AMENDMENTS RELATED TO SECTION 226.—

(1) AMOUNT CONSTITUTING DIVIDEND.—Paragraph (2) of section 304(b) (relating to amount constituting dividend) is amended to read as follows:

"(2) AMOUNT CONSTITUTING DIVIDEND.—In the case of any acquisition of stock to which subsection (a) applies, the determination of the amount which is a dividend (and the source thereof) shall be made as if the property were distributed—

"(A) by the acquiring corporation to the extent of its earnings and profits, and

"(B) then by the issuing corporation to the extent of its earnings and profits."

(2) COORDINATION WITH SECTION 351.—Subparagraph (A) of section 304(b)(3) (relating to coordination with section 351) is amended by striking out "(and not part III)" and inserting in lieu thereof "(and not section 351 and not so much of sections 357 and 358 as relates to section 351)".

(3) CERTAIN ASSUMPTIONS OF LIABILITY.—

(A) The first sentence of clause (i) of section 304(b)(3)(B) (relating to certain assumptions of liability, etc.) is amended by striking out "Subsection (a)" and inserting in lieu thereof "In the case of an acquisition described in section 351, subsection (a)".

(B) Subparagraph (B) of section 304(b)(3) (relating to coordination with section 351) is amended by adding at the end thereof the following new clause:

"(iii) CLAUSE (i) DOES NOT APPLY TO STOCK ACQUIRED FROM RELATED PERSON EXCEPT WHERE COMPLETE TERMINATION.—Clause (i) shall apply only to stock acquired by the transferor from a person—

"(I) none of whose stock is attributable to the transferor under section 318(a) (other than paragraph (4) thereof), or

"(II) who satisfies rules similar to the rules of section 302(c)(2) with respect to both the acquiring and the issuing corporations (determined as if such person were a distributee of each such corporation)."

(4) DISTRIBUTIONS INCIDENT TO FORMATION OF BANK HOLDING COMPANIES.—Subparagraph (C) of section 304(b)(3) (relating to distributions incident to formation of bank holding companies) is amended by adding at the end thereof the following new sentence: "For purposes of this subparagraph, any assumption of (or acquisition of stock subject to) a liability under subparagraph (B) shall not be treated as a distribution of property."

(5) CONSTRUCTIVE OWNERSHIP.—

(A) Paragraph (3) of section 304(c) (relating to constructive ownership) is amended to read as follows:

"(3) CONSTRUCTIVE OWNERSHIP.—

"(A) IN GENERAL.—Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this section.

"(B) MODIFICATION OF 50-PERCENT LIMITATIONS IN SECTION 318.—For purposes of subparagraph (A)—

"(i) paragraph (2)(C) of section 318(a) shall be applied by substituting '5 percent' for '50 percent', and

"(ii) paragraph (3)(C) of section 318(a) shall be applied—

"(I) by substituting '5 percent' for '50 percent', and

"(II) in any case where such paragraph would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation."

(B) Paragraph (4) of section 306(c) is amended by striking out the last sentence and inserting in lieu thereof the following: "For purposes of applying the preceding sentence to paragraph (3), the rules of section 304(c)(3)(B) shall apply."

(6) CERTAIN STOCK ACQUIRED IN SECTION 351 EXCHANGE.—Paragraph (3) of section 306(c) (relating to certain stock acquired in section 351 exchange) is amended by striking out the last sentence and inserting in lieu thereof the following: "Rules similar to the rules of section 304(b)(2) shall apply—

"(A) for purposes of the preceding sentence, and

"(B) for purposes of determining the application of this section to any subsequent disposition of stock which is section 306 stock by reason of an exchange described in the preceding sentence."

(7) EFFECTIVE DATES FOR AMENDMENTS MADE BY PARAGRAPHS (1) AND (3).—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, the amendments made by paragraphs (1) and (3) shall apply to stock acquired after June 18, 1984, in taxable years ending after such date.

(B) ELECTION BY TAXPAYER TO HAVE AMENDMENTS APPLY EARLIER.—Any taxpayer may elect, at such time and in such manner as the Secretary of the Treasury or his delegate may prescribe, to have the amendments made by paragraphs (1) and (3) apply as if included in section 226 of the Tax Equity and Fiscal Responsibility Act of 1982.

(C) SPECIAL RULE FOR CERTAIN TRANSFERS TO FORM BANK HOLDING COMPANY.—Except as provided in subparagraph (D), the amendments made by paragraphs (1) and (3) shall not apply to transfers pursuant to an application to form a BHC (as defined in section 304(b)(3)(D)(ii) of the Internal Revenue Code of 1954) filed with the Federal Reserve Board before June 18, 1984, if—

(i) such BHC was formed not later than the 90th day after the date of the last required approval of any regulatory authority to form such BHC, and

(ii) such BHC did not elect (at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe) not to have the provisions of this subparagraph apply.

(D) AMENDMENTS TO APPLY TO CERTAIN LIABILITIES INCURRED BEFORE OCTOBER 20, 1983.—The amendment made by paragraph (3)(A) shall apply to the acquisition of any stock to the extent the liability assumed, or to which such stock is subject, was incurred by the transferor after October 20, 1983.

(m) AMENDMENT RELATED TO SECTION 229.—Subsection (c) of section 229 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to modification of regulations on the completed contract method of accounting) is amended by adding at the end thereof the following new paragraph:

"(4) UNDERPAYMENTS OF ESTIMATED TAX FOR 1982.—To the extent provided in regulations, no addition to tax shall be made under section 6654 or 6655 of the Internal Revenue Code of 1954 for the taxpayer's first taxable year ending after December 31, 1982, by reason of a long-term contract, but only with respect to installments required to be paid before April 13, 1983."

(n) AMENDMENT RELATED TO SECTION 233.—Paragraph (11) of section 51(d) (defining members of economically disadvantaged families) is amended by adding at the end thereof the following new sentence: "Any such determination with respect to an individual who is a qualified summer youth employee or youth participating in a qualified cooperative education program with respect to any employer shall also apply for purposes of determining whether such individual is a member of another targeted group with respect to such employer."

SEC. 713. TECHNICAL CORRECTIONS OF PENSION PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 235.—

(1) ACTUARIAL ADJUSTMENTS MADE TO BENEFIT LIMIT RATHER THAN TO BENEFIT.—

(A) Subparagraph (C) of section 415(b)(2) (relating to adjustment to $90,000 limit where benefit begins before age 62) is amended by striking out the first sentence and inserting in lieu thereof the following: "If the retirement income benefit under the plan begins before age 62, the determination as to whether the $90,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by reducing the limitation of paragraph (1)(A) so that such limitation (as so reduced) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $90,000 annual benefit beginning at age 62."

(B) Subparagraph (D) of section 415(b)(2) (relating to adjustment to $90,000 limitation where benefit begins after age 65) is amended to read as follows:

"(D) ADJUSTMENT TO $90,000 LIMIT WHERE BENEFIT BEGINS AFTER AGE 65.—If the retirement income benefit under the plan begins after age 65, the determination as to whether the $90,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by increasing the limitation of paragraph (1)(A) so that such limitation (as so increased) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $90,000 annual benefit beginning at age 65."

(C)(i) Clauses (i) and (iii) of section 415(b)(2)(E) are each amended by striking out "any benefit" and inserting in lieu thereof "any benefit or limitation".

(ii) Clause (ii) of section 415(b)(2)(E) is amended by striking out "any benefit" and inserting in lieu thereof "any limitation".

(2) DEFINITION OF CURRENT ACCRUED BENEFIT IN THE CASE OF COLLECTIVELY BARGAINED PLANS.—Clause (i) of section 235(g)(4)(B) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining current accrued benefit) is amended by adding at the end thereof the following new sentence: "In the case of any plan described in the first sentence of paragraph (5), the preceding sentence shall be applied by substituting for 'January 1, 1983' the applicable date determined under paragraph (5)."

(3) TRANSITION FRACTION ONLY APPLIES TO PLANS IN EXISTENCE BEFORE JULY 1, 1982.—Paragraph (6) of section 415(e) (relating to special transition rule for defined contribution fraction for years ending after December 31, 1982) is amended by adding at the end thereof the following new subparagraph:

"(C) PLAN MUST HAVE BEEN IN EXISTENCE ON OR BEFORE JULY 1, 1982.—This paragraph shall apply only to plans which were in existence on or before July 1, 1982."

(4) TREATMENT OF CERTAIN COLLECTIVE BARGAINING AGREEMENTS ENTERED INTO BEFORE JULY 1, 1982.—Clause (ii) of section 235(g)(4)(B) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining current accrued benefit) is amended by adding at the end thereof the following new sentence: "For purposes of subclause (I), any change in the terms and conditions of the plan pursuant to a collective bargaining agreement entered into before July 1, 1982, and ratified before September 3, 1982, shall be treated as a change made before July 1, 1982."

(b) AMENDMENTS RELATED TO SECTION 236.—

(1) EXCEPTION FOR CERTAIN LOANS NOT TO APPLY TO LOANS FROM DEDUCTIBLE EMPLOYEE CONTRIBUTIONS.—

(A) Subparagraph (A) of section 72(o)(3) (relating to amounts constructively received) is amended by striking out "subsection (p)" and inserting in lieu thereof "subsection (p) (other than the exception contained in paragraph (2) thereof)".

(B) Subparagraph (A) of section 72(p)(2) (relating to exception for certain loans) is amended by adding at the end thereof the following new sentence:

"For purposes of clause (ii), the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (o)(5)(B))."

(2) DEFINITION OF REQUIRED PRINCIPAL PAYMENT.—Subparagraph (C) of section 236(c)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by inserting before the period at the end thereof the following: "or if such loan was payable on demand".

(3) REPEAL OF PROVISION TREATING CERTAIN LOAN REPAYMENTS AS CONTRIBUTIONS.—Subsection (f) of section 404 (relating to certain loan repayments considered as contributions) is hereby repealed.

(4) CLARIFICATION OF EXCEPTION FOR SMALL LOANS.—Clause (ii) of section 72(p)(2)(A) (relating to exception for certain loans) is amended to read as follows:

"(ii) the greater of (I) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or (II) $10,000."

(c) AMENDMENTS RELATED TO SECTION 237.—

(1) AMENDMENTS CONFORMING TO LIMITING TO KEY EMPLOYEES THE PENALTY FOR PREMATURE DISTRIBUTIONS.—

(A) Clause (i) of section 72(m)(5)(A) is amended by striking out "as an owner-employee" and inserting in lieu thereof "as a key employee".

(B) The paragraph heading of section 72(m)(5) is amended by striking out "OWNER-EMPLOYEES" and inserting in lieu thereof "KEY EMPLOYEES".

(C) Sections 46(a)(4), 53(a), and 901(a) are each amended by striking out "tax on premature distributions to owner-employees" and inserting in lieu thereof "tax on premature distributions to key employees".

(2) CORRECTION OF CROSS REFERENCE TO DEFINITION OF BANK.—

(A) Subsection (f) of section 401 is amended by striking out "(as defined in subsection (d)(1))" and inserting in lieu thereof "(as defined in section 408(n))".

(B) Subsection (h) of section 408 is amended by striking out "(as defined in section 401(d)(1))" and inserting in lieu thereof "(as defined in subsection (n))".

(3) LIMITATION ON ROLLOVERS TO APPLY ONLY TO KEY EMPLOYEES.—Clause (ii) of section 402(a)(5)(E) (relating to self-employed individuals and owner-employees) is amended to read as follows:

"(ii) KEY EMPLOYEES.—An eligible retirement plan described in subclause (IV) or (V) of subparagraph (D)(iv) shall not be treated as an eligible retirement plan for the transfer of a distribution if any part of the distribution is attributable to contributions made on behalf of the employee while he was a key employee in a top-heavy plan. For purposes of the preceding sentence, the terms 'key employee' and 'top-heavy plan' have the same respective meanings as when used in section 416."

(d) AMENDMENTS RELATED TO SECTION 238.—

(1) REPEAL OF SECTION 72(m)(9).—Paragraph (9) of section 72(m) (relating to return of excess contributions before due date of return) is hereby repealed.

(2) INCREASE IN AMOUNT OF DEDUCTION FOR SIMPLIFIED EMPLOYEE PENSIONS.—Clause (ii) of section 219(b)(2)(A) (relating to special rules

for employer contributions under simplified employee pensions) is amended by striking out "but not in excess of $15,000" and inserting in lieu thereof "but not in excess of the limitation in effect under section 415(c)(1)(A)".

(3) REPEAL OF SECTION 401(e).—Subsection (e) of section 401 (relating to contributions for premiums on annuity, etc., contracts) is hereby repealed.

(4) REPEAL OF SECTION 404(a)(9).—

(A) Subsection (a) of section 404 is amended by striking out paragraph (9) and by redesignating paragraph (10) as paragraph (9).

(B) Subparagraph (C) of section 415(c)(6) is amended—

(i) by striking out "paragraph (10) of section 404(a)" and inserting in lieu thereof "paragraph (9) of section 404(a)",

(ii) by striking out "section 404(a)(10)(A)" and inserting in lieu thereof "section 404(a)(9)(A)", and

(iii) by striking out "section 404(a)(10)(B)" and inserting in lieu thereof "section 404(a)(9)(B)".

(5) REPEAL OF SECTION 404(h)(4).—Paragraph (4) of section 404(h) (relating to effect on self-employed individuals or shareholder employees) is hereby repealed.

(6) DETERMINATION OF EARNED INCOME OF SELF-EMPLOYED FOR PURPOSES OF SECTION 404(a)(8)(D).—Subparagraph (D) of section 404(a)(8) is amended by striking out "the earned income of such individual" and inserting in lieu thereof "the earned income of such individual (determined without regard to the deductions allowed by this section and section 405(c))".

(7) REPEAL OF SECTION 415(C)(7).—

(A) Subsection (c) of section 415 is amended by striking out paragraph (7) and by redesignating paragraph (8) as paragraph (7).

(B) Subclause (II) of section 415(e)(3)(B)(ii) is amended by striking out "subsection (c)(7) or (8)" and inserting in lieu thereof "subsection (c)(7)".

(8) COORDINATION OF REPEALS OF CERTAIN SECTIONS.—Sections 404(e) and 1379(b) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of the Tax Equity and Fiscal Responsibility Act of 1982) shall not apply to any plan to which section 401(j) of such Code applies (or would apply but for its repeal).

(9) AMENDMENT OF SECTION 404(e).—Subsection (e) of section 404 is amended by striking out "under this section" and inserting in lieu thereof "under paragraph (1), (2), or (3) of subsection (a)".

(e) AMENDMENT RELATED TO SECTION 239.—Subparagraph (B) of section 101(b)(3) (relating to treatment of self-employed individuals for exclusion of employees' death benefits) is amended to read as follows:

"(B) SPECIAL RULE FOR CERTAIN DISTRIBUTIONS.—In the case of any amount paid or distributed—

"(i) by a trust described in section 401(a) which is exempt from tax under section 501(a), or

"(ii) under a plan described in section 403(a),

the term 'employee' includes a self-employed individual described in section 401(c)(1)."

(f) AMENDMENTS RELATED TO SECTION 240.—

(1) DEFINITION OF KEY EMPLOYEE.—

(A) Subparagraph (A) of section 416(i)(1) (defining key employee) is amended by striking out "any participant in an employer plan" and inserting in lieu thereof "an employee".

(B) Clause (ii) of section 416(i)(1)(A) is amended to read as follows:

"(ii) 1 of the 10 employees having annual compensation from the employer of more than the limitation in effect under section 415(c)(1)(A) and owning (or considered as owning within the meaning of section 318) the largest interests in the employer,".

(C) Subparagraph (A) of section 416(i)(1) (defining key employee) is amended by adding at the end thereof the following new sentence: "For purposes of clause (ii), if 2 employees have the same interest in the employer, the employee having greater annual compensation from the employer shall be treated as having a larger interest."

(D) Subparagraph (C) of section 416(i)(1) is amended by striking out "DETERMINING 5-PERCENT OR 1-PERCENT OWNERS" in the subparagraph heading and inserting in lieu thereof "DETERMINING OWNERSHIP IN THE EMPLOYER".

(2) TREATMENT OF SIMPLIFIED EMPLOYEE PENSIONS.—Paragraph (1) of section 408(k) (defining simplified employee pension) is amended to read as follows:

"(1) IN GENERAL.—For purposes of this title, the term 'simplified employee pension' means an individual retirement account or individual retirement annuity—

"(A) with respect to which the requirements of paragraphs (2), (3), (4), and (5) of this subsection are met, and

"(B) if such account or annuity is part of a top-heavy plan (as defined in section 416), with respect to which the requirements of section 416(c)(2) are met."

(3) CLARIFICATION OF TRANSITIONAL RULE.—Paragraph (3) of section 235(g) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new sentence: "A similar rule shall apply with respect to the last plan year beginning before January 1, 1984, for purposes of applying section 416(h) of the Internal Revenue Code of 1954."

(4) TREATMENT OF DISTRIBUTIONS FROM TERMINATED PLANS.—Paragraph (3) of section 416(g) (relating to distributions during last 5 years taken into account) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall also apply to distributions under a terminated plan which (if it had not been terminated) would have been required to be included in an aggregation group."

(5) CLARIFICATION OF COST-OF-LIVING ADJUSTMENTS.—

(A) IN GENERAL.—Paragraph (2) of section 416(d) (relating to cost-of-living adjustments) is amended by striking out "in the same manner" and inserting in lieu thereof "at the same time and in the same manner".

(B) SIMPLIFIED EMPLOYEE PENSIONS.—Subparagraph (C) of section 408(k)(3) (relating to contributions must bear uniform relationship to total compensation) is amended by adding at the end thereof the following new sentence: "The Secretary shall annually adjust the $200,000 amount contained in the preceding sentence at the same time and in the same manner as he adjusts the dollar amount contained in section 415(c)(1)(A)."

(6) CLERICAL AMENDMENTS.—

(A) Subsection (j) of section 416 is amended by striking out "require" and inserting in lieu thereof "required".

(B) Clause (iii) of section 416(i)(1)(B) is amended by striking out "subparagraph (A)(ii)(II)" and inserting in lieu thereof "subparagraph (A)(ii)".

(g) AMENDMENTS RELATED TO SECTION 243.—

(1) EFFECTIVE DATE FOR PROVISIONS RELATED TO INHERITED INDIVIDUAL RETIREMENT PLANS.—Subsection (c) of section 243 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended to read as follows:

"(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to individuals dying after December 31, 1983."

(2) CLERICAL AMENDMENT.—The subparagraph (C) of section 408(d)(3) which was added by section 335(a)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 is redesignated as subparagraph (D).

(h) AMENDMENT RELATED TO SECTION 247.—Subsection (a) of section 247 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to existing personal service corporations may liquidate under section 333 during 1983 and 1984) is amended by inserting "which is in existence on September 3, 1982," after "section 535(c)(2)(B) of the Internal Revenue Code of 1954)".

(i) AMENDMENT RELATED TO SECTION 248.—Paragraph (2) of section 414(n) (defining leased employee) is amended by striking out "any person" in the material preceding subparagraph (A) and inserting in lieu thereof "any person who is not an employee of the recipient and".

(j) AMENDMENT RELATED TO SECTION 249.—Subparagraph (D) of section 408(k)(3) (relating to treatment of certain contributions and taxes) is amended by striking out the second and third sentences and inserting in lieu thereof the following: "If the employer does not maintain an integrated plan at any time during the taxable year, OASDI contributions (as defined in section 401(l)(2)) may, for purposes of this paragraph, be taken into account as contributions by the employer to the employee's simplified employee pension, but only if such contributions are so taken into account with respect to each employee maintaining a simplified employee pension."

(k) AMENDMENTS RELATED TO SECTION 253.—

(1) LIMITATION OF PROFIT-SHARING AND STOCK BONUS PLANS.—Subparagraph (C) of section 415(c)(3) is amended by striking out "In the case of a participant" and inserting in lieu thereof "In the case of a participant in a profit-sharing or stock bonus plan".

(2) CLARIFICATION OF RULE THAT CONTRIBUTIONS BE NONFORFEITABLE.—Subparagraph (C) of section 415(c)(3) (relating to special rules for permanent and total disability) is amended by striking out the last sentence and inserting in lieu thereof the following: "This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made."

SEC. 714. MISCELLANEOUS PROVISIONS.

(a) AMENDMENT RELATED TO SECTION 255.—Subsection (c) of section 811 (relating to special rule for dividends to policyholders under reinsurance contracts) is amended by striking out "conventional coinsurance contract" and inserting in lieu thereof "reinsurance contract".

(b) AMENDMENT RELATED TO SECTION 281A.—Paragraph (2) of section 281A(b) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by striking out "subsection (a)" and inserting in lieu thereof "paragraph (1)".

(c) AMENDMENT RELATED TO SECTION 292.—Paragraph (2) of section 7430(a) (relating to awarding of court costs and certain fees) is amended by striking out "including the Tax Court" and inserting in lieu thereof "including the Tax Court and the United States Claims Court".

(d) AMENDMENT RELATED TO SECTION 309.—Paragraph (2) of section 6042(b) (relating to exceptions from dividend reporting requirements) is amended to read as follows:

"(2) EXCEPTIONS.—For purposes of this section, the term 'dividend' does not include any distribution or payment—

"(A) to the extent provided in regulations prescribed by the Secretary—

"(i) by a foreign corporation, or

"(ii) to a foreign corporation, a nonresident alien, or a partnership not engaged in a trade or business in the United States and

composed in whole or in part of nonresident aliens, or

"(B) except to the extent otherwise provided in regulations prescribed by the Secretary, to any person described in section 6049(b)(4)."

(e) AMENDMENTS RELATED TO SECTION 311.—

(1) IN GENERAL.—Section 6045(c) (relating to returns of brokers) is amended by adding at the end thereof the following new paragraph:

"(4) PERSON.—The term 'person' includes any governmental unit and any agency or instrumentality thereof."

(2) NO PENALTY FOR PAYMENTS BEFORE JANUARY 1, 1985.—No penalty shall be imposed under the Internal Revenue Code of 1954 with respect to any person required (by reason of the amendment made by paragraph (1)) to file a return under section 6045 of such Code with respect to any payment before January 1, 1985.

(f) AMENDMENT RELATED TO SECTION 314.—Subparagraph (E) of section 6678(a)(3) is amended by striking out "section 6053(c)" and inserting in lieu thereof "section 6053".

(g) AMENDMENTS RELATED TO SECTION 320.—

(1) PERMITTING THE JOINDER OF REFUND AND INJUNCTIVE ACTIONS WITH RESPECT TO CERTAIN PENALTIES.—Section 7422 (relating to civil actions for refund) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) SPECIAL RULE FOR ACTIONS WITH RESPECT TO TAX SHELTER PROMOTER AND UNDERSTATEMENT PENALTIES.—No action or proceeding may be brought in the United States Claims Court for any refund or credit of a penalty imposed by section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability)."

(2) AMENDMENT TO TITLE 28.—Chapter 91 of title 28, United States Code, is amended by adding at the end thereof the following new section:

"§ 1509. No jurisdiction in cases involving refunds of tax shelter promoter and understatement penalties

"The United States Claims Court shall not have jurisdiction to hear any action or proceeding for any refund or credit of any penalty imposed under section 6700 of the Internal Revenue Code of 1954 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 of such Code (relating to penalties for aiding and abetting understatement of tax liability)."

(3) CONFORMING AMENDMENT.—The table of sections for chapter 91 of title 28, United States Code, is amended by adding at the end thereof the following new item:

"1509. No jurisdiction in cases involving refunds of tax shelter promoter and understatement penalties."

(4) EFFECTIVE DATE.—The amendments made by this subsection shall apply to any claim for refund or credit filed after the date of the enactment of this Act.

(h) AMENDMENTS RELATED TO SECTION 323.—

(1) Subsection (b) of section 5684 is amended—

(A) by striking out "SECTION 6660" in the heading and inserting in lieu thereof "SECTION 6662", and

(B) by striking out "section 6660(a)" in the text and inserting in lieu thereof "section 6662(a)".

(2) Subsection (c) of section 5761 is amended—

(A) by striking out "SECTION 6660" in the heading and inserting in lieu thereof "SECTION 6662", and

(B) by striking out "section 6660(a)" in the text and inserting in lieu thereof "section 6662(a)".

(3) Clause (ii) of section 6661(b)(2)(A) (defining understatement) is amended by inserting ", reduced by any rebate (within the meaning of section 6211(b)(2))" after "return".

(i) AMENDMENT RELATED TO SECTION 333.—Section 7609(c)(1) (relating to summons to which section applies) is amended by striking out "section 7602" and inserting in lieu thereof "section 7602(a)".

(j) AMENDMENTS RELATED TO SECTION 334.—

(1) CLARIFICATION THAT DEATH BENEFIT EXCLUSION APPLIES TO DISTRIBUTIONS UNDER SECTION 403(b).—Subparagraph (C) of section 3405(b)(2) (relating to special rule for distributions by reason of death) is amended to read as follows:

"(C) SPECIAL RULE FOR DISTRIBUTIONS BY REASON OF DEATH.—In the case of any nonperiodic distribution from or under any plan or contract described in section 401(a), 403(a), or 403(b)—

"(i) which is made by reason of a participant's death, and

"(ii) with respect to which the requirements of clauses (ii) and (iv) of subsection (d)(4)(A) are met,

subparagraph (A) or (B) (as the case may be) shall be applied by taking into account the exclusion from gross income provided by section 101(b) (whether or not allowable)."

(2) CLARIFICATION OF CREDIT FOR WITHHELD AMOUNTS.—Paragraph (1) of section 31(a) is amended by striking out "under section 3402 as tax on the wages of any individual" and inserting in lieu thereof "as tax under chapter 24".

(3) PENALTY FOR FAILURE TO GIVE NOTICE.—Section 6652 (relating to penalty for failure to file certain information returns, registration statements, etc.) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) FAILURE TO GIVE NOTICE TO RECIPIENTS OF CERTAIN PENSION, ETC., DISTRIBUTIONS.—In the case of each failure to provide notice as required by section 3405(d)(10)(B), at the time prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such notice, an amount equal to $10 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $5,000."

(4) EXCEPTION FOR AMOUNTS PAID TO NONRESIDENT ALIENS.—Subparagraph (B) of section 3405(d)(1) (relating to exceptions) is amended by striking out "and" at the end of clause (i), by striking out the period at the end of clause (ii) and inserting in lieu thereof ", and", and by adding at the end thereof the following new clause:

"(iii) any amount which is subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty."

(5) CLARIFICATION OF AMOUNT WITHHELD WHERE EMPLOYER SECURITY DISTRIBUTED.—Paragraph (8) of section 3405(d) (relating to maximum amount withheld) is amended by adding at the end thereof the following new sentence: "No amount shall be required to be withheld under this section in the case of any designated distribution which consists only of employer securities of the employer corporation (within the meaning of section 402(a)(3)) and cash (not in excess of $200) in lieu of fractional shares."

(k) AMENDMENT RELATED TO SECTION 337.—Subsection (d) of section 982 (relating to admissibility of documentation maintained in foreign countries) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(l) AMENDMENT RELATED TO SECTION 339.—Paragraph (1) of section 6038A(c) (defining control) is amended by striking out "section 6038(d)(1)" and inserting in lieu thereof "section 6038(e)(1)".

(m) AMENDMENT RELATED TO SECTION 345.—Subsection (b) of section 345 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to effective date) is amended by striking out "taking effect on" and inserting in lieu thereof "taking effect on or after".

(n) AMENDMENTS RELATED TO SECTION 346.—

(1) CLERICAL AMENDMENT.—Subparagraph (B) of section 346(c)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended to read as follows:

"(B) Subparagraph (A) of section 6601(d)(2) is amended by striking out 'the last day of' each place it appears and inserting in lieu thereof 'the filing date for'."

(2) INTEREST ON REFUNDS CAUSED BY CARRYBACKS.—

(A) Paragraph (3) of section 6611(f) (relating to refund of tax caused by carryback, etc.) is amended by adding at the end thereof the following new subparagraph:

"(C) APPLICATION OF SUBPARAGRAPH (B) WHERE SECTION 6411(a) CLAIM FILED.—For purposes of subparagraph (B)(i)(II), if a taxpayer—

"(i) files a claim for refund of any overpayment described in paragraph (1) or (2) with respect to the taxable year to which a loss or credit is carried back, and

"(ii) subsequently files an application under section 6411(a) with respect to such overpayment,

then the claim for overpayment shall be treated as having been filed on the date the application under section 6411(a) was filed."

(B) The last sentence of section 6411(a) is amended by striking out "An" and inserting in lieu thereof "Except for purposes of applying section 6611(f)(3)(B), an".

(o) AMENDMENT RELATED TO SECTION 349.—Subsection (b) of section 6331 is amended by striking out "subsection (d)(3)" and inserting in lieu thereof "subsection (e)".

(p) AMENDMENTS RELATED TO TITLE IV.—

(1) EXTENSION OF PARTNERSHIP AUDIT PROVISIONS TO ENTITIES FILING PARTNERSHIP RETURNS, ETC.—Subchapter C of chapter 63 (relating to tax treatment of partnership items) is amended by adding at the end thereof the following new section:

"SEC. 6233. EXTENSION TO ENTITIES FILING PARTNERSHIP RETURNS, ETC.

"(a) GENERAL RULE.—If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

"(b) SIMILAR RULES IN CERTAIN CASES.—If for any taxable year—

"(1) an entity files a return as an S corporation but it is determined that the entity was not an S corporation for such year, or

"(2) a partnership return or S corporation return is filed but it is determined that there is no entity for such taxable year,

then, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply."

(2) TECHNICAL AND CLERICAL AMENDMENTS.—

(A) Subparagraph (B) of section 6230(c)(1) is amended by striking out "(or erroneously computed the amount of any such credit or refund)".

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(E) Paragraph (9) of section 6231(a) is amended by striking out "electing small business corporation" and inserting in lieu thereof "S corporation".

(C) Subparagraph (A) of section 6231(d)(1) is amended to read as follows:

"(A) in the case of a partner whose entire interest in the partnership is disposed of during such partnership taxable year, as of the moment immediately before such disposition, or".

(D) Subsection (f) of section 6231 is amended by striking out "such deduction or credit" and inserting in lieu thereof "such loss or credit".

(E) The table of sections for subpart C of chapter 63 is amended by adding at the end thereof the following new item:

"Sec. 6233. Extension to entities filing partnership returns, etc."

(F) Paragraph (3) of section 6501(q) is amended to read as follows:

"(3) CROSS REFERENCE.—

"For extension of period for windfall profit tax items of partnerships, see section 6229 as made applicable by section 6232."

(G) Paragraph (3) of section 6511(h) is amended to read as follows:

"(3) CROSS REFERENCE.—

"For period of limitation for windfall profit tax items of partnerships, see section 6227(a) and subsections (c) and (d) of section 6230 as made applicable by section 6232."

(H) Subsection (h) of section 7422 is amended by striking out "section 6131(a)(3)" and inserting in lieu thereof "section 6231(a)(3)".

(I) Subparagraph (B) of section 6231(b)(2) (relating to items cease to be partnership items in certain cases) is amended by striking out "section 6227(b)" and inserting in lieu thereof "section 6227(c)".

(q) ESTATES AND TRUSTS AND S CORPORATIONS REQUIRED TO PROVIDE INFORMATION TO CERTAIN BENEFICIARIES AND SHAREHOLDERS.—

(1) ESTATES AND TRUSTS.—Subpart A of part III of subchapter A of chapter 61 (relating to information concerning persons subject to special provisions) is amended by adding after section 6034 the following new section:

"SEC. 6034A. INFORMATION TO BENEFICIARIES OF ESTATES AND TRUSTS.

"The fiduciary of any estate or trust making the return required to be filed under section 6012(a) for any taxable year shall, on or before the date on which such return was filed, furnish to each beneficiary—

"(1) who receives a distribution from such estate or trust with respect to such taxable year, or

"(2) to whom any item with respect to such taxable year is allocated,

a statement containing such information shown on such return as the Secretary may prescribe."

(2) S CORPORATIONS.—Section 6037 (relating to return of S corporation) is amended—

(A) by striking out "Every" and inserting in lieu thereof "(a) In General.—Every", and

(B) by adding at the end thereof the following new subsection:

"(b) COPIES TO SHAREHOLDERS.—Each S corporation required to file a return under subsection (a) for any taxable year shall (on or before the day on which the return for such taxable year was filed) furnish to each person who is a shareholder at any time during such taxable year a copy of such information shown on such return as may be required by regulations."

(3) PENALTY FOR FAILURE TO PROVIDE INFORMATION.—Section 6678(a)(3) (relating to failure to furnish certain statements) is amended by striking out "or" at the end of subparagraph (D), by inserting "or" at the end of subparagraph (E), and by adding after subparagraph (E) the following new subparagraph:

"(F) section 6031(b), 6034A, or 6037(b) (relating to statements furnished by certain pass-thru entities),".

(4) CONFORMING AMENDMENT.—The table of sections for subpart A of III of subchapter A of chapter 61 is amended by adding after the item relating to section 6034 the following new item:

"Sec. 6034A. Information to beneficiaries of estates and trusts."

(5) EFFECTIVE DATE.—The amendments made by this subsection shall apply to taxable years beginning after December 31, 1984.

SEC. 718. EFFECTIVE DATE.

Any amendment made by this subtitle shall take effect as if included in the provision of the Tax Equity and Fiscal Responsibility Act of 1982 to which such amendment relates.

Subtitle B—Amendments Related to Subchapter S Revision Act of 1982; Etc.

SEC. 721. TECHNICAL CORRECTIONS OF SUBCHAPTER S REVISION ACT OF 1982.

(a) LIMITATION ON RECOGNITION OF GAIN IN THE CASE OF CERTAIN DISTRIBUTIONS.—

(1) Section 1363 (relating to effect of election on corporation) is amended by adding at the end thereof the following new subsection:

"(e) SUBSECTION (d) NOT TO APPLY TO COMPLETE LIQUIDATIONS AND REORGANIZATIONS.—Subsection (d) shall not apply to any distribution—

"(1) of property in complete liquidation of the corporation, or

"(2) to the extent it consists of property permitted by section 354, 355, or 356 to be received without the recognition of gain."

(2) Subsection (d) of section 1363 is amended by striking out "If" and inserting in lieu thereof "Except as provided in subsection (e), if".

(b) COORDINATION WITH RULES RELATING TO INCOME FROM DISCHARGE OF INDEBTEDNESS.—

(1) Paragraph (2) of section 1363(c) (relating to elections of the S corporation) is amended by striking out subparagraph (A) and by redesignating subparagraphs (B), (C), and (D) as subparagraphs (A), (B), and (C), respectively.

(2) Subsection (d) of section 108 (relating to income from discharge of indebtedness) is amended by redesignating paragraphs (7), (8), and (9) as paragraphs (8), (9), and (10), respectively, by striking out paragraph (6), and by inserting after paragraph (5) the following new paragraphs:

"(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level.

"(7) SPECIAL RULES FOR S CORPORATION.—

"(A) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT CORPORATE LEVEL.—In the case of an S corporation, subsections (a), (b), and (c) shall be applied at the corporate level.

"(B) REDUCTION IN CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(C) applies to such discharge.

"(C) COORDINATION WITH BASIS ADJUSTMENTS UNDER SECTION 1367(b)(2).—For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2)."

(c) TREATMENT OF INACTIVE SUBSIDIARIES.—Paragraph (6) of section 1361(c) (relating to ownership of stock in certain inactive corporations) is amended to read as follows:

"(6) OWNERSHIP OF STOCK IN CERTAIN INACTIVE CORPORATIONS.—For purposes of subsection (b)(2)(A), a corporation shall not be treated as a member of an affiliated group during any period within a taxable year by reason of the ownership of stock in another corporation if such other corporation—

"(A) has not begun business at any time on or before the close of such period, and

"(B) does not have gross income for such period."

(d) TREATMENT OF WORTHLESS DEBT.—Paragraph (3) of section 1367(b) (relating to coordination with section 165(g)) is amended to read as follows:

"(3) COORDINATION WITH SECTIONS 165(g) AND 166(d).—This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless."

(e) ADJUSTMENT TO EARNINGS AND PROFITS FOR RECAPTURE UNDER SECTION 47.—

(1) Subsection (d) of section 1371 (relating to coordination with investment credit recapture) is amended by adding at the end thereof the following new paragraph:

"(3) ADJUSTMENT TO EARNINGS AND PROFITS FOR AMOUNT OF RECAPTURE.—Paragraph (1) of subsection (c) shall not apply to any increase in tax under section 47 for which the S corporation is liable."

(2) Paragraph (1) of section 1371(c) is amended by striking out "paragraphs (2) and (3)" and inserting in lieu thereof "paragraphs (2) and (3) and subsection (d)(3)".

(f) QUALIFIED SUBCHAPTER S TRUSTS.—

(1) GRACE PERIOD.—Subparagraph (D) of section 1361(d)(2) (relating to grade period) is amended by striking out "60 days" and inserting in lieu thereof "15 days and 2 months".

(2) DEFINITION OF QUALIFIED SUBCHAPTER S TRUST.—Subsection (d) of section 1361 (relating to special rule for qualified subchapter S trust) is amended by striking out paragraphs (3) and (4) and inserting in lieu thereof the following:

"(3) QUALIFIED SUBCHAPTER S TRUST.—For purposes of this subsection, the term 'qualified subchapter S trust' means a trust—

"(A) the terms of which require that—

"(i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,

"(ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,

"(iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and

"(iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

"(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

"(4) TRUST CEASING TO BE QUALIFIED.—

"(A) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(A).—If a qualified subchapter S trust ceases to meet any requirement of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirement.

"(B) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(B).—If any qualified subchapter S trust ceases to meet any requirement of

paragraph (3)(B) but continues to meet the requirements of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of paragraph (3)(B)."

(3) TECHNICAL AMENDMENT.—Clause (i) of section 1361(d)(2)(B) (relating to separate election with respect to each S corporation) is amended by striking out "S corporation" each place it appears and inserting in lieu thereof "corporation".

(g) COORDINATION WITH SECTION 338.—

(1) Paragraph (6) of section 1362(e) (relating to treatment of S termination year) is amended by adding at the end thereof the following new subparagraph:

"(C) PARAGRAPH (2) NOT TO APPLY TO ITEMS RESULTING FROM SECTION 338.—Paragraph (2) shall not apply with respect to any item resulting from the application of section 338."

(2) Paragraph (2) of section 1362(e) is amended by striking out "as provided in paragraph (3)" and inserting in lieu thereof "as provided in paragraphs (3) and (6)(C)".

(h) ELECTION TO HAVE ITEMS ASSIGNED TO SHORT TAXABLE YEAR UNDER NORMAL ACCOUNTING RULES.—Subparagraph (B) of section 1362(e)(3) (relating to election to have items assigned to each short taxable year under normal accounting rules) is amended to read as follows:

"(B) SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this subsection shall be valid only if all persons who are shareholders in the corporation at any time during the S short year and all persons who are shareholders in the corporation on the first day of the C short year consent to such election."

(i) ELECTION TO HAVE NEW PASSIVE INCOME RULES NOT APPLY DURING 1982.—Paragraph (3) of section 6(b) of the Subchapter S Revision Act of 1982 (relating to new passive income rules apply to taxable years beginning during 1982) is amended by adding at the end thereof the following new sentences: "The preceding sentence shall not apply in the case of any corporation which elects (at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe) to have such sentence not apply. Subsection (e) shall not apply to any termination resulting from an election under the preceding sentence."

(j) S CORPORATION TREATED AS PARTNERSHIP FOR PURPOSES OF SECTION 318.—Paragraph (5) of section 318(a) (relating to constructive ownership of stock) is amended by adding at the end thereof the following new subparagraphs:

"(E) S CORPORATION TREATED AS PARTNERSHIP.—For purposes of this subsection—

"(i) an S corporation shall be treated as a partnership, and

"(ii) any shareholder of the S corporation shall be treated as a partner of such partnership.

The preceding sentence shall not apply for purposes of determining whether stock in the S corporation is constructively owned by any person."

(k) CLARIFICATION OF TREATMENT OF CERTAIN ELECTIONS UNDER PRIOR LAW.—Subsection (e) of section 6 of the Subchapter S Revision Act of 1982 (relating to treatment of certain elections under prior law) is amended by striking out "any termination" and inserting in lieu thereof "any termination or revocation".

(l) ELECTION FOR CERTAIN SHORT TAXABLE YEARS.—

(1) Subsection (b) of section 1362 (relating to when subchapter S election made) is amended by adding at the end thereof the following new paragraph:

"(4) TAXABLE YEARS OF 2½ MONTHS OR LESS.—For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year."

(2) Paragraph (3) of section 1362(b) is amended by striking out "on or before the last day of such taxable year" and inserting in lieu thereof "on or before the 15th day of the 3rd month of the following taxable year".

(m) TAXABLE YEAR OF EXISTING S CORPORATIONS.—Paragraph (1) of section 1378(c) (relating to existing S corporations required to use permitted year after 50-percent shift in ownership) is amended by striking out "which includes December 31, 1982" and inserting in lieu thereof "which includes December 31, 1982 (or which is an S corporation for a taxable year beginning during 1983 by reason of an election made on or before October 19, 1982)".

(n) REFERENCES TO PRIOR LAW.—Subsection (b) of section 1379 (relating to references to prior law included) is amended to read as follows:

"(b) REFERENCES TO PRIOR LAW INCLUDED.—Any references in this title to a provision of this subchapter shall, to the extent not inconsistent with the purposes of this subchapter, include a reference to the corresponding provision as in effect before the enactment of the Subchapter S Revision Act of 1982."

(o) ELECTION TO TREAT DISTRIBUTIONS AS DIVIDENDS DURING CERTAIN POST-TERMINATION TRANSITION PERIODS.—Subsection (e) of section 1371 (relating to coordination with subchapter C) is amended to read as follows:

"(e) CASH DISTRIBUTIONS DURING POST-TERMINATION TRANSITION PERIOD.—

"(1) IN GENERAL.—Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.

"(2) ELECTION TO DISTRIBUTE EARNINGS FIRST.—An S corporation may elect to have paragraph (1) not apply to all distributions made during a post-termination transition period described in section 1377(b)(1)(A). Such election shall not be effective unless all shareholders of the S corporation to whom distributions are made by the S corporation during such post-termination transition period consent to such election."

(p) CORPORATE PREFERENCE RULES APPLIED TO S CORPORATIONS WHICH WERE RECENT C CORPORATIONS.—Subsection (b) of section 1363 (relating to computation of corporation's taxable income) is amended by striking out "and" at the end of paragraph (2), by striking out the period at the end of paragraph (3) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(4) section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years."

(q) TREATMENT OF STOCK HELD BY ESTATE OF QUALIFIED TRANSFEROR.—Clause (i) of section 1378(c)(3)(B) (relating to existing S corporations required to use permitted year after 50-percent shift in ownership) is amended by striking out "who held" and inserting in lieu thereof "who (or whose estate) held".

(r) AMENDMENTS RELATED TO ACCUMULATED ADJUSTMENTS ACCOUNT.—

(1) Subparagraph (A) of section 1368(e)(1) (defining accumulated adjustments account) is amended by striking out "(except that" and all that follows through the end thereof and inserting in lieu thereof the following: "(except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase '(but not below zero)' shall be disregarded in section 1367(b)(2)(A))".

(2) Subsection (c) of section 1368 (relating to S corporation having earning and profits) is amended by adding at the end thereof the following new sentence: "Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes."

(s) SPECIAL RULES FOR CERTAIN EXPENSES OF S CORPORATIONS.—Paragraph (1) of section 267(f) (as in effect on the day before the date of the enactment of this Act) is amended by striking out all that follows subparagraph (B) and inserting in lieu thereof the following: "then any deduction allowable under such sections in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph)."

(t) PRO RATA ALLOCATION FOR S TERMINATION YEAR NOT TO APPLY IF 50-PERCENT CHANGE IN OWNERSHIP.—Paragraph (6) of section 1362(e) (relating to special rules) is amended by adding at the end thereof the following new subparagraph:

"(D) PRO RATA ALLOCATION FOR S TERMINATION YEAR NOT TO APPLY IF 50-PERCENT CHANGE IN OWNERSHIP.—Paragraph (2) shall not apply to an S termination year if there is a sale or exchange of 50 percent or more of the stock in such corporation during such year."

(u) TREATMENT OF PREDECESSOR CORPORATION UNDER SECTION 1374.—Paragraph (2) of section 1374(c) (relating to exception for new corporations) is amended—

(1) by striking out "(and any predecessor corporation)" in subparagraph (A), and

(2) by adding at the end thereof the following new sentence:

"To the extent provided in regulations, an S corporation and any predecessor corporation shall be treated as 1 corporation for purposes of this paragraph and paragraph (1)."

(v) AUTHORITY TO WAIVE TAX ON PASSIVE INVESTMENT INCOME.—Section 1375 (relating to tax imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts) is amended by adding at the end thereof the following new subsection:

"(d) WAIVER OF TAX IN CERTAIN CASES.—If the S corporation establishes to the satisfaction of the Secretary that—

"(1) it determined in good faith that it had no subchapter C earnings and profits at the close of a taxable year, and

"(2) during a reasonable period of time after it was determined that it did have subchapter C earnings and profits at the close of such taxable year such earnings and profits were distributed,

the Secretary may waive the tax imposed by subsection (a) for such taxable year."

(w) APPLICATION OF DEBT RESTORATION RULES.—Subparagraph (B) of section 1367(b)(2) (relating to adjustments in basis of indebtedness) is amended by striking out "for any taxable year there is" and inserting in lieu thereof "for any taxable year beginning after December 31, 1982, there is".

(x) CLERICAL AMENDMENTS.—

(1) Clause (i) of section 48(k)(5)(D) is amended by striking out "electing small

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business corporation" and inserting in lieu thereof "S corporation".

(2) Subparagraph (B) of section 465(a)(1) (relating to limitation to amount at risk) is amended by striking out "a corporation" and inserting in lieu thereof "a C corporation".

(3) Subsection (e) of section 1371 (relating to cash distributions during post-termination transition period) is amended by inserting before the period at the end thereof the following: "(within the meaning of section 1368(e))".

(4) Paragraph (2) of section 6659(f) is amended by striking out "section 465(a)(1)(C)" and inserting in lieu thereof "section 465(a)(1)(B)".

(5) Subparagraph (C) of section 6362(d)(2) is amended by striking out "electing small business corporation (within the meaning of section 1371(a))" and inserting in lieu thereof "an S corporation".

(y) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, any amendment made by this section shall take effect as if included in the Subchapter S Revision Act of 1982.

(2) AMENDMENT MADE BY SUBSECTION (b)(3).—Subparagraph (C) of section 108(d)(7) of the Internal Revenue Code of 1954 (as amended by subsection (b)(2)) shall apply to contributions to capital after December 31, 1980, in taxable years ending after such date.

(3) AMENDMENT MADE BY SUBSECTION (g)(1).—If—

(A) any portion of a qualified stock purchase is pursuant to a binding contract entered into on or after October 19, 1982, and before the date of the enactment of this Act, and

(B) the purchasing corporation establishes by clear and convincing evidence that such contract was negotiated on the contemplation that, with respect to the deemed sale under section 338 of the Internal Revenue Code of 1954, paragraph (2) of section 1362(e) of such Code would apply,

then the amendment made by paragraph (1) of subsection (g) shall not apply to such qualified stock purchase.

(4) AMENDMENTS MADE BY SUBSECTION (l).—The amendments made by subsection (l) shall apply to any election under section 1362 of the Internal Revenue Code of 1954 (or any corresponding provision of prior law) made after October 19, 1982.

(5) AMENDMENT MADE BY SUBSECTION (t).—If—

(A) on or before the date of the enactment of this Act 50 percent or more of the stock of an S corporation has been sold or exchanged in 1 or more transactions, and

(B) the person (or persons) acquiring such stock establish by clear and convincing evidence that such acquisitions were negotiated on the contemplation that paragraph (2) of section 1362(e) of the Internal Revenue Code of 1954 would apply to the S termination year in which such sales or exchanges occur,

then the amendment made by subsection (t) shall not apply to such S termination year.

SEC. 722. MISCELLANEOUS PROVISIONS.

(a) AMENDMENTS RELATED TO TECHNICAL CORRECTIONS ACT OF 1982.—

(1) Paragraph (12) of section 57(a) (relating to accelerated cost recovery deduction) is amended—

(A) by striking out "(or, in the case of property described in section 167(k), under section 167)" in subparagraph (A), and

(B) by inserting "(or, in the case of property described in section 167(k), under section 167)" after "section 168(a)" in subparagraph (B).

(2) Subparagraph (A) of section 1256(g)(1) (defining foreign currency contract) is amended by inserting after "delivery of" the following: ", or the settlement of which depends on the value of,".

(3) Subclause (I) of section 306(a)(8)(A)(ii) of the Technical Corrections Act of 1982 is amended by striking out "the date of the enactment of the Tax Equity and Fiscal Responsibility Act of 1982" and inserting in lieu thereof "September 1, 1982".

(4)(A) Subparagraph (A) of section 172(b)(2) (relating to amount of carrybacks and carryovers) is amended by striking out "and (6)" and inserting in lieu thereof "and (5)".

(B) Subsection (d) of section 172 (relating to modifications) is amended by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(5) Subsection (b) of section 5684 is amended by striking out "subsections (a) and (b)" and inserting in lieu thereof "subsection (a)".

(6) Any amendment made by this subsection shall take effect as if included in the provisions of the Technical Corrections Act of 1982 to which such amendment relates.

(7)(A) If—

(i) there is an overpayment of tax imposed by section 4986 of the Internal Revenue Code of 1954 for any period before January 1, 1983, by reason of section 201(h)(1)(E) of the Technical Corrections Act of 1982,

(ii) refund of such overpayment is payable to the partners of a partnership, and

(iii) such partners are obligated to pay over any such refund to 1 or more organizations referred to in such section 201(h)(1)(E),

such partnership shall be treated as authorized to act for each person who was a partner at any time in such partnership in claiming and paying over such refund.

(B) Notwithstanding section 6511 of the Internal Revenue Code of 1954, the time for filing a claim for credit or refund of the overpayment referred to in subparagraph (A)(i) shall not expire before the date 1 year after the date of the enactment of this Act.

(b) COORDINATION OF CERTAIN AMENDMENTS MADE BY HIGHWAY REVENUE ACT OF 1982 AND PUBLIC LAW 97-473.—For purposes of applying the amendments made by section 547 of the Highway Revenue Act of 1982 and the amendment made by section 202(b)(2) of Public Law 97-473, Public Law 97-473 shall be deemed to have been enacted immediately before the Highway Revenue Act of 1982.

(c) NO DESIGNATION OF PRINCIPAL CAMPAIGN COMMITTEE REQUIRED WHERE ONLY ONE POLITICAL COMMITTEE.—Effective for taxable years beginning after December 31, 1981, subparagraph (B) of section 527(h)(2) (relating to special rule for principal campaign committees) is amended by adding at the end thereof the following new sentence: "Nothing in this subsection shall be construed to require any designation where there is only one political committee with respect to a candidate."

(d) AMOUNT OF CREDIT FOR PRODUCING FUEL FROM A NONCONVENTIONAL SOURCE IN CASE OF FISCAL YEAR TAXPAYER.—

(1) Subparagraph (A) of section 44D(b)(1) (relating to credit for producing fuel from a nonconventional source) is amended by striking out "in which the taxable year begins" and inserting in lieu thereof "in which the sale occurs".

(2) Paragraph (2) of section 44D(b) is amended by striking out "in which a taxable year begins" and inserting in lieu thereof "in which the sale occurs".

(3) The amendments made by this subsection shall apply to taxable years ending after December 31, 1979.

(e) BASIS ADJUSTMENTS IN PARTNERSHIP INTERESTS AND SUBCHAPTER S STOCK FOR PERCENTAGE DEPLETION.—

(1) PARTNERSHIP INTERESTS.—Paragraph (3) of section 705(a) (relating to determination of basis of partner's interest) is amended to read as follows:

"(3) decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under section 613A(c)(7)(D)."

(2) SUBCHAPTER S STOCK.—Subparagraph (E) of section 1367(a)(2) (relating to adjustments to basis of stock of shareholders, etc.) is amended to read as follows:

"(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(13)(B)."

(3) EFFECTIVE DATE.—

(A) The amendment made by paragraph (1) shall take effect on January 1, 1975.

(B) The amendment made by paragraph (2) shall apply to taxable years beginning after December 31, 1982.

(f) CLARIFICATION OF INCREASE IN BASIS FOR GAIN RECOGNIZED ON TRANSFER TO PARTNERSHIP.—

(1) IN GENERAL.—Sections 722 and 723 are each amended by striking out "gain recognized" and inserting in lieu thereof "gain recognized under section 721(b)".

(2) EFFECTIVE DATE.—The amendments made by paragraph (1) shall take effect as if included in the amendments made by section 2131 of the Tax Reform Act of 1976.

(g) AMENDMENTS RELATED TO INCOME TAXES OF CERTAIN MILITARY AND CIVILIAN EMPLOYEES OF THE UNITED STATES DYING AS A RESULT OF INJURIES SUSTAINED OVERSEAS.—

(1) EFFECTIVE DATE.—Paragraph (1) of section 1(b) of Public Law 98-259 is amended by striking out "December 31, 1979" and inserting in lieu thereof "November 17, 1978".

(2) REQUIREMENT THAT EMPLOYMENT RELATIONSHIP EXIST AT TIME OF INJURY.—Paragraph (1) of section 692 (relating to certain military and civilian employees of the United States dying as a result of injuries sustained overseas) is amended by striking out "as a result of wounds or injury incurred" and inserting in lieu thereof "as a result of wounds or injury which was incurred while the individual was a military or civilian employee of the United States and which was incurred".

(3) CLARIFICATION OF DEFINITION OF TERRORISTIC ACTIVITY AGAINST THE UNITED STATES.—Subparagraph (A) of section 692(c)(2) (defining terroristic or military action) is amended to read as follows:

"(A) any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies, and".

(4) TREATMENT OF DIRECTOR GENERAL OF MULTINATIONAL FORCE IN SINAI.—For purposes of section 692(c) of the Internal Revenue Code of 1954, the Director General of the Multinational Force and Observers in the Sinai who died on February 15, 1984, shall be treated as if he were a civilian employee of the United States while he served as such Director General.

(5) EFFECTIVE DATE.—

(A) IN GENERAL.—The amendments made by this subsection shall take effect as if they were included in the amendments made by section 1 of Public Law 98-259.

(B) STATUTE OF LIMITATIONS WAIVED.—Notwithstanding section 6511 of the Internal Revenue Code of 1954, the time for filing a claim for credit or refund of any overpayment of tax resulting from the amendments

made by this subsection shall not expire before the date 1 year after the date of the enactment of this Act.

(h) AMENDMENTS TO THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983.—

(1) BROKER NOTIFICATION OF PAYOR.—

(A) Subparagraph (A) of section 3406(d)(2) (relating to special rules for readily tradable instruments) is amended—

(i) by inserting "the payor was notified by a broker under subparagraph (B) or" after "if (and only if)", and

(ii) by striking out clause (i) and redesignating clauses (ii) and (iii) as clauses (i) and (ii).

(B) Subparagraph (B) of section 3406(d)(2) is amended to read as follows:

"(B) BROKER NOTIFIES PAYOR.—If—

"(i) a payee acquires any readily tradable instrument through a broker, and

"(ii) with respect to such acquisition—

"(I) the payee fails to furnish his TIN to the broker in the manner required under subsection (a)(1)(A),

"(II) the Secretary notifies such broker before such acquisition that the TIN furnished by the payee is incorrect,

"(III) the Secretary notifies such broker before such acquisition that such payee is subject to withholding under subsection (a)(1)(C), or

"(IV) the payee does not provide a certification to such broker under subparagraph (C),

such broker shall, within such period as the Secretary may prescribe by regulations (but not later than 15 days after such acquisition), notify the payor that such payee is subject to withholding under subparagraph (A), (B), (C), or (D) of subsection (a)(1), respectively."

(2) NOTIFIED PAYEE UNDERREPORTING.—Paragraph (1) of section 3406(c) (relating to notified payee underreporting) is amended by striking out "(but not the reasons therefor)" and inserting in lieu thereof "(but not the reasons for the withholding under subsection (a)(1)(C))".

(3) APPLICATION WITH TRUSTS.—Section 643 (relating to definitions applicable to trusts) is amended by adding at the end thereof the following new subsection:

"(d) COORDINATION WITH BACK-UP WITHHOLDING.—Except to the extent otherwise provided in regulations, this subchapter shall be applied with respect to payments subject to withholding under section 3406—

"(1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31(c) (on the basis of their respective shares of any such payment taken into account under this subchapter),

"(2) by treating each beneficiary to whom such credit is allocated as if an amount equal to such credit has been paid to him by the estate or trust, and

"(3) by allowing the estate or trust a deduction in an amount equal to the credit so allocated to beneficiaries."

(4) COORDINATION OF PENSION AND BACK-UP WITHHOLDING.—

(A) Section 3405(d) (relating to definitions and special rules) is amended by adding at the end thereof the following new paragraph:

"(12) FAILURE TO PROVIDE CORRECT TIN.—If—

"(A) a payee fails to furnish his TIN to the payor in the manner required by the Secretary, or

"(B) the Secretary notifies the payor before any payment or distribution that the TIN furnished by the payee is incorrect,

no election under subsection (a)(2) or (b)(3) shall be treated as in effect and subsection (a)(4) shall not apply to such payee."

(B) Section 6041(a) (relating to information at source) is amended by inserting "6047(e)," after "6044(a)(1),".

(5) EFFECTIVE DATES.—

(A) Except as provided in this paragraph, the amendments made by this subsection shall apply as if included in the amendments made by the Interest and Dividend Tax Compliance Act of 1983.

(B) The amendments made by paragraph (4) shall apply to payments or distributions after December 31, 1984, unless the payor elects to have such amendments apply to payments or distributions before January 1, 1985.

Subtitle C—Amendments Relating to Highway Revenue Act of 1982

SEC. 731. VALUE OF USED COMPONENTS FURNISHED BY FIRST USER NOT TAKEN INTO ACCOUNT IN DETERMINING PRICE.

Subparagraph (B) of section 4052(b)(1) (relating to determination of price) is amended by striking out "and" at the end of clause (ii) and by inserting after clause (iii) the following new clause:

"(iv) the value of any component of such article if—

"(I) such component is furnished by the first user of such article, and

"(II) such component has been used before such furnishing, and".

SEC. 732. CLARIFICATION OF APPLICATION OF GASOLINE EXCISE TAX TO GASOHOL, ETC.

(a) GASOLINE EXCISE TAX TO APPLY TO GALLON OF GASOHOL.—

(1) IN GENERAL.—Paragraph (1) of section 4081(c) (relating to gasoline mixed with alcohol) is amended to read as follows:

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, subsection (a) shall be applied—

"(A) by substituting '4 cents' for '9 cents' in the case of the sale of any gasohol (the gasoline in which was not taxed under subparagraph (B)), and

"(B) by substituting '4⅜ cents' for '9 cents' in the case of the sale of any gasoline for use in producing gasohol.

For purposes of this paragraph, the term 'gasohol' means any mixture of gasoline if at least 10 percent of such mixture is alcohol."

(2) LATER SEPARATION OF GASOLINE.—Paragraph (2) of section 4081(c) is amended—

(A) by striking out "at the rate of 4 cents a gallon" and inserting in lieu thereof "at a rate equivalent to 4 cents a gallon", and

(B) by striking out "5 cents a gallon" and inserting in lieu thereof "4⅜ cents a gallon".

(3) CREDIT OR REFUND.—Paragraph (1) of section 6427(f) (relating to gasoline used to produce certain alcohol fuels) is amended by striking out "5 cents" and inserting in lieu thereof "4⅜ cents".

(b) LOWER FLOOR STOCKS TAX ON GASOHOL.—Subsection (a) of section 521 of the Highway Revenue Act of 1982 is amended by inserting "(4 cents a gallon in the case of a gallon of gasohol, as defined in section 4081(c))" after "5 cents a gallon".

SEC. 733. CERTAIN CHAIN OPERATORS OF RETAIL GASOLINE STATIONS TREATED AS PRODUCERS.

(a) IN GENERAL.—Subsection (d) of section 4082 (defining wholesale distributor) is amended to read as follows:

"(d) WHOLESALE DISTRIBUTOR.—As used in subsection (a), the term 'wholesale distributor' includes—

"(1) any person who—

"(A) sells gasoline to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks, or

"(B) purchases gasoline from a producer and distributes such gasoline to 10 or more retail gasoline stations under common management with such person,

"(2) but only if such person elects to register with respect to the tax imposed by section 4081.

Such term does not include any person who (excluding the term 'wholesale distributor' from subsection (a)) is a producer or importer."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the first day of the first calendar quarter beginning after the date of the enactment of this Act.

SEC. 734. OTHER TECHNICAL AMENDMENTS.

(a) FLOOR STOCKS REFUNDS FOR TIRES TAXED AT LOWER RATE AFTER JANUARY 1, 1984.—

(1) IN GENERAL.—Paragraph (1) of section 523(b) of the Highway Revenue Act of 1982 (relating to floor stocks refunds for tires) is amended by inserting "(or will be subject to a lower rate of tax under such section)" after "and which will not be subject to tax under such section".

(2) AMOUNT OF REFUND LIMITED TO REDUCTION IN TAX, ETC.—

(A) IN GENERAL.—Subsection (b) of section 523 of the Highway Revenue Act of 1982 (relating to floor stocks refunds for tires) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULES FOR TIRES TAXED AT LOWER RATE AFTER JANUARY 1, 1984.—In the case of any tire which is a tax-repealed article solely by reason of the parenthetical matter in paragraph (1)—

"(A) the amount of the credit or refund under subsection (a) shall not exceed the excess of—

"(i) the tax imposed with respect to such tire by section 4071(a) as in effect on December 31, 1983, over

"(ii) the tax which would have been imposed with respect to such tire by section 4071(a) on January 1, 1984, and

"(B) paragraph (1) of section 522(a) shall be applied—

"(i) by substituting 'January 1, 1985' for 'July 1, 1983', and

"(ii) by substituting 'April 1, 1985' for 'October 1, 1983' each place it appears."

(B) CONFORMING AMENDMENT.—Paragraph (2) of section 523(b) of such Act is amended by striking out "In the case of" and inserting in lieu thereof "Except as provided in paragraph (3), in the case of".

(b) OVERPAYMENTS OF TAX ON TRUCKS, ETC., AND TIRES.—

(1) TRUCKS, ETC.—

(A) IN GENERAL.—Subsection (b) of section 6416 (relating to special cases in which tax payments considered overpayments) is amended by inserting after paragraph (5) the following new paragraph:

"(6) TRUCK CHASSIS, BODIES, AND SEMITRAILERS USED FOR FURTHER MANUFACTURE.—If—

"(A) the tax imposed by section 4051 has been paid with respect to the sale of any article, and

"(B) before any other use, such article is by any person used as a component part of another article taxable under section 4051 manufactured or produced by him,

such tax shall be deemed to be an overpayment by such person. For purposes of the preceding sentence, an article shall be treated as having been used as a component part of another article if, had it not been broken or rendered useless in the manufacture or production of such other article, it would have been so used."

(B) TECHNICAL AMENDMENT.—Subparagraph (B) of section 6416(a)(2) is amended by striking out "or (5)" and inserting in lieu thereof "(5), or (6)".

(2) TIRES.—

(A) IN GENERAL.—Paragraph (4) of section 6416(b) (relating to tires) is amended to read as follows:

"(4) TIRES.—If—

"(A) the tax imposed by section 4071 has been paid with respect to the sale of any tire by the manufacturer, producer, or importer thereof, and

"(B) such tire is sold by any person on or in connection with, or with the sale of, any other article, such tax shall be deemed to be an overpayment by such person if such other article is—

"(i) an automobile bus chassis or an automobile bus body, or

"(ii) by such person exported, sold to a State or local government for the exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft."

(B) TECHNICAL AMENDMENTS.—

(i) Paragraph (2) of section 6416(b) is amended by striking out subparagraph (E).

(ii) Paragraph (3) of section 6416(b) (relating to tax-paid articles used for further manufacture, etc.) is amended by striking out subparagraph (C).

(iii) Subparagraph (C) of section 6416(a)(1) is amended by striking out ", (b)(3) (C) or (D), or (b)(4)".

(iv) Subparagraph (B) of section 6416(a)(2), as amended by paragraph (1)(B), is amended by inserting "(4)," before "(5)".

(v) Paragraph (3) of section 6416(a) is amended to read as follows:

"(3) SPECIAL RULE.—For purposes of this subsection, in any case in which the Secretary determines that an article is not taxable, the term 'ultimate purchaser' when used in paragraph (1)(B) of this subsection includes a wholesaler, jobber, distributor, or retailer who, on the 15th day after the date of such determination, holds such article for sale; but only if claim for credit or refund by reason of this paragraph is filed on or before the date for filing the return with respect to the taxes imposed under chapter 32 for the first period which begins more than 60 days after the date on such determination."

(c) ALLOWANCE OF TAX-FREE SALES OF GASOLINE FOR USE IN NONCOMMERCIAL AVIATION.—

(1) IN GENERAL.—Section 4082 (relating to definitions with respect to the tax on gasoline) is amended by adding at the end thereof the following new subsection:

"(e) CERTAIN SELLERS OF GASOLINE FOR USE IN NONCOMMERCIAL AVIATION TREATED AS PRODUCERS.—For purposes of this subpart, the term 'producer' includes any person who regularly sells gasoline to owners, lessees, or operators of aircraft for use as fuel in such aircraft in noncommercial aviation (as defined in section 4041(c)(4))."

(2) REFUNDS.—Section 6427 (relating to fuels not used for taxable purposes) is amended by redesignating subsections (j), (k), and (l) as subsections (k), (l), and (m), respectively, and by inserting after subsection (i) the following new subsection:

"(j) SPECIAL RULES WITH RESPECT TO NONCOMMERCIAL AVIATION.—For purposes of subsection (a), in the case of gasoline—

"(1) on which tax was imposed under section 4041(c)(2),

"(2) on which tax was not imposed under section 4081, and

"(3) which was not used as an off-highway business use (within the meaning of section 6421(d)(2)),

the amount of the payment under subsection (a) shall be an amount equal to the amount of gasoline used as described in subsection (a) or resold multiplied by the rate equal to the excess of the rate of tax imposed by section 4041(c)(2) over the rate of tax imposed by section 4081."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on the first day of the first calendar quarter beginning after the date of the enactment of this Act.

(d) FLOOR STOCKS REFUNDS FOR TREAD RUBBER.—Paragraph (1) of section 523(b) of the Highway Revenue Act of 1982 (relating to floor stocks refunds for tires) is amended by adding at the end thereof the following new sentence: "Any tread rubber which was subject to tax under section 4071(a)(4) as in effect on December 31, 1983, and which on January 1, 1984, is part of a retread tire which is held by a dealer and has not been used and is intended for sale shall be treated as a tax-repealed article for purposes of subsection (a) of section 522."

(e) PENALTIES, ETC., TO APPLY TO FLOOR STOCKS TAXES.—Subsection (c) of section 521 of the Highway Revenue Act of 1982 is amended by adding at the end thereof the following: "All other provisions of law, including penalties, applicable with respect to the taxes imposed by section 4081 or 4071(a) (whichever is appropriate) shall apply to the floor stocks taxes imposed by this section."

(f) NO 1984 SHORT TAXABLE PERIOD FOR OWNER-OPERATORS.—Subsection (a) of section 4481 (relating to tax on use of certain vehicles), as in effect before the amendments made by the Highway Revenue Act of 1982, is amended by striking out the last sentence.

(g) CLARIFICATION OF SECONDARY LIABILITY OF INSTALLERS OF PARTS AND ACCESSORIES PURCHASED SEPARATELY.—The text of section 4051(b)(3) is amended to read as follows: "The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1)."

(h) NO INFERENCE FOR PAST PERIODS TO BE DRAWN FROM AMENDMENT RELATING TO CUSTOMARY USE OF TRAILERS.—The subsection heading of subsection (c) of section 513 of the Highway Revenue Act of 1982 is amended by striking out "Clarification of".

(i) WIRE TRANSFER TO FEDERAL RESERVE BANK REQUIRED WHERE EXTENSION OF PAYMENT DUE DATE FOR CERTAIN FUEL TAXES.—Subsection (a) of section 518 of the Highway Revenue Act of 1982 (relating to extension of payment due date for certain fuel taxes) is amended by striking out "any government depository authorized under section 6302 of such Code" and inserting in lieu thereof "any Federal Reserve Bank".

(j) CREDIT OR REFUND OF RETAIL TAX ON TRUCKS AND TRAILERS WHERE PRICE READJUSTMENTS.—Subparagraph (A) of section 6416(b)(1) (relating to price readjustments) is amended by inserting "or by section 4051" after "by chapter 32".

SEC. 735. REPEAL OF CERTAIN PROVISIONS MADE OBSOLETE BY HIGHWAY REVENUE ACT OF 1982.

(a) DELETION OF TERMINATED MANUFACTURERS EXCISE TAX ON MOTOR VEHICLES.—

(1) Part I of subchapter A of chapter 32 is amended by striking out sections 4061, 4062, and 4063.

(2) The part heading and the table of sections for such part I are amended to read as follows:

"PART I—GAS GUZZLERS

"Sec. 4064. Gas guzzlers tax."

(3) The table of parts for subchapter A of chapter 32 is amended by striking out the item relating to part I and inserting in lieu thereof the following:

"Part I. Gas guzzlers."

(b) CROSS-REFERENCES TO TERMINATED MANUFACTURERS EXCISE TAX ON MOTOR VEHICLES STATED AS PART OF RETAIL TAX.—

(1) EXEMPTIONS.—Section 4053 (relating to exemptions from retail tax on heavy trucks, etc.) is amended to read as follows:

"SEC. 4053. EXEMPTIONS.

"No tax shall be imposed by section 4051 on any of the following articles:

"(1) CAMPER COACHES BODIES FOR SELF-PROPELLED MOBILE HOMES.—Any article designed—

"(A) to be mounted or placed on automobile trucks, automobile truck chassis, or automobile chassis, and

"(B) to be used primarily as living quarters or camping accommodations.

"(2) FEED, SEED, AND FERTILIZER EQUIPMENT.—Any body primarily designed—

"(A) to process or prepare seed, feed, or fertilizer for use on farms,

"(B) to haul feed, seed, or fertilizer to and on farms,

"(C) to spread feed, seed, or fertilizer on farms,

"(D) to load or unload feed, seed, or fertilizer on farms, or

"(E) for any combination of the foregoing.

"(3) HOUSE TRAILERS.—Any house trailer.

"(4) AMBULANCES, HEARSES, ETC.—Any ambulance, hearse, or combination ambulance-hearse.

"(5) CONCRETE MIXERS.—Any article designed—

"(A) to be placed or mounted on an automobile truck chassis or truck trailer or semitrailer chassis, and

"(B) to be used to process or prepare concrete.

"(6) TRASH CONTAINERS, ETC.—Any box, container, receptacle, bin or other similar article—

"(A) which is designed to be used as a trash container and is not designed for the transportation of freight other than trash, and

"(B) which is not designed to be permanently mounted on or permanently affixed to an automobile truck chassis or body.

"(7) RAIL TRAILERS AND RAIL VANS.—Any chassis or body of a trailer or semitrailer which is designed for use both as a highway vehicle and a railroad car. For purposes of the preceding sentence, piggy-back trailer or semitrailer shall not be treated as designed for use as a railroad car."

(2) CERTAIN COMBINATIONS NOT TREATED AS MANUFACTURE.—Subsection (c) of section 4052 (relating to definitions and special rules) is amended to read as follows:

"(c) CERTAIN COMBINATIONS NOT TREATED AS MANUFACTURE.—

"(1) IN GENERAL.—For purposes of this subchapter (other than subsection (a)(3)(B)), a person shall not be treated as engaged in the manufacture of any article by reason of merely combining such article with any item listed in paragraph (2).

"(2) ITEMS.—The items listed in this paragraph are any coupling device (including any fifth wheel), wrecker crane, loading and unloading equipment (including any crane, hoist, winch, or power liftgate), aerial ladder or tower, snow and ice control equipment, earthmoving, excavation and construction equipment, spreader, sleeper cab, cab shield, or wood or metal floor."

(c) OTHER TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Clause (i) of section 48(l)(16)(B) (defining qualified intercity bus) is amended to read as follows:

"(i) the chassis of which is an automobile bus chassis and the body of which is an automobile bus body,".

(2)(A) The first sentence of section 4071(b) is amended by striking out "or inner tube" and by striking out "or tube" each place it appears.

(B) The first sentence of section 4071(c) is amended by striking out "on total weight," and all that follows and inserting in lieu thereof "on total weight exclusive of metal rims or rim bases."

(C) Subsection (e) of section 4071 is amended—

(i) by striking out "or inner tubes (other than bicycle tires and inner tubes)",

(ii) by striking out "and inner tubes" in paragraphs (1) and (2), and

(iii) by striking out the last sentence and inserting in lieu thereof the following: "This subsection shall not apply with respect to the sale of an automobile bus chassis or an automobile bus body."

(D) Subsection (f) of section 4071 (relating to imported recapped or retreaded United States tires) is hereby repealed.

(3) Section 4072 (relating to definitions) is amended by striking out subsection (b) and by redesignating subsection (c) as subsection (b).

(4) Section 4073 (relating to exemptions) is amended to read as follows:

"SEC. 4073. EXEMPTION FOR TIRES WITH INTERNAL WIRE FASTENING.

"The tax imposed by section 4071 shall not apply to tires of extruded tiring with an internal wire fastening agent."

(5)(A) The heading for part II of subchapter A of chapter 32 is amended by striking out "AND TUBES".

(B) The table of parts for subchapter A of chapter 32 is amended by striking out "and tubes" in the item relating to part II.

(C) The item relating to section 4073 in the table of sections for part II of subchapter A of chapter 32 is amended to read as follows:

"Sec. 4073. Exemption for tires with internal wire fastening."

(6)(A) Paragraph (1) of section 4216(b) (defining constructive sale price) is amended—

(i) by striking out "(other than an article the sale of which is taxable under section 4061(a))" in the second sentence, and

(ii) by striking out the third sentence.

(B) Paragraph (2) of section 4216(b) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (B), and by redesignating subparagraph (D) as subparagraph (C).

(C) Subsection (b) of section 4216 is amended by striking out paragraph (5).

(D) Paragraph (3) of section 4216(b) is amended by striking out "paragraphs (4) and (5)" and inserting in lieu thereof "paragraph (4)".

(E) Paragraph (6) of section 4216(b) is redesignated as paragraph (5) and is amended by striking out "(1), (3), and (5)" and inserting in lieu thereof "(1) and (3)".

(F) Subsection (f) of section 4216 (relating to certain trucks incorporating used components) is hereby repealed.

(7)(A) Subsection (b) of section 4218 (relating to use by manufacturer or importer considered as sale) is amended—

(i) by striking out "or inner tube", and

(ii) by striking out "Except as provided in subsection (d), if" and inserting in lieu thereof "If".

(B) The heading for subsection (b) of section 4218 is amended by striking out "and Tubes".

(C) Section 4218 is amended by striking out subsections (c) and (d) and by redesignating subsection (e) as subsection (c).

(D) Subsection (a) of section 4218 is amended by striking out "(other than an article specified in subsection (b), (c), or (d))" and inserting in lieu thereof "(other than a tire taxable under section 4071)".

(8)(A) Subsection (a) of section 4221 (relating to tax-free sales) is amended by inserting "(or under section 4051 on the first retail sale)" after "manufacturer".

(B) Subsection (c) of section 4221 is amended by striking out "section 4063(a) (6) or (7), 4063(b), 4063(e)," and inserting in lieu thereof "section 4053(a)(6)".

(C) Paragraph (1) of section 4221(d) (defining manufacturer) is amended by inserting before the period ", and, in the case of the tax imposed by section 4051, includes the retailer with respect to the first retail sale".

(D) Paragraph (6) of section 4221(d) (relating to use in further manufacture) is amended—

(i) by striking out subparagraph (B) and the last sentence,

(ii) by striking out "(other than an article referred to in subparagraph (B))" in subparagraph (A),

(iii) by redesignating subparagraph (C) as subparagraph (B), and

(iv) by adding "or" at the end of subparagraph (A).

(E) Paragraph (2) of section 4221(e) is amended—

(i) by striking out "or inner tube" each place it appears; and

(ii) by striking out "or tube" each place it appears.

(F) The heading for paragraph (2) of section 4221(e) is amended by striking out "AND TUBES".

(G) Subsection (e) of section 4221 is amended by striking out paragraphs (4), (5), and (6) and inserting in lieu thereof the following:

"(3) TIRES USED ON INTERCITY, LOCAL, AND SCHOOL BUSES.—Under regulations prescribed by the Secretary, the tax imposed by section 4071 shall not apply in the case of tires sold for use by the purchaser on or in connection with a qualified bus."

(9) Subsection (d) of section 4222 is amended by striking out "4063(a)(7), 4063(b), 4063(e)," and inserting in lieu thereof "4053(a)(6),".

(10) Paragraph (1) of section 4223(b) is amended by striking out "section 4218(e)" and inserting in lieu thereof "4218(c)".

(11) Paragraph (2) of section 4227 is amended by striking out "and tubes".

(12)(A) So much of paragraph (1) of section 6412(a) (relating to floor stock refunds) as precedes "there shall be credited or refunded" is amended to read as follows:

"(1) TIRES AND GASOLINE.—Where before October 1, 1988, any article subject to the tax imposed by section 4071 or 4081 has been sold by the manufacturer, producer, or importer and on such date is held by a dealer and has not been used and is intended for sale,".

(B) Paragraph (1) of section 6412(a) is amended by striking out the last sentence.

(C) Subparagraph (A) of section 6412(a)(2) is amended to read as follows:

"(A) The term 'dealer' includes a wholesaler, jobber, distributor, or retailer."

(D) Subsection (c) of section 6412 is amended by striking out "4061, 4071," and inserting in lieu thereof "4071".

(13)(A) Subparagraph (C) of section 6416(b)(1) (relating to adjustment of tire price) is amended by striking out "section 4071(a) (1) or (2) or section 4071(b)" and inserting in lieu thereof "subsection (a) or (b) of section 4071".

(B) Paragraph (2) of section 6416(b) is amended by striking out subparagraph (F) and all that follows to the end thereof and inserting in lieu thereof the following:

"(E) in the case of any tire taxable under section 4071(a), sold to any person for use as described in section 4221(e)(3); or

"(F) in the case of gasoline, used or sold for use in the production of special fuels referred to in section 4041.

Subparagraphs (C) and (D) shall not apply in the case of any tax paid under section 4064."

(C) Paragraph (3) of section 6416(b) is amended by striking out all subparagraphs and the last sentence thereof and inserting in lieu thereof the following:

"(A) in the case of any article other than gasoline taxable under section 4081, such article is used by the subsequent manufacturer or producer as material in the manufacture or production of, or as a component part of—

"(i) another article taxable under chapter 32; or

"(ii) an automobile bus chassis or an automobile bus body,

manufactured or produced by him; or

"(B) in the case of gasoline taxable under section 4081, such gasoline is used by the subsequent manufacturer or producer, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him."

(D) Subparagraph (B) of section 6416(a)(2) is amended by striking out "or (B)".

(E) Section 6416 is amended by striking out subsections (c) and (g) and by redesignating subsections (e), (f), (h), and (i) as subsections (c), (d), (e), and (f), respectively.

(F) Subparagraph (A) of section 6416(b)(2) is amended by striking out "(except in any case to which subsection (g) applies)".

(14) Section 6511 is amended by striking out subsection (i) and by redesignating subsection (j) as subsection (i).

(15) Paragraph (3) of section 9502(b) is amended by striking out "under paragraphs (2) and (3) of section 4071(a), with respect to tires and tubes of types used on aircraft" and inserting in lieu thereof "under section 4071 with respect to tires of the types used on aircraft".

(16) Sections 1366(f)(1) and 6401(b) are each amended by striking out ", special fuels, and lubricating oil" and inserting in lieu thereof "and special fuels".

SEC. 736. EFFECTIVE DATE.

Except as otherwise provided in this subtitle, any amendment made by this subtitle shall take effect as if included in the provisions of the Highway Revenue Act of 1982 to which such amendment relates.

TITLE VIII—FOREIGN SALES CORPORATIONS

SEC. 801. FOREIGN SALES CORPORATIONS.

(a) IN GENERAL.—Part III of subchapter N of chapter 1 (relating to income from sources outside the United States) is amended by inserting after subpart B the following new subpart:

"Subpart C—Taxation of Foreign Sale Corporations

"Sec. 921. Exempt foreign trade income excluded from gross income.
"Sec. 922. FSC defined.
"Sec. 923. Exempt foreign trade income.
"Sec. 924. Foreign trading gross receipts.
"Sec. 925. Transfer pricing rules.
"Sec. 926. Distributions to shareholders.
"Sec. 927. Other definitions and special rules.

"SEC. 921. EXEMPT FOREIGN TRADE INCOME EXCLUDED FROM GROSS INCOME.

"(a) EXCLUSION.—Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.

"(b) PROPORTIONATE ALLOCATION OF DEDUCTIONS TO EXEMPT FOREIGN TRADE INCOME.—Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by a FSC from any transaction shall be allocated between—

"(1) the exempt foreign trade income derived from such transaction, and

"(2) the foreign trade income (other than exempt foreign trade income) derived from such transaction, on a proportionate basis.

"(c) DENIAL OF CREDITS.—Notwithstanding any other provision of this chapter, no credit (other than a credit allowable under

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section 27(a), 33, or 34) shall be allowed under this chapter to any FSC.

"(d) FOREIGN TRADE INCOME, INVESTMENT INCOME, AND CARRYING CHARGES TREATED AS EFFECTIVELY CONNECTED WITH UNITED STATES BUSINESS.—For purposes of this chapter—

"(1) all foreign trade income of a FSC other than—

"(A) exempt foreign trade income, and

"(B) section 923(a)(2) non-exempt income,

"(2) all interest, dividends, royalties, and other investment income received by a FSC, and

"(3) all carrying charges received by a FSC,

shall be treated as income effectively connected with the conduct of a trade of business conducted through a permanent establishment of such corporation within the United States. Income described in paragraph (1) shall be treated as derived from sources within the United States.

"SEC. 922. FSC DEFINED.

"(a) FSC DEFINED.—For purposes of this title, the term 'FSC' means any corporation—

"(1) which—

"(A) was created or organized—

"(i) under the laws of any foreign country which meets the requirements of section 927(e)(3), or

"(ii) under the laws applicable to any possession of the United States,

"(B) has no more than 25 shareholders at any time during the taxable year,

"(C) does not have any preferred stock outstanding at any time during the taxable year,

"(D) during the taxable year—

"(i) maintains an office located outside the United States in a foreign country which meets the requirements of section 927(e)(3),

"(ii) maintains a set of the permanent books of account (including invoices) of such corporation at such office, and

"(iii) maintains at a location within the United States the records which such corporation is required to keep under section 6001,

"(E) at all times during the taxable year, has a board of directors which includes at least one individual who is not a resident of the United States, and

"(F) is not a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member, and

"(2) which has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a FSC.

"(b) SMALL FSC DEFINED.—For purposes of this title, a FSC is a small FSC with respect to any taxable year if—

"(1) such corporation has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a small FSC, and

"(2) such corporation is not a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such other FSC has also made an election under paragraph (1) which is in effect for such year.

"SEC. 923. EXEMPT FOREIGN TRADE INCOME.

"(a) EXEMPT FOREIGN TRADE INCOME.—For purposes of this subpart—

"(1) IN GENERAL.—The term 'exempt foreign trade income' means the aggregate amount of all foreign trade income of a FSC for the taxable year which is described in paragraph (2) or (3).

"(2) INCOME DETERMINED WITHOUT REGARD TO ADMINISTRATIVE PRICING RULES.—In the case of any transaction to which paragraph (3) does not apply, 32 percent of the foreign trade income derived from such transaction shall be treated as described in this paragraph. For purposes of the preceding sentence, foreign trade income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 927(a)(2) (relating to intangibles).

"(3) INCOME DETERMINED WITH REGARD TO ADMINISTRATIVE PRICING RULES.—In the case of any transaction with respect to which paragraph (1) or (2) of section 925(a) (or the corresponding provisions of the regulations prescribed under section 925(b)) applies, 16/23 of the foreign trade income derived from such transaction shall be treated as described in this paragraph.

"(4) SPECIAL RULE FOR FOREIGN TRADE INCOME ALLOCABLE TO A COOPERATIVE.—

"(A) IN GENERAL.—In any case in which a qualified cooperative is a shareholder of a FSC, paragraph (3) shall be applied with respect to that portion of the foreign trade income of such FSC for any taxable year which is properly allocable to the marketing of agricultural or horticultural products (or the providing of related services) by such cooperative by substituting '100 percent' for '16/23'.

"(B) PARAGRAPH ONLY TO APPLY TO AMOUNTS FSC DISTRIBUTES.—Subparagraph (A) shall not apply for any taxable year unless the FSC distributes to the qualified cooperative the amount which (but for such subparagraph) would not be treated as exempt foreign trade income. Any distribution under this subparagraph for any taxable year—

"(i) shall be made before the due date for filing the return of tax for such taxable year, but

"(ii) shall be treated as made on the last day of such taxable year.

"(5) SPECIAL RULE FOR MILITARY PROPERTY.—Under regulations prescribed by the Secretary, that portion of the foreign trading gross receipts of the FSC for the taxable year attributable to the disposition of, or services relating to, military property (within the meaning of section 995(b)(3)(B)) which may be treated as exempt foreign trade income shall equal 50 percent of the amount which (but for this paragraph) would be treated as exempt foreign trade income.

"(b) Foreign Trade Income Defined.—For purposes of this subpart, the term 'foreign trade income' means the gross income of a FSC attributable to foreign trading gross receipts.

"SEC. 924. FOREIGN TRADING GROSS RECEIPTS.

"(a) IN GENERAL.—Except as otherwise provided in this section, for purposes of this subpart, the term 'foreign trading gross receipts' means the gross receipts of any FSC which are—

"(1) from the sale, exchange, or other disposition of export property,

"(2) from the lease or rental of export property for use by the lessee outside the United States,

"(3) for services which are related and subsidiary to—

"(A) any sale, exchange, or other disposition of export property by such corporation, or

"(B) any lease or rental of export property described in paragraph (2) by such corporation,

"(4) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

"(5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraph (1), (2), or (3).

Paragraph (5) shall not apply to a FSC for any taxable year unless at least 50 percent of its gross receipts for such taxable year is from activities described in paragraph (1), (2), or (3).

"(b) FOREIGN MANAGEMENT AND FOREIGN ECOMOMIC PROCESS REQUIREMENTS.—

"(1) IN GENERAL.—Except as provided in paragraph (2)—

"(A) a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of such corporation during such taxable year takes place outside the United States as required by subsection (c), and

"(B) a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by subsection (d).

"(2) EXCEPTION FOR SMALL FSC.—

"(A) IN GENERAL.—Paragraph (1) shall not apply with respect to any small FSC.

"(B) LIMITATION ON AMOUNT OF FOREIGN TRADING GROSS RECEIPTS OF SMALL FSC TAKEN INTO ACCOUNT.—

"(i) IN GENERAL.—Any foreign trading gross receipts of a small FSC for the taxable year which exceed $5,000,000 shall not be taken into account in determining the exempt foreign trade income of such corporation and shall not be taken into account under any other provision of this subpart.

"(ii) ALLOCATION OF LIMITATION.—If the foreign trading gross receipts of a small FSC exceed the limitation of clause (i), the corporation may allocate such limitation among such gross receipts in such manner as it may select (at such time and in such manner as may be prescribed in regulations).

"(iii) RECEIPTS OF CONTROLLED GROUP AGGREGATED.—For purposes of applying clauses (i) and (ii), all small FSC's which are members of the same controlled group of corporations shall be treated as a single corporation.

"(iv) ALLOCATION OF LIMITATION AMONG MEMBERS OF CONTROLLED GROUP.—The limitation under clause (i) shall be allocated among the foreign trading gross receipts of small FSC's which are members of the same controlled group of corporations in a manner provided in regulations prescribed by the Secretary.

"(c) REQUIREMENT THAT FSC BE MANAGED OUTSIDE THE UNITED STATES.—The management of a FSC meets the requirements of this subsection for the taxable year if—

"(1) all meetings of the board of directors of the corporation, and all meetings of the shareholders of the corporation, are outside the United States,

"(2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year, and

"(3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation maintained outside the United States.

"(d) REQUIREMENT THAT ECONOMIC PROCESSES TAKE PLACE OUTSIDE THE UNITED STATES.—

"(1) IN GENERAL.—The requirements of this subsection are met with respect to the gross receipts of a FSC derived from any transaction if—

"(A) such corporation (or any person acting under a contract with such corporation) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and

"(B) the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.

"(2) ALTERNATIVE 85-PERCENT TEST.—A corporation shall be treated as satisfying the requirements of paragraph (1)(B) with respect to any transaction if, with respect to each of at least 2 paragraphs of subsection (e), the foreign direct costs incurred by such corporation attributable to activities described in such paragraph equal or exceed 85 percent of the total direct costs attributable to activities described in such paragraph.

"(3) DEFINITIONS.—For purpose of this subsection—

"(A) TOTAL DIRECT COSTS.—The term 'total direct costs' means, with respect to any transaction, the total direct costs incurred by the FSC attributable to activities described in subsection (e) performed at any location by the FSC or any person acting under a contract with such FSC.

"(B) FOREIGN DIRECT COSTS.—The term 'foreign direct costs' means with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.

"(4) RULES FOR COMMISSIONS, ETC.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (e) in the case of commissions, rentals, and furnishing of services.

"(e) ACTIVITIES RELATING TO DISPOSITION OF EXPORT PROPERTY.—The activities referred to in subsection (d) are—

"(1) advertising and sales promotion,

"(2) the processing of customer orders and the arranging for delivery of the export property,

"(3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer,

"(4) the determination and transmittal of a final invoice or statement of account and the receipt of payment, and

"(5) the assumption of credit risk.

"(f) CERTAIN RECEIPTS NOT INCLUDED IN FOREIGN TRADING GROSS RECEIPTS.—

"(1) CERTAIN RECEIPTS EXCLUDED ON BASIS OF USE; SUBSIDIZED RECEIPTS AND RECEIPTS FROM RELATED PARTIES EXCLUDED.—The term 'foreign trading gross receipts' shall not include receipts of a FSC from a transaction if—

"(A) the export property or services—

"(i) are for ultimate use in the United States, or

"(ii) are for use by the United States or any instrumentality thereof and such use of export property or services is required by law or regulation,

"(B) such transaction is accomplished by a subsidy granted by the United States or any instrumentality thereof, or

"(C) such receipts are from another FSC which is a member of the same controlled group of corporations of which such corporation is a member.

"(2) INVESTMENT INCOME; CARRYING CHARGES.—The term 'foreign trading gross receipts' shall not include any investment income or carrying charges.

"SEC. 925. TRANSFER PRICING RULES.

"(a) IN GENERAL.—In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

"(1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,

"(2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or

"(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

"(b) RULES FOR COMMISSIONS, RENTALS, AND MARGINAL COSTING.—The Secretary shall prescribe regulations setting forth—

"(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

"(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

"(c) REQUIREMENTS FOR USE OF ADMINISTRATIVE PRICING RULES.—A sale by a FSC meets the requirements of this subsection if—

"(1) all of the activities described in section 924(e) attributable to such sale, and

"(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale,

have been performed by such FSC (or by another person acting under a contract with such FSC).

"(d) LIMITATION ON GROSS RECEIPTS PRICING RULE.—The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the amount which would be determined under subsection (a)(2) with respect to such transaction.

"(e) TAXABLE INCOME.—For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

"(f) SPECIAL RULE FOR COOPERATIVES.—In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

"SEC. 926. DISTRIBUTIONS TO SHAREHOLDERS.

"(a) DISTRIBUTIONS MADE FIRST OUT OF FOREIGN TRADE INCOME.—For purposes of this title, any distribution to a shareholder of a FSC by such FSC which is made out of earnings and profits shall be treated as made—

"(1) first, out of earnings and profits attributable to foreign trade income, to the extent thereof, and

"(2) then, out of any other earnings and profits.

"(b) DISTRIBUTIONS BY FSC TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS TREATED AS UNITED STATES CONNECTED.—For purposes of this title, any distribution by a FSC which is made out of earnings and profits attributable to foreign trade income to any shareholder of such corporation which is a foreign corporation or a nonresident alien individual shall be treated as a distribution—

"(1) which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and

"(2) of income which is derived from sources within the United States.

"(c) FSC INCLUDES FORMER FSC.—For purposes of this section, the term 'FSC' includes a former FSC.

"SEC. 927. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) EXPORT PROPERTY.—For purposes of this subpart—

"(1) IN GENERAL.—The term 'export property' means property—

"(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,

"(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and

"(C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.

"(2) EXCLUDED PROPERTY.—The term 'export property' shall not include—

"(A) property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member,

"(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property,

"(C) oil or gas (or any primary product thereof), or

"(D) products the export of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979 (relating to the protection of the domestic economy).

"(3) PROPERTY IN SHORT SUPPLY.—If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, he may by Executive order designate the property as in short supply. Any property so designated shall not be treated as export property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President's determination that the property is no longer in short supply.

"(4) QUALIFIED COOPERATIVE.—The term 'qualified cooperative' means any organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products.

"(b) GROSS RECEIPTS.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'gross receipts' means—

"(A) the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and

"(B) gross income from all other sources.

"(2) GROSS RECEIPTS TAKEN INTO ACCOUNT IN CASE OF COMMISSION.—In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this subpart as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose.

"(c) INVESTMENT INCOME.—For purposes of this subpart, the term 'investment income' means—

"(1) dividends,

"(2) interest,

"(3) royalties,

"(4) annuities,

"(5) rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States),

"(6) gains from the sale or exchange of stock or securities,

"(7) gains from futures transactions in any commodity on, or subject to the rules of,

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a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct business of the FSC in the manner in which such business is customarily conducted by others),

"(8) amounts includible in computing the taxable income of the corporation under part I of subchapter J, and

"(9) gains from the sale or other disposition of any interest in an estate or trust.

"(d) OTHER DEFINITIONS.—For purposes of this subpart—

"(1) CARRYING CHARGES.—The term 'carrying charges' means—

"(A) carrying charges, and

"(B) under regulations prescribed by the Secretary, any amount in excess of the price for an immediate cash sale and any other unstated interest.

"(2) TRANSACTION.—

"(A) IN GENERAL.—The term 'transaction' means—

"(i) any sale, exchange, or other disposition,

"(ii) any lease or rental, and

"(iii) any furnishing of services.

"(B) GROUPING OF TRANSACTIONS.—To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

"(3) UNITED STATES DEFINED.—The term 'United States' includes the Commonwealth of Puerto Rico.

"(4) CONTROLLED GROUP OF CORPORATIONS.—The term 'controlled group of corporations' has the meaning given to such term by section 1563(a), except that—

"(A) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears therein, and

"(B) section 1563(b) shall not apply.

"(5) POSSESSIONS.—The term 'possession of the United States' means Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States.

"(6) SECTION 923(a)(2) NON-EXEMPT INCOME.—The term 'section 923(a)(2) non-exempt income' means any foreign trade income from a transaction with respect to which paragraph (1) or (2) of section 925(a) does not apply and which is not exempt foreign trade income.

"(e) SPECIAL RULES.—

"(1) SOURCE RULES FOR RELATED PERSONS.—Under regulations, the income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section 925 with respect to such transaction applied to such transaction.

"(2) PARTICIPATION IN INTERNATIONAL BOYCOTTS, ETC.—Under regulations prescribed by the Secretary, the exempt foreign trade income of a FSC for any taxable year shall be limited under rules similar to the rules of clauses (i) and (ii) of section 995(b)(1)(F).

"(3) EXCHANGE OF INFORMATION REQUIREMENTS.—For purposes of this title, the term 'FSC' shall not include any corporation which was credited or organized under the laws of any foreign country unless, at the time such corporation was created or organized, there was in effect between such country and the United States—

"(A) a bilateral or multilateral agreement described in section 274(h)(6)(C), or

"(B) an income tax treaty with respect to which the Secretary certifies that the exchange of information program with such country under such treaty carries out the purposes of this paragraph.

"(4) DISALLOWANCE OF TREATY BENEFITS.—Any corporation electing to be treated as a FSC under subsection (f)(1) may not claim any benefits under any income tax treaty between the United States and any foreign country.

"(5) EXEMPTION FROM CERTAIN OTHER TAXES.—

"(A) IN GENERAL.—No tax shall be imposed on any foreign trade income derived before January 1, 1987, by any jurisdiction described in subsection (d)(5).

"(B) EXCEPTION FOR TAX LIABILITY INCURRED TO POSSESSION.—Subparagraph (A) shall not apply with respect to any income tax liability which is incurred to any jurisdiction described in subsection (d)(5).

"(f) ELECTION OF STATUS AS FSC (AND AS SMALL FSC).—

"(1) ELECTION.—

"(A) TIME FOR MAKING.—An election by a corporation under section 922(A)(2) to be treated as a FSC, and an election under section 922(b)(1) to be a small FSC, shall be made by such corporation for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year, except that the Secretary may give his consent to the making of an election at such other times as he may designate.

"(B) MANNER OF ELECTION.—An election under subparagraph (A) shall be made in such manner as the Secretary shall prescribe and shall be valid only if all persons who are shareholders in such corporation on the first day of the first taxable year for which such election is effective consent to such election.

"(2) EFFECT OF ELECTION.—If a corporation makes an election under paragraph (1), then the provisions of this subpart shall apply to such corporation for the taxable year of the corporation for which made and for all succeeding taxable years.

"(3) TERMINATION OF ELECTION.—

"(A) REVOCATION.—An election under this subsection made by any corporation may be terminated by revocation of such election for any taxable year of the corporation after the first taxable year of the corporation for which the election is effective. A termination under this paragraph shall be effective with respect to such election—

"(i) for the taxable year in which made, if made at any time during the first 90 days of such taxable year, or

"(ii) for the taxable year following the taxable year in which made, if made after the close of such 90 days, and

for all succeeding taxable years of the corporation. Such termination shall be made in such manner as the Secretary shall prescribe by regulations.

"(B) CONTINUED FAILURE TO BE A FSC.—If a corporation is not a FSC for each of any 5 consecutive taxable years of the corporation for which an election under this subsection is effective, the election to be a FSC shall be terminated and not be in effect for any taxable year of the corporation after such 5th year.".

(b) DIVIDEND RECEIVED DEDUCTION FOR DOMESTIC CORPORATIONS.—

(1) IN GENERAL.—Section 245 (relating to dividends received from certain foreign corporations) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) CERTAIN DIVIDENDS RECEIVED FROM FSC.—

"(1) IN GENERAL.—In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to 100 percent of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC. The deduction allowable under the preceding sentence with respect to any dividend shall be in lieu of any deduction allowable under subsection (a) or (b) with respect to such dividend.

"(2) EXCEPTION FOR CERTAIN DIVIDENDS.—Paragraph (1) shall not apply to any dividend which is distributed out of earnings and profits attributable to foreign trade income which—

"(A) is section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)), or

"(B) would not, but for section 923(a)(4), be treated as exempt foreign trade income.

"(3) DEFINITIONS.—For purposes of this subsection, the terms 'foreign trade income' and 'exempt foreign trade income' have the meaning given such terms by section 923.".

"(2) CONFORMING AMENDMENTS.—

(A) Paragraph (1) of section 246(b) (relating to limitation on aggregate amount of deduction) is amended by striking out "245" each place it appears and inserting in lieu thereof "subsection (a) or (b) of section 245".

(B) Subsection (d) of section 245 (relating to property distributions), as redesignated by paragraph (1), is amended by striking out "subsections (a) and (b)" and inserting in lieu thereof "this section".

(c) CLARIFICATION OF INFORMATION EXCHANGE AGREEMENTS.—Subparagraph (D) of section 274(h)(6) (relating to coordination with section 6103) is amended—

(1) by adding at the end thereof the following new sentence: "The Secretary may exercise his authority under subchapter A of chapter 78 to carry out any obligation of the United States under an agreement referred to in subparagraph (C).", and

(2) by striking out the heading thereof and inserting in lieu thereof "COORDINATION WITH OTHER PROVISIONS.—".

(d) CONFORMING AMENDMENTS.—

(1) Section 901 (relating to foreign tax credit) is amended by redesignating subsection (h) as subsection (i) and inserting after subsection (g) the following new subsection:

"(h) TAXES PAID WITH RESPECT TO FOREIGN TRADE INCOME.—No credit shall be allowed under this section for any income, war profits, and excess profits taxes paid or accrued with respect to the foreign trade income (within the meaning of section 923(b)) of a FSC, other than section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)).".

(2) Paragraph (1) of section 904(d) (relating to application of section in case of certain interest income and dividends from a DISC) as amended—

(A) by striking out "and" at the end of subparagraph (B),

(B) by striking out subparagraph (C) and inserting in lieu thereof the following:

"(C) taxable income attributable to foreign trade income (within the meaning of section 923(b)),

"(D) distributions from a FSC (or former FCS) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)), and

"(E) income other than income described in subparagraph (A), (B), (C), or (D).", and

(C) by striking out the heading and inserting in lieu thereof:

"(d) SEPARATE APPLICATION OF SECTION WITH RESPECT TO CERTAIN INTEREST INCOME AND INCOME FROM DISC, FORMER DISC, FSC, OR FORMER FSC.—".

(3) Subsection (b) of section 906 (relating to special rules) is amended by adding at the end thereof the following new paragraph:

"(5) No credit shall be allowed under this section for any income, war profits, and excess profits taxes paid or accrued with respect to the foreign trade income (within the meaning of section 923(b)) of a FSC.".

(4) Section 951 (relating to amounts included in gross income of shareholders) is amended by adding at the end thereof the following new subsection:

"(e) FOREIGN TRADE INCOME NOT TAKEN INTO ACCOUNT.—

"(1) IN GENERAL.—The foreign trade income of a FSC and any deductions which are apportioned or allocated to such income shall not be taken into account under this subpart. For purposes of the preceding sentence, income described in paragraph (2) or (3) of section 921(d) shall be treated as derived from sources within the United States.

"(2) FOREIGN TRADE INCOME.—For purposes of this subsection, the term 'foreign trade income' has the meaning given such term by section 923(b), but does not include section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)).".

(5) Paragraph (4) of section 275(a) (relating to disallowance of deduction for certain taxes) is amended to read as follows:

"(4) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States if—

"(A) the taxpayer chooses to take to any extent the benefits of section 901, or

"(B) such taxes are paid or accrued with respect to foreign trade income (within the meaning of section 923(b)) of a FSC.".

"(6) Subsection (d) of section 1248 (relating to exclusions from earnings and profits) is amended by adding at the end thereof the following new paragraph:

"(6) FOREIGN TRADE INCOME.—Earnings and profits of the foreign corporation attributable to foreign trade income (within the meaning of section 923(b)) of a FSC.".

(7) Section 934 (relating to limitation on reduction in income tax liability incurred to the Virgin Islands) is amended by adding at the end thereof the following new subsection:

"(f) FSC.—Subsection (a) shall not apply in the case of a Virgin Islands corporation which is a FSC.".

(8) Paragraph (2) of section 956(b) (defining United States property) is amended by striking out "and" at the end of subparagraph (G), by striking out the period at the end of subparagraph (H) and inserting in lieu thereof a semicolon and "and", and by adding at the end thereof the following new subparagraph:

"(I) to the extent provided in regulations prescribed by the Secretary, property which is otherwise United States property which is held by a FSC and which is related to the export activities of such FSC.".

(9) Subparagraph (B) of section 7651(5), as amended by this Act, is amended by inserting "or subpart C of part III of subchapter N of chapter 1" after "881(b)(1)".

(10) Section 996(g) (relating to effectively connected income) is amended by inserting "and which are derived from sources within the United States" after "United States".

SEC. 802. INTEREST CHARGES DISC.

(a) INTEREST CHARGE ON DEFERRED TAX.—Section 995 (relating to taxation of DISC income to shareholders) is amended—

(1) by striking out subsections (e) and (f),

(2) by redesignating subsection (g) as subsection (e), and

(3) by adding at the end thereof the following new subsection:

"(f) INTEREST ON DISC-RELATED DEFERRED TAX LIABILITY.—

"(1) IN GENERAL.—A shareholder of a DISC shall pay for each taxable year interest in an amount equal to the product of—

"(A) the shareholder's DISC-related deferred tax liability for such year, and

"(B) the base period T-bill rate.

"(2) SHAREHOLDER'S DISC-RELATED DEFERRED TAX LIABILITY.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'shareholder's DISC-related deferred tax liability' means, with respect to any taxable year of a shareholder of a DISC, the excess of—

"(i) the amount which would be the tax liability of the shareholder for the taxable year if the deferred DISC income of such shareholder for such taxable year were included in gross income as ordinary income, over

"(ii) the actual amount of the tax liability of such shareholder for such taxable year.

Determinations under the preceding sentence shall be made without regard to carrybacks to such taxable year.

"(B) ADJUSTMENTS FOR LOSSES, CREDITS, AND OTHER ITEMS.—The Secretary shall prescribe regulations which provide such adjustments—

"(i) to the accounts of the DISC, and

"(ii) to the amount of any carryover or carryback of the shareholder,

as may be necessary or appropriate in the case of net operating losses, credits, and carryovers and carrybacks of losses, credits, and carryovers and carrybacks of losses and credits.

"(C) TAX LIABILITY.—The term 'tax liability' means the amount of the tax imposed by this chapter for the taxable year reduced by credits allowable against such tax (other than credits allowable under sections 31, 32, and 34).

"(3) DEFERRED DISC INCOME.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'deferred DISC income' means, with respect to any taxable year of a shareholder, the excess of—

"(i) the shareholder's pro rata share of accumulated DISC income (for periods after 1984) of the DISC as of the close of the computation year, over

"(ii) the amount of the distributions-in-excess-of-income for the taxable year of the DISC following the computation year.

"(B) COMPUTATION YEAR.—For purposes of applying subparagraph (A) with respect to any taxable year of a shareholder, the computation year is the taxable year of the DISC which ends with (or within) the taxable year of the shareholder which precedes the taxable year of the shareholder for which the amount of deferred DISC income is being determined.

"(C) DISTRIBUTIONS-IN-EXCESS-OF-INCOME.—For purposes of subparagraph (A), the term 'distributions-in-excess-of-income' means, with respect to any taxable year of a DISC, the excess (if any) of—

"(i) the amount of actual distributions to the shareholder out of accumulated DISC income, over

"(ii) the shareholder's pro rata share of the DISC income for such taxable year.

"(3) BASE PERIOD T-BILL RATE.—For purposes of this subsection, the term 'base period T-bill rate' means the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the 1-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder.

"(4) SHORT YEARS.—The Secretary shall prescribe such regulations as may be necessary for the application of this subsection to short years of the DISC, the shareholder, or both.

"(5) PAYMENT AND ASSESSMENT AND COLLECTION OF INTEREST.—The interest accrued during any taxable year which a shareholder is required to pay under paragraph (1) shall be treated, for purposes of this title, as interest payable under section 6601 and shall be paid by the shareholder at the time the tax imposed by this chapter for such taxable year is required to be paid.".

(b) TAXABLE INCOME IN EXCESS OF $10,000,000 DEEMED DISTRIBUTED.—

(1) IN GENERAL.—Subparagraph (E) of section 995(b)(1) (relating to based period export gross receipts) is amended to read as follows:

"(E) the taxable income of the DISC attributable to qualified export receipts of the DISC for the taxable year which exceed $10,000,000,".

(2) AGGREGATION OF RECEIPTS.—Subsection (b) of section 995 (relating to deemed distributions) is amended by adding at the end thereof the following new paragraph:

"(4) AGGREGATION OF QUALIFIED EXPORT RECEIPTS.—

"(A) IN GENERAL.—For purposes of applying paragraph (1)(E), all DISC's which are members of the same controlled group shall be treated as a single corporation.

"(B) ALLOCATION.—The dollar amount under paragraph (1)(E) shall be allocated among the DISC's which are members of the same controlled group in a manner provided in regulations prescribed by the Secretary.".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (a)(1) of section 992 (relating to definition of DISC) is amended—

(A) by striking out "and" at the end of subparagraph (C),

(B) by striking out the period at the end of subparagraph (D) and inserting in lieu thereof ", and", and

(C) by adding at the end thereof the following new subparagraph:

"(E) such corporation is not a member of any controlled group of which a FSC is a member.".

(2) Paragraph (3) of section 993(a) (relating to controlled groups) is amended by striking out "such term by" and inserting in lieu thereof "the term 'controlled group of corporations' by".

(3) Subsection (c) of section 999 (relating to international boycott factor) is amended by striking out "995(b)(1)(F)(i)" each place it appears and inserting in lieu thereof "995(b)(1)(F)(i)".

(4) The table of subparts of part III of subchapter N of chapter 1 is amended by inserting after the item relating to subpart B the following new item:

"Subpart C. Taxation of foreign sales corporations."

SEC. 803. TAXABLE YEAR OF DISC AND FSC REQUIRED TO CONFORM TO TAXABLE YEAR OF MAJORITY SHAREHOLDER.

(a) IN GENERAL.—Subsection (b) of section 441 (relating to period for computation of taxable income) is amended—

(1) by striking out "or" at the end of paragraph (2),

(2) by striking out the period at the end of paragraph (3) and inserting in lieu thereof "; or", and

(3) by adding at the end thereof the following new paragraph:

"(4) in the case of a FSC or DISC filing a return for a period of at least 12 months, the period determined under subsection (h).".

(b) DETERMINATION OF TAXABLE YEAR.—Section 441 is amended by adding at the end thereof the following new subsection:

"(h) TAXABLE YEAR OF FSC'S AND DISC'S.—

"(1) IN GENERAL.—For purposes of this subtitle, the taxable year of any FSC or DISC shall be the taxable year of that shareholder (or group of shareholders with the same 12-month taxable year) who has the highest percentage of voting power.

"(2) SPECIAL RULE WHERE MORE THAN ONE SHAREHOLDER (OR GROUP) HAS HIGHEST PERCENTAGE.—If 2 or more shareholders (or groups) have the highest percentage of voting power under paragraph (1), the taxable year of the FSC or DISC shall be the same 12-month period as that of any such shareholder (or group).

"(3) SUBSEQUENT CHANGES OF OWNERSHIP.—The Secretary shall prescribe regulations under which paragraphs (1) and (2) shall apply to a change of ownership of a corporation after the taxable year of the corporation has been determined under paragraph (1) or (2) only if such change is a substantial change of ownership.

"(4) VOTING POWER DETERMINED.—For purposes of this subsection, voting power shall be determined on the basis of total combined voting power of all classes of stock of the corporation entitled to vote.".

SEC. 804. REPORTING REQUIREMENTS.

(a) IN GENERAL.—The Secretary of the Treasury shall, for calendar year 1985 and each second calendar year thereafter, submit a report to the Congress within 27½ months following the close of such calendar year setting forth an analysis of the operation and effect of the provisions of this title.

(b) REPEAL OF DISC REPORTING REQUIREMENTS.—

(1) IN GENERAL.—Section 806 of the Revenue Act of 1971 (relating to submission of annual reports to Congress) is hereby repealed.

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to reports for calendar years after 1984.

SEC. 805. EFFECTIVE DATE; TRANSITION RULES.

(a) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this title shall apply to transactions after December 31, 1984, in taxable years ending after such date.

(2) SPECIAL RULE FOR CERTAIN CONTRACTS.—To the extent provided in regulations prescribed by the Secretary, subsections (c) and (d) of section 924 of the Internal Revenue Code of 1954 (as added by this title shall not apply to—

(A) any contract with respect to which the taxpayer uses the completed contract method of accounting and which—

(i) was entered into before March 16, 1984, or

(ii) was entered into after March 15, 1984, and before January 1, 1985, pursuant to a written plan to enter into such contract which was in effect on March 15, 1984,

(B) any contract which was entered into before March 16, 1984, except that this subparagraph shall only apply to the first 2 taxable years of the FSC ending after Janurary 1, 1985, or such later taxable years as the Secretary of the Treasury may designate, or

(C) any contract which was entered into after March 15, 1984, and before January 1, 1985, except that this subparagraph shall only apply to the first taxable year of the FSC ending after January 1, 1985, or such later taxable year as the Secretary of the Treasury may designate.

(3) SECTION 801(d)(10).—The amendment made by section 801(d)(10) shall apply to distributions on or after June 22, 1984.

(4) SECTION 803.—The amendments made by section 803 shall apply to any DISC established after March 21, 1984.

(b) TRANSITION RULES FOR DISC'S.—

(1) CLOSE OF 1984 TAXABLE YEARS OF DISC'S.—

(A) IN GENERAL.—For purposes of applying the Internal Revenue Code of 1954, the taxable year of each DISC which begins before January 1, 1985, and which (but for this paragraph) would include January 1, 1985, shall close on December 31, 1984. For purposes of such Code, the requirements of section 992(a)(1)(B) of such Code (relating to percentage of qualified export assets on last day of the taxable year) shall not apply to any taxable year ending on December 31, 1984.

(B) UNDERPAYMENTS OF ESTIMATED TAX.—To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, no addition to tax shall be made under section 6654 or 6655 of such Code with respect to any underpayment of any installment required to be paid before April 13, 1985, to the extent the underpayment was created or increased by reason of subparagraph (A).

(2) EXEMPTION OF ACCUMULATED DISC INCOME FROM TAX.—

(A) IN GENERAL.—For purposes of applying the Internal Revenue Code of 1954 with respect to actual distributions made after December 31, 1984, by a DISC or former DISC which was a DISC on December 31, 1984, any accumulated DISC income of a DISC or former DISC (within the meaning of section 996(f)(1) of such Code) which is derived before January 1, 1985, shall be treated as previously taxed income (within the meaning of section 996(f)(2) of such Code).

(B) EXCEPTION FOR DISTRIBUTION OF AMOUNTS PREVIOUSLY DISQUALIFIED.—Subparagraph (A) shall not apply to the distribution of any accumulated DISC income of a DISC or former DISC to which section 995(b)(2) of such Code applied by reason of any revocation or disqualification (other than a revocation which under regulations prescribed by the Secretary results solely from the provisions of this title.

(3) INSTALLMENT TREATMENT OF CERTAIN DEEMED DISTRIBUTIONS OF SHAREHOLDERS.—

(A) IN GENERAL.—Notwithstanding section 995(b) of such Code, if a shareholder of a DISC elects the application of this paragraph, any qualified distribution shall be treated, for purposes of such Code, as received by such shareholder in 10 equal installments on the last day of each of the 10 taxable years of such shareholder which begins after the first taxable year of such shareholder beginning in 1984. The preceding sentence shall apply without regard to whether the DISC exists after December 31, 1984.

(B) QUALIFIED DISTRIBUTION.—The term 'qualified distribution' means any distribution which a shareholder is deemed to have received by reason of section 995(b) of such Code with respect to income derived by the DISC in the first taxable year of the DISC beginning—

(i) in 1984, and

(ii) after the date in 1984 on which the taxable year of such shareholder begins.

(C) SHORTER PERIOD FOR INSTALLMENTS.—The Secretary of the Treasury or his delegate may by regulations provide for the election by any shareholder to be treated as receiving a qualified distribution over such shorter period as the taxpayer may elect.

(D) ELECTIONS.—Any election under this paragraph shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may prescribe.

(4) TREATMENT OF TRANSFERS FROM DISC TO FSC.—Except to the extent provided in regulations, section 367 of such Code shall not apply to transfers made before January 1, 1986 (or, if later, the date 1 year after the date on which the corporation ceases to be a DISC), to a FSC of qualified export assets (as defined in section 993(b) of such Code) held on August 4, 1983, by a DISC in a transaction described in section 351 or 368(a)(1) of such Code.

(5) DEEMED TERMINATION OF A DISC.—Under regulations prescribed by the Secretary, if any controlled group of corporations of which a DISC is a member establishes a FSC, then any DISC which is a member of such group shall be treated as having terminated its DISC status.

(6) DEFINITIONS.—For purposes of this subsection, the terms "DISC" and "former DISC" have the respective meanings given to such terms by section 992 of such Code.

(c) SPECIAL RULE FOR EXPORT TRADE CORPORATIONS.—

(1) IN GENERAL.—If, before January 1, 1985, any export trade corporation—

(A) make an election under section 927(f)(1) of the Internal Revenue Code of 1954 to be treated as a FSC, or

(B) elects not to be treated as an export trade corporation with respect to taxable years beginning after December 31, 1984,

rules similar to the rules of paragraphs (2) and (4) of subsection (b) shall apply to such export trade corporation.

(2) TREATMENT OF TRANSFERS TO FSC.—In the case of any export trade corporation which—

(A) makes an election described in paragraph (1), and

(B) transfers before January 1, 1986, any portion of its property to a FSC in a transaction described in section 351 or 368(a)(1), then, subject to such rules as the Secretary of the Treasury or his delegate may prescribe based on principles similar to the principles of section 505 (a) and (b) of the Revenue Act of 1971, no income, gain, or loss shall be recognized on such transfer or on the distribution of any stock of the FSC received (or treated as received) in connection with such transfer.

(3) EXPORT TRADE CORPORATION.—For purposes of this subsection, the term "export trade corporation" has the meaning given such term by section 971 of the Internal Revenue Code of 1954.

TITLE IX—HIGHWAY REVENUE PROVISIONS

Subtitle A— Provisions Relating to Heavy Vehicle Use Tax

SEC. 901. REDUCTION OF HEAVY VEHICLE USE TAX.

(a) GENERAL RULE.—Subsection (a) of section 4481 (as amended by section 513(a) of the Highway Revenue Act of 1982) is amended to read as follows:

"(a) IMPOSITION OF TAX.—A tax is hereby imposed on the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of at least 55,000 pounds at the rate specified in the following table:

"Taxable gross weight:	Rate of tax:
"At least 55,000 pounds, but not over 75,000 pounds.	$100 per year plus $22 for each 1,000 pounds (or fraction thereof) in excess of 55,000 pounds.
Over 75,000 pounds.....	$550."

(b) SPECIAL RULES IN THE CASE OF CERTAIN OWNER-OPERATORS.—

(1) SPECIAL RULE FOR TAXABLE PERIOD BEGINNING ON JULY 1, 1984.—In the case of a small owner-operator, the amount of the tax imposed by section 4481 of the Internal Revenue Code of 1954 on the use of any highway motor vehicle subject to tax under section 4481(a) of such Code (as amended by subsection (a)) for the taxable period which begins on July 1, 1984, shall be the lesser of—

(A) $3 for each 1,000 pounds of taxable gross weight (or fraction thereof), or

(B) the amount of the tax which would be imposed under such section 4481(a) without regard to this paragraph.

(2) EXEMPTION FOR VEHICLES USED FOR LESS THAN 5,000 MILES (AND CERTAIN OTHER AMENDMENTS) TO TAKE EFFECT ON JULY 1, 1984.—In the case of a small owner-operator, notwithstanding subsection (f)(2) of section 513 of the Highway Revenue Act of 1982, the amendments made by subsections (b), (c), and (d) of such section shall take effect on July 1, 1984.

(3) SMALL OWNER-OPERATOR DEFINED.—For purposes of this subsection, the term "small owner-operator" has the meaning given such term by section 513(f)(2) of the Highway Revenue Act of 1982.

(4) TAXABLE GROSS WEIGHT.—For purposes of this subsection, the term 'taxable gross weight' has the same meaning as when used in section 4481 of the Internal Revenue Code of 1954.

(c) EFFECTIVE DATE.—The amendment made by subsection (a) (and the provisions of subsection (b)) shall take effect on July 1, 1984.

SEC. 902. SPECIAL RULE FOR TRUCKS USED IN LOGGING.

(a) IN GENERAL.—Section 4483 (relating to exemptions from highway use tax) is amended by redesignating subsection (e) as subsection (f) and inserting after subsection (d) the following new subsection:

"(e) REDUCTION IN TAX FOR TRUCKS USED IN LOGGING.—The tax imposed by section 4481 shall be reduced by 25 percent with respect to any highway motor vehicle if—

"(1) the exclusive use of such vehicle during any taxable period is the transportation, to and from a point located on a forested site, of products harvested from such forested site, and

"(2) such vehicle is registered (under the laws of the State in which such vehicle is required to be registered) as a highway motor vehicle used in the transportation of harvested forest products.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on July 1, 1984.

SEC. 903. SPECIAL RULE FOR CERTAIN AGRICULTURAL VEHICLES.

(a) IN GENERAL.—Subsection (d) of section 4483 (relating to exemptions from highway use tax) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) 7,500-MILES EXEMPTION FOR AGRICULTURAL VEHICLES.—

"(A) IN GENERAL.—In the case of an agricultural vehicle, paragraphs (1) and (2) shall be applied by substituting '7,500' for '5,000' each place it appears.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) AGRICULTURAL VEHICLE.—The term 'agricultural vehicle' means any highway motor vehicle—

"(I) used primarily for farming purposes, and

"(II) registered (under the laws of the State in which such vehicle is required to be registered) as a highway motor vehicle used for farming purposes.

"(ii) FARMING PURPOSES.—The term 'farming purposes' means the transporting of any farm commodity to or from a farm or the use directly in agricultural production.

"(iii) FARM COMMODITY.—The term 'farm commodity' means any agricultural or horticultural commodity, feed, seed, fertilizer, livestock, bees, poultry, fur-bearing animals, or wildlife.".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect as if included in the amendments made by section 513 of the Highway Revenue Act of 1982.

Subtitle B—Provisions Relating to Fuel Taxes

SEC. 911. INCREASE IN DIESEL FUEL TAX.

(a) GENERAL RULE.—Paragraph (1) of section 4041(a) (relating to diesel fuel) is amended by striking out "9 cents" and inserting in lieu thereof "15 cents".

(b) INCOME TAX CREDIT FOR PURCHASE OF DIESEL-POWERED AUTOMOBILE OR LIGHT TRUCK.—Section 6427 (relating to fuels not used for taxable purposes), as amended by this Act, is amended by redesignating subsections (g), (h), (i), (j), (k), (l), and (m) as subsections (h), (i), (j), (k), (l), (m), and (n), respectively, and by inserting after subsection (f) the following new subsection:

"(g) ADVANCE REPAYMENT OF INCREASED DIESEL FUEL TAX TO ORIGINAL PURCHASERS OF DIESEL-POWERED AUTOMOBILES AND LIGHT TRUCKS.—

"(1) IN GENERAL.—Except as provided in subsection (j), the Secretary shall pay (without interest) to the original purchaser of any qualified diesel-powered highway vehicle an anount equal to the diesel fuel differential amount.

"(2) QUALIFIED DIESEL-POWERED HIGHWAY VEHICLE.—For purposes of this subsection, the term 'qualified diesel-powered highway vehicle' means any diesel-powered highway vehicle which—

"(A) has at least 4 wheels,

"(B) has a gross vehicle weight rating of 10,000 pounds or less, and

"(C) is registered for highway use in the United States under the laws of any State.

"(3) DIESEL FUEL DIFFERENTIAL AMOUNT.—For purposes of this subsection, the term 'diesel fuel differential amount' means—

"(A) except as provided in subparagraph (B), $102, or

"(B) in the case of a truck or van, $198.

"(4) ORIGINAL PURCHASER.—For purposes of this subsection—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'original purchaser' means the first person to purchase the qualified diesel-powered vehicle for use other than resale.

"(B) EXCEPTION FOR CERTAIN PERSONS NOT SUBJECT TO FUELS TAX.—The term 'original purchaser' shall not include any State or local government (as defined in section 4221(d)(4)) or any nonprofit educational organization (as defined in section 4221(d)(5)).

"(C) TREATMENT OF DEMONSTRATION USE BY DEALER.—For purposes of subparagraph (A), use as a demonstrator by a dealer shall not be taken into account.

"(5) VEHICLES TO WHICH SUBSECTION APPLIES.—Except as provided in paragraph (6), this subsection shall only apply to qualified diesel-powered highway vehicles originally purchased after January 1, 1985, and before January 1, 1988.

"(6) SPECIAL RULE FOR CERTAIN VEHICLES HELD ON JANUARY 1, 1985.—

"(A) IN GENERAL.—In the case of any person holding a qualified diesel-powered highway vehicle on January 1, 1985—

"(i) such person shall be treated as if he originally purchased such vehicle on December 31, 1984, but

"(ii) the amount payable under paragraph (1) to such person for such vehicle shall be the applicable fraction of the diesel fuel differential amount.

"(B) APPLICABLE FRACTION.—For purposes of subparagraph (A), the applicable fraction is the fraction determined in accordance with the following table:

"If the model year of the vehicle is:	*The applicable fraction is:*
1984 or 1985	*1*
1983	*⅚*
1982	*⅔*
1981	*½*
1980	*⅓*
1979	*⅙*

In the case of a 1978 or earlier model year vehicle, the applicable fraction shall be zero.

"(7) BASIS REDUCTION.—For the purposes of subtitle A, the basis of any qualified diesel-powered highway vehicle shall be reduced by the amount payable under this subsection with respect to such vehicle."

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) AMENDMENTS TO HIGHWAY TRUST FUND.—

(A) TRANSFERS TO MASS TRANSIT ACCOUNT.—Paragraph(2) of section 9503(e) (relating to transfers to Mass Transit Account) is amended to read as follows:

"(2) TRANSFERS TO MASS TRANSIT ACCOUNT.—The Secretary of the Treasury shall transfer to the Mass Transit Account the mass transit portion of the amounts appropriated to the Highway Trust Fund under subsection (b) which are attributable to taxes under sections 4041 and 4081 imposed after March 31, 1983. For purposes of the preceding sentence, the term 'mass transit portion' means an amount determined at the rate of 1 cent for each gallon with respect to which tax was imposed under section 4041 or 4081."

(B) INCOME TAX CREDITS PAYABLE OUT OF HIGHWAY TRUST FUND.—Clause (ii) of section 9503(c)(2)(A) is amended by striking out "used before October 1, 1988" and inserting in lieu thereof "used before October 1, 1988 (or with respect to qualified diesel-powered highway vehicles purchased before January 1, 1988)".

(2) CONFORMING AMENDMENTS TO INCOME TAX CREDIT.—

(A) Subsections (a)(4) and (b) of section 39 (as in effect before the enactment made by title IV of this Act) are each amended by striking out "6427(i)" and inserting in lieu thereof "6427(j)".

(B) Subsections (a), (b)(1), (c), (d), (e)(1), and (f)(1) of section 6427 are each amended by striking out "(i)" and inserting in lieu thereof "(j)".

(C) Subsection (h)(1) of section 6427 (as redesignated by subsection (c)) is amended—

(i) by striking out "or (f)" and inserting in lieu thereof "(f), or (g)", and

(ii) by striking out "fuel used" each place it appears and inserting in lieu thereof "fuel used (or a qualified diesel powered highway vehicle purchased)".

(D) Subsection (h)(2)(A) of section 6427 (as so redesignated) is amended—

(i) by striking out "and (e)" in clause (i) and inserting in lieu thereof "(e), and (g)", and

(ii) by striking out "fuel used" each place it appears and inserting in lieu thereof "fuel used (or a qualified diesel powered highway vehicle purchased)".

(E) Subsection (k)(2) of section 6427 (as so redesignated) is amended by striking out "(g)(2)" and inserting in lieu thereof "(h)(2)".

(F) Subsection (m) of section 6427 (as so redesignated) is amended by striking out "and (d)" each place it appears and inserting in lieu thereof "(d), and (g)".

(G) Sections 7210, 7603, 7604(b), 7604(c)(2), 7605(a), 7609(c)(1), and 7610(c) are each amended by striking out "6427(h)(2)" each place it appears and inserting in lieu thereof "6427(i)(2)".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on August 1, 1984.

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

SEC. 912. DECREASE IN TAX IMPOSED ON GASOHOL.

(a) AMENDMENT OF SECTION 4041.—Paragraph (1) of section 4041(k) (relating to fuels containing alcohol) is amended to read as follows:

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, in the case of the sale or use of any liquid at least 10 percent of which consists of alcohol (as defined in section 4081(c)(3))—

"(A) subsection (a)(1) shall be applied by substituting '9 cents' for '15 cents', and

"(B) subsection (a)(2) shall be applied by substituting '3 cents' for '9 cents', and

"(C) no tax shall be imposed by subsection (c).".

(b) AMENDMENTS OF SECTION 4081.—Subsection (c) of section 4081 (relating to imposition of tax on petroleum products), as amended by title VII of this Act, is amended—

(A) by striking out "4 cents" each place it appears and inserting in lieu thereof "3 cents",

(B) by striking out "4¼ cent" and inserting in lieu thereof "3¼ cents", and

(C) by striking out "4¾ cent" and inserting in lieu thereof "5¾ cents".

(c) CREDIT FOR ALCOHOL USED AS A FUEL.—Section 40 (relating to alcohol used as a fuel) (as amended by title IV of this Act) is amended

(1) by striking out "50 cents" each place it appears and inserting in lieu thereof "60 cents", and

(2) by striking out "37.5 cents" each place it appears and inserting in lieu thereof "45 cents".

(d) AMENDMENT OF SECTION 6427.—Paragraph (1) of section 6427(f) (relating to gasoline used to produce certain alcohol fuels) is amended by striking out "4¾ cents" and inserting in lieu thereof "5¾ cents".

(e) TARIFF IMPORTED FOR USE AS A FUEL.—Item 901.50 of the Tariff Schedules of the United States (19 U.S.C. 1202) is amended by striking out "50 cents per gal." each place it appears and inserting in lieu thereof "60 cents per gal.".

(f) DEFINITION OF ALCOHOL.—Sections 40(d)(1)(A)(i) (as amended by title IV of this Act) and 4081 (c)(3) (defining alcohol) are each amended by striking out "coal" and inserting in lieu thereof "coal (including peat)".

(g) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1985.

SEC. 913. MODIFICATION OF TAX IMPOSED ON METHANOL AND ETHANOL.

(a) IN GENERAL.—Section 4041 (relating to imposition of tax on special fuels) is amended by adding at the end thereof the following new subsection.

"(m) CERTAIN ALCOHOL FUELS.—

"(1) IN GENERAL.—In the case of the sale or use of any partially exempt methanol or ethanol fuel—

"(A) subsection (a)(2) shall be applied by substituting "4¾ cents" for "9 cents", and

"(B) no tax shall be imposed by subsection (c).

"(2) PARTIALLY EXEMPT METHANOL OR ETHANOL FUEL.—The term 'partially exempt methanol or ethanol fuel' means any liquid at least 85 percent of which consists of methanol, ethanol, or other alcohol produced from natural gas.".

(b) CONFORMING AMENDMENT.—Subsection (c) of section 40 (relating to coordination of credit for alcohol used as a fuel with exemption from excise tax) (as redesignated by title IV of this Act) is amended by striking out "(b)(2)" or (k)" and inserting in lieu thereof "(b)(2), (k), or (m)".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on August 1, 1984.

SEC. 914. EXTENSION OF REDUCTION IN TAX FOR FUEL USED BY TAXICABS.

Paragraph (3) of section 6427(e) (relating to termination of use in certain taxicabs) is amended by striking out "September 30, 1984" and inserting in lieu thereof "September 30, 1985".

SEC. 915. 3 CENT TAX ON DIESEL FUEL, ETC., USED IN CERTAIN BUSES.

(a) IN GENERAL.—Subsection (b) of section 6427 (relating to fuels not used for taxable purposes) is amended by redesignating paragraph (2) as paragraph (3) and inserting after paragraph (1) the following new paragraph:

"(2) 3-cent reduction in refund in certain cases.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the rate of tax taken into account under paragraph (1) shall not exceed 12 cents.

"(B) EXCEPTION.—Subparagraph (A) shall not apply to fuel used in any automobile bus while engaged in furnishing (for compensation) intracity passenger land transportation—

"(i) which is available to the general public, and

"(ii) which is scheduled and along regular routes,

but only if such bus is a qualified local bus.

"(C) QUALIFIED LOCAL BUS.—For purposes of this paragraph, the term 'qualified local bus' means any local bus—

"(i) which has a seating capacity of at least 20 adults (not including the driver), and

"(ii) which is under contract (or is receiving more than a nominal subsidy) from any State or local government (as defined in section 4221(d)) to furnish such transportation."

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on August 1, 1984.

Subtitle C—Temporary Reduction in Retail Tax on Certain Piggyback Trailers

SEC. 921. TEMPORARY REDUCTION IN TAX.

Section 4051 (relating to retail tax on heavy trucks and trailers) is amended by redesignating subsection (d) as subsection (e) and inserting after subsection (c) the following new subsection:

"(d) TEMPORARY REDUCTION IN TAX ON CERTAIN PIGGYBACK TRAILERS.—

"(1) IN GENERAL.—In the case of piggybank trailers or semitrailers sold within the 1-year period beginning on the date of the enactment of the Tax Reform Act of 1984, subsection (a) shall be applied by substituting '6 percent' for '12 percent'.

"(2) PIGGYBANK TRAILERS OR SEMITRAILERS.—For purposes of this subsection, the term 'piggybank trailers or semitrailers' means any trailer or semitrailer—

"(A) which is designed for use principally in connection with trailer-on-flatcar service by rail, and

"(B) with respect to which the seller certifies, in such manner and form and at such time as the Secretary prescribes by regulations, that such trailers or semitrailer—

"(i) will be used, or resold for use, principally in connection with such service, or

"(ii) will be incorporated into an article which will be so used or resold.

"(3) ADDITIONAL TAX WHERE NONQUALIFIED USE.—If any piggybank trailer or semitrailer was subject to tax under subsection (a) at the 6 percent rate and such trailer or semitrailer is used or resold for use other than for a use described in paragraph (2)—

"(A) such use or resale shall be treated as a sale to which subsection (a) applies,

"(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to the amount of the tax which was imposed on the first retail sale, and

"(C) the person so using or reselling such trailer or semitrailer shall be liable for the tax imposed by subsection (a)."

Subtitle D—Studies

PART I—STUDIES RELATING TO HEAVY VEHICLE USE TAX

SEC. 931. WHETHER HEAVY VEHICLES BEAR FAIR SHARE OF HIGHWAY COSTS.

The Secretary of Transportation shall conduct a study of whether highway motor vehicles with taxable gross weights of 80,000 pounds or more bear their fair share of the costs of the highway system.

SEC. 932. TRANS-BORDER TRUCKING.

The Secretary of Transportation shall conduct a study to determine the significance of the tax imposed by section 4481 of the Internal Revenue Code of 1954 (relating to tax on use of certain vehicles) on trans-border trucking operations.

SEC. 933. WEIGHT-DISTANCE TAXES.

The Secretary shall conduct a study to evaluate the feasibility and ability of weight-distance truck taxes to provide the greatest degree of equity among highway users, to ease the costs of compliance of such taxes, and to improve the efficiency by which such taxes might be administered. Such study shall also include an evaluation of the evasion potential for weight-distance taxes and an assessment of the benefits to interstate commerce of replacing all Federal truck taxes (other than fuel taxes) with a weight-distance tax.

SEC. 934. REPORTS, ETC.

(a) CONSULTATION WITH TREASURY.—Studies conducted under this part shall be conducted in consultation with the Secretary of the Treasury.

(b) REPORT.—Not later than October 1, 1987, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on each study conducted under this part together with such recommendations as the Secretary may deem advisable.

PART II—OTHER STUDIES

SEC. 935. STUDY OF REDUCED FUEL TAXES FOR TAXICABS.

The Secretary of the Treasury or his delegate shall conduct a study of the reduced rate of fuel taxes provided by section 6427(e) of the Internal Revenue Code of 1954. Not later than January 1, 1985, such Secretary shall submit a report on such study to the Congress, together with such recommendations as the Secretary may deem advisable.

SEC. 936. STUDY OF PIGGYBACK TRAILERS.

(a) IN GENERAL.—The Secretary of Transportation (in consultation with the Secretary of the Treasury) shall conduct a study of the appropriate application and level of the tax imposed by section 4051 of the Internal Revenue Code of 1954 (relating to tax on trucks and trailers sold at retail) on piggyback trailers and semi-trailers.

(b) REPORT.—Not later than May 1, 1985, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a) together with such recommendations as the Secretary may deem advisable.

TITLE X—MISCELLANEOUS REVENUE PROVISIONS

Subtitle A—Capital Gains and Losses

SEC. 1001. DECREASE IN HOLDING PERIOD REQUIRED FOR LONG-TERM CAPITAL GAIN TREATMENT.

(a) IN GENERAL.—

(1) CAPITAL GAINS.—Paragraphs (1) and (3) of section 1222 (relating to other terms relat-

ing to capital gains and losses) are each amended by striking out "1 year" and inserting in lieu thereof "6 months".

(2) CAPITAL LOSSES.—Paragraphs (2) and (4) of section 1222 are each amended by striking out "1 year" and inserting in lieu thereof "6 months".

(b) CONFORMING AMENDMENTS.—The following provisions are each amended by striking out "1 year" each place it appears and inserting in lieu thereof "6 months".

(1) Paragraph (1)(B) of section 166(d) (relating to nonbusiness debts).

(2) Subsection (a) of section 341 (relating to treatment of gain to shareholders in the case of collapsible corporations).

(3) Paragraph (2) of subsection (a) and subparagraph (L) of subsection (e)(4) of section 402 (relating to capital gains treatment for certain distributions in the case of a beneficiary of an exempt employees' trust).

(4) Subparagraph (A) of section 403(a)(2) (relating to capital gains treatment for certain distributions in the case of a beneficiary under a qualified annuity plan).

(5) Paragraph (1) of section 423(a) (relating to employee stock purchase plans).

(6) Paragraph (2) of section 582(c) (relating to capital gains of banks).

(7) Subparagraphs (A) and (B) of section 584(c)(1) (relating to inclusions in taxable income of participants in common trust funds).

(8) Paragraphs (3) and (4) of section 642(c) (relating to charitable deductions for certain trusts).

(9) Paragraphs (1) and (2) of section 702(a) (relating to income and credits of partner).

(10) Subparagraph (A) of section 817(a)(1) (relating to certain gains and losses in the case of life insurance companies).

(11) Subparagraph (B) of section 852(b)(3) (relating to taxation of shareholders of regulated investment companies).

(12) Subparagraph (A) of section 856(c)(4) (relating to definition of real estate investment trust).

(13) Paragraphs (3)(B) and (7) of section 857(b) (relating to taxation of shareholders of real estate investment trust).

(14) Paragraphs (11) and (12) of section 1223 (relating to holding period of property).

(15) Section 1231 (relating to property used in the trade or business and involuntary conversions).

(16) Paragraph (2) of section 1232(a) (relating to sale or exchange in the case of bonds and other evidences of indebtedness).

(17) Subsections (b), (d), and subparagraph (A) of subsection (e)(4) of section 1233 (relating to gains and losses from short sales).

(18) Paragraph (1) of section 1234(b) (relating to treatment of the grantor of an option in the case of stock, securities, or commodities).

(19) Subsection (a) of section 1235 (relating to sale or exchange of patents).

(20) Paragraph (4) of section 1246(a) (relating to holding period in the case of gain on foreign investment company stock).

(21) Subsection (l) of section 1247 (relating to loss on sale or exchange of certain stock in the case of foreign investment companies electing to distribute income currently).

(22) Subsections (b) and (g)(3)(C) of section 1248 (relating to gain from certain sales or exchanges of stock in certain foreign corporations).

(23) Subparagraph (A) of section 1251(e)(1) (defining farm recapture property).

(c) TECHNICAL AMENDMENT RELATING TO TIMBER, COAL, AND DOMESTIC IRON ORE.—Section 631 (relating to gain or loss in the case of timber, coal, or domestic iron ore) is amended—

(1) by striking out "for a period of more than 1 year" in the first sentence of subsection (a) and inserting in lieu thereof "on the first day of such year and for a period of more than 6 months before such cutting", and

(2) by striking out "1 year" in subsections (b) and (c) and inserting in lieu thereof "6 months".

(d) TECHNICAL AMENDMENT RELATING TO CERTAIN SHORT-TERM GOVERNMENT OBLIGATIONS.—Section 1232(a)(3)(A) (relating to certain short-term government obligations) is amended by striking out "held less than 1 year".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to property acquired after June 22, 1984, and before January 1, 1988.

SEC. 1002. REPEAL OF SPECIAL RULE FOR PRE-1970 LOSSES.

(c) IN GENERAL.—Paragraph (3) of section 1212(b) (relating to transitional rule for taxpayers other than corporations) is repealed.

(d) EFFECTIVE DATE.—The repeal made by subsection (a) shall apply to taxable years beginning after December 31, 1986.

Subtitle B—Excise Tax Provisions

PART I—BOATING SAFETY AND SPORT FISH RESTORATION

Subpart A—Boating Safety Amendments

SEC. 1010. POLICY.

It is declared to be the policy of Congress and the purpose of this part to improve recreational boating safety and to foster greater development, use, and enjoyment of all waters of the United States by encouraging and assisting participation by the States, the boating industry, and the boating public in activities related to increasing boating safety; by authorizing the establishment of national construction and performance standards for boats and associated equipment; by creating more flexible authority governing the use of boats and equipment; and by facilitating the provision of services by the United States Coast Guard on behalf of boating safety. It is further declared to be the policy of Congress to encourage greater and continuing uniformity of boating laws and regulations among the States and the Federal Government, to encourage and assist the States in exercising their authorities in boating safety, to foster greater cooperation and assistance between the Federal Government and the States in administering and enforcing Federal and State laws and regulations pertaining to boating safety, and to equitably utilize taxes paid on fuel use in motor boats in a manner which enhances boating safety.

SEC. 1011. GENERAL AMENDMENTS TO TITLE 46.

(a) Section 2102 of title 46, United States Code, is amended—

(1) by striking out "and facilities improvement" in paragraph (1);

(2) by striking out paragraphs (3) and (4); and

(3) by redesignating paragraph (5) as paragraph (3).

(b)(1) Section 13101 of such title is amended—

(A) by striking out "and facility improvement" in subsection (a); and

(B) by striking out "and facilities improvement" each place it appears.

(2) Subsection (a) of section 13101 of such title is amended by striking out "may" in the second sentence and inserting in lieu thereof "shall".

(c)(1) Section 13102 of such title is amended by striking out "and facilities improvement" each place it appears.

(2) Subsection (a) of section 13102 of such title is amended by striking out "may" and inserting in lieu thereof "shall".

(3) Paragraph (2) of section 13102(a) of such title is amended by striking out ", (d), or (f)".

(4) Subsections (d) and (f) of section 13102 of such title are repealed, and subsection (e) of such section (and any reference thereto) is redesignated as subsection (d).

(d)(1) Subsections (b), (d), and (f) of section 13103 of such title are repealed, and subsections (c) and (e) of such section (and all references thereto) are redesignated as subsections (b) and (c), respectively.

(2) Subsections (b) and (c) of section 13103 of such title (as redesignated by paragraph (1) of this subsection) are amended by striking out "and facilities improvement" each place it appears.

(e) Section 13105 of such title is amended by striking out "and facilities improvement".

(f) Subsection (c) of section 13108 of such title is amended by striking out "and facilities improvement" each place it appears.

(g) Section 13109 of such title is amended by striking out "and facilities improvement" each place it appears.

SEC. 1012. AUTHORIZATION OF FUNDS FOR BOATING SAFETY.

Section 13106 of title 46, United States Code, is amended to read as follows:

"(a) The Secretary may expend in each of the fiscal years 1985, 1986, 1987, and 1988, subject to amounts as are provided in appropriations laws for liquidation of contract authority, an amount equal to two-thirds of the amount transferred for such fiscal year to the Boat Safety Account under section 9503(c)(4) of the Internal Revenue Code of 1954 (26 U.S.C. 9503(c)(4)). The amount shall be allocated as provided under section 13103 of this title and shall be available for State recreational boating safety programs as provided under the guidelines established under subsection (b) of this section. Amounts authorized to be expended for State recreational boating safety programs shall remain available until expended and are deemed to have been expended only if an amount equal to the total amounts authorized to be expended under this section for the fiscal year in question and all prior fiscal years have been obligated. Amounts previously obligated but released by payment of a final voucher or modification of a program acceptance shall be credited to the balance of unobligated amounts and are immediately available for expenditure.

"(b) The Secretary shall establish guidelines prescribing the purposes for which amounts available under this chapter for State recreational boating safety programs may be used. Those purposes may include—

"(1) providing facilities, equipment, and supplies for boating safety education and law enforcement, including purchase, operation, maintenance, and repair;

"(2) training personnel in skills related to boating safety and to the enforcement of boating safety laws and regulations;

"(3) providing public boating safety education, including educational programs and lectures, to the boating community and the public school system;

"(4) acquiring, constructing, or repairing public access sites used primarily by recreational boaters;

"(5) conducting boating safety inspections and marine casualty investigations;

"(6) establishing and maintaining emergency or search and rescue facilities, and providing emergency or search and rescue assistance;

"(7) establishing and maintaining waterway markers and other appropriate aids to navigation; and

"(8) providing State recreational vessel numbering or titling programs.

"(c) An amount equal to one-third of the amount transferred for each fiscal year to the Boat Safety Account under section 9503(c)(4) of the Internal Revenue Code of 1954 (26 U.S.C. 9503(c)(4)) is available to the Secretary for expenditures out of the operating expenses account of the Coast Guard for services provided by the Coast Guard for recreational boating safety, including services provided by the Coast Guard Auxiliary. Amounts made available by this subsection shall remain available until expended."

SEC. 1013. EFFECTIVE DATE.

The amendments made by this subpart shall take effect on October 1, 1984, and shall apply with respect to fiscal years beginning after September 30, 1984.

Subpart B—Sport Fish Restoration Program

SEC. 1014. AMENDMENTS TO THE SPORT FISH RESTORATION PROGRAM.

(a) The Act entitled "An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes", approved August 9, 1950 (16 U.S.C. 777 et seq.), is amended as follows:

(1) The first section is amended—

(A) by inserting "(a)" after "That"; and

(B) by adding at the end thereof the following new subsection:

"(b) Each coastal State, to the extent practicable, shall equitably allocate the following sums between marine fish projects and freshwater fish projects in the same proportion as the estimated number of resident marine anglers and the estimated number of resident freshwater anglers, respectively, bear to the estimated number of all resident anglers in that State:

"(1) The additional sums apportioned to such State under this Act as a result of the taxes imposed by the amendments made by section 1015 of the Tax Reform Act of 1984 on items not taxed under section 4161(a) of the Internal Revenue Code of 1954 before October 1, 1984.

"(2) The sums apportioned to such State under this Act that are not attributable to any tax imposed by such section 4161(a).

As used in this subsection, the term 'coastal State' means any one of the States of Alabama, Alaska, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Oregon, Rhode Island, South Carolina, Texas, Virginia, and Washington. The term also includes the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Marianas."

(2) The first sentence of section 3 is amended to read as follows: "To carry out the provisions of this Act for fiscal years after September 30, 1984, there are authorized to be appropriated from the Sport Fish Restoration Account established by section 9504(a) of the Internal Revenue Code of 1954 the amounts paid, transferred, or otherwise credited to that Account. For purposes of the provision of the Act of August 31, 1951, which refers to this section, such amounts shall be treated as the amounts that are equal to the revenues described in this section."

(3) The first sentence of section 4 is amended to read as follows: "So much, not to exceed 6 per centum, of each annual appropriation made in accordance with the provisions of section 3 of this Act as the Secretary of the Interior may estimate to be necessary for his expenses in the conduct of necessary investigations, administration, and the execution of this Act and for aiding in the formulation, adoption, or administration of any compact between two or more States for the conservation and management of migratory fishes in marine or freshwaters shall be deducted for that purpose, and such sum is authorized to be made available therefor until the expiration of the next succeeding fiscal year."

(4) Section 5 is amended by striking all after the first sentence.

(5) Section 6 is amended by adding at the end thereof the following new subsection:

"(d) The Secretary of the Interior may enter into agreements to finance up to 75 per centum of the initial costs of the acquisition of lands or interests therein and the construction of structures or facilities for appropriations currently available for the purposes of this Act; and to agree to finance up to 75 per centum of the remaining costs over such a period of time as the Secretary may consider necessary. The liability of the United States in any such agreement is contingent upon the continued availability of funds for the purposes of this Act."

(6) Section 8 is amended by inserting "(a)" before the first sentence, and by adding at the end thereof the following new subsections:

"(b)(1) Each State shall allocate 10 per centum of the funds apportioned to it for each fiscal year under section 4 of this Act for the payment of up to 75 per centum of the costs of the acquisition, development, renovation, or improvement of facilities (and auxiliary facilities necessary to insure the safe use of such facilities) that create, or add to, public access to the waters of the United States to improve the suitability of such waters for recreational boating purposes.

"(2) So much of the funds that are allocated by a State under paragraph (1) in any fiscal year that remained unexpended or unobligated at the close of such year are authorized to be made available for the purposes described in paragraph (1) during the succeeding fiscal year, but any portion of such funds that remain unexpended or unobligated at the close of such succeeding fiscal year are authorized to be made available for expenditure by the Secretary of the Interior in carrying out the research program of the Fish and Wildlife Service in respect to fish of material value for sport or recreation.

"(c) Each State may use not to exceed 10 per centum of the funds apportioned to it under section 4 of this Act to pay up to 75 per centum of the costs of an aquatic resource education program for the purpose of increasing public understanding of the Nation's water resources and associated aquatic life forms. The non-Federal share of such costs may not be derived from other Federal grant programs. The Secretary shall issue not later than the one hundred and twentieth day after the effective date of this subsection such regulations as he deems advisable regarding the criteria for such programs."

(7) Section 12 is amended—

(A) inserting "the Mayor of the District of Columbia," immediately after "the Secretary of Agriculture of Puerto Rico,";

(B) by inserting "for the District of Columbia one-third of 1 per centum," immediately after "for Puerto Rico 1 per centum,"; and

(C) by inserting "the District of Columbia," after "Puerto Rico," each place it appears therein.

(b) The amendments made by subsection (a) shall take effect on October 1, 1984, and shall apply with respect to fiscal years beginning after September 30, 1984.

Subpart C—Taxes on Sales of Sport Fishing Equipment, Etc.

SEC. 1015. TAX ON SALE OF SPORT FISHING EQUIPMENT.

(a) GENERAL RULE.—Subsection (a) of section 4161 (relating to imposition of tax on the sale of rods, reels, etc.) is amended to read as follows:

"(a) SPORT FISHING EQUIPMENT.—

"(1) IMPOSITION OF TAX.—There is hereby imposed on the sale of any article of sport fishing equipment by the manufacturer, producer, or importer a tax equal to 10 percent of the price for which so sold.

"(2) 3 PERCENT RATE OF TAX FOR ELECTRIC OUTBOARD MOTORS AND SONAR DEVICES SUITABLE FOR FINDING FISH.—

"(A) IN GENERAL.—In the case of an electric outboard motor or a sonar device suitable for finding fish, paragraph (1) shall be applied by substituting '3 percent' for '10 percent'.

"(B) $30 LIMITATION ON TAX IMPOSED ON SONAR DEVICES SUITABLE FOR FINDING FISH.—The tax imposed by paragraph (1) on any sonar device suitable for finding fish shall not exceed $30.

"(3) PARTS OR ACCESSORIES SOLD IN CONNECTION WITH TAXABLE SALE.—In the case of any sale by the manufacturer, producer, or importer of any article of sport fishing equipment, such article shall be treated as including any parts or accessories of such article sold on or in connection therewith or with the sale thereof."

(b) DEFINITION OF SPORT FISHING EQUIPMENT, ETC.—Part I of subchapter D of chapter 32 is amended by adding at the end thereof the following new section:

"SEC. 4162. DEFINITIONS; TREATMENT OF CERTAIN RESALES.

"(a) SPORT FISHING EQUIPMENT DEFINED.—For purposes of this part, the term 'sport fishing equipment' means—

"(1) fishing rods and poles (and component parts therefor),

"(2) fishing reels,

"(3) fly fishing lines, and other fishing lines not over 130 pounds test,

"(4) fishing spears, spear guns, and spear tips,

"(5) items of terminal tackle, including—

"(A) leaders,

"(B) artificial lures,

"(C) artificial baits,

"(D) artificial flies,

"(E) fishing hooks,

"(F) bobbers,

"(G) sinkers,

"(H) snaps,

"(I) drayles, and

"(J) swivels,

but not including natural bait or any item of terminal tackle designed for use and ordinarily used on fishing lines not described in paragraph (3), and

"(6) the following items of fishing supplies and accessories—

"(A) fish stringers,

"(B) creels,

"(C) tackle boxes,

"(D) bags, baskets, and other containers designed to hold fish,

"(E) portable bait containers,

"(F) fishing vests,

"(G) landing nets,

"(H) gaff hooks,

"(I) fishing hood disgorgers, and

"(J) dressing for fishing lines and artificial flies,

"(7) fishing tip-ups and tilts,

"(8) fishing rod belts, fishing rodholders, fishing harnesses, fish fighting chairs, fishing outriggers, and fishing downriggers,

"(9) electric outboard boat motors, and

"(10) sonar devices suitable for finding fish.

"(b) SONAR DEVICE SUITABLE FOR FINDING FISH.—For purposes of this part, the term 'sonar device suitable for finding fish' shall not include any sonar device which is—

"(1) a graph recorder,

"(2) a digital type,
"(3) a meter readout, or
"(4) a combination graph recorder meter readout.
"(c) TREATMENT OF CERTAIN RESALES.—
"(1) IN GENERAL.—If—
"(A) the manufacturer, producer, or importer sells any article taxable under section 4161(a) to any person,
"(B) the constructive sale price rules of section 4216(b) do not apply to such sale, and
"(C) such person (or any other person) sells such article to a related person with respect to the manufacturer, producer, or importer,
then such related person shall be liable for tax under section 4161 in the same manner as if such related person were the manufacturer of the article.
"(2) CREDIT FOR TAX PREVIOUSLY PAID.—If—
"(A) tax is imposed on the sale of any article by reason of paragraph (1), and
"(B) the related person establishes the amount of the tax which was paid on the sale described in paragraph (1)(A),
the amount of the tax so paid shall be allowed as a credit against the tax imposed by reason of paragraph (1).
"(3) RELATED PERSON.—For purposes of this subsection, the term 'related person' has the meaning given such term by section 168(e)(4)(D).
"(4) REGULATIONS.—Except to the extent provided in regulations, rules similar to the rules of this subsection shall also apply in cases (not described in paragraph (1)) in which intermediaries or other devices are used for purposes of reducing the amount of the tax imposed by section 4161(a)."
(c) TIME FOR PAYMENT OF TAX.—Section 6302 (relating to mode or time of collecting tax) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:
"(d) TIME FOR PAYMENT OF MANUFACTURERS EXCISE TAX ON SPORT FISHING EQUIPMENT.—The tax imposed by section 4161(a) (relating to manufacturers excise tax on sport fishing equipment) shall be due and payable on the date for filing the return for such tax."
(d) Clerical Amendment.—The table of sections for part I of subchapter D of chapter 32 is amended by adding at the end thereof the following new item:

"Sec. 4162. Definitions; treatment of certain resales."

(e) EFFECTIVE DATE.—
(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply with respect to articles sold by the manufacturer, producer, or importer after September 30, 1984.
(2) TREATMENT OF CERTAIN RESALES.—Subsection (c) of section 4162 of the Internal Revenue Code of 1954 (relating to treatment of certain resales), as added by this section, shall apply to sales by related persons (as defined in such subsection) after the date of the enactment of this Act.

SEC. 1016. ESTABLISHMENT OF AQUATIC RESOURCES TRUST FUND.

(a) GENERAL RULE.—Subchapter A of chapter 98 (relating to Trust Fund Code) is amended by adding at the end thereof the following new section:

"SEC. 9504. AQUATIC RESOURCES TRUST FUND.

"(a) CREATION OF TRUST FUND.—
"(1) IN GENERAL.—There is hereby established in the Treasury of the United States a trust fund to be known as the 'Aquatic Resources Trust Fund'.
"(2) ACCOUNTS IN TRUST FUND.—The Aquatic Resources Trust Fund shall consist of—
"(A) a Sport Fish Restoration Account, and
"(B) a Boat Safety Account.
Each such Account shall consist of such amounts as may be appropriated, credited, or paid to it as provided in this section, section 9503(c)(4), or section 9602(b).
"(b) SPORT FISH RESTORATION ACCOUNT.—
"(1) TRANSFER OF CERTAIN TAXES TO ACCOUNT.—There is hereby appropriated to the Sport Fish Restoration Account amounts equivalent to the following amounts received in the Treasury on or after October 1, 1984—
"(A) the taxes imposed by section 4161(a) (relating to sport fishing equipment), and
"(B) the import duties imposed on fishing tackle under subpart B of part 5 of schedule 7 of the Tariff Schedules of the United States (19 U.S.C. 1202) and on yachts and pleasure craft under subpart D of part 6 of schedule 6 of such Schedules.
"(2) EXPENDITURES FROM ACCOUNT.—Amounts in the Sport Fish Restoration Account shall be available, as provided by appropriation Acts, to carry out the purposes of the Act entitled 'An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes', approved August 9, 1950 (as in effect on June 1, 1984).
"(c) EXPENDITURES FROM BOAT SAFETY ACCOUNT.—Amounts in the Boat Safety Account shall be available, as provided by appropriation Acts, for making expenditures before April 1, 1989, to carry out the purposes of section 13106 of title 46, United States Code (as in effect on June 1, 1984).
"(d) CROSS REFERENCE.—

"For provision transferring motorboat fuels taxes to Boat Safety Account and Sport Fish Restoration Account, see section 9503(c)(4)."

(b) TRANSFERS FROM HIGHWAY TRUST FUND.—
(1) Subparagraph (A) of section 9503(c)(4) of such Code is amended—
(A) by striking out "the National Recreational Boating Safety and Facilities Improvement Fund established by section 202 of the Recreational Boating Fund Act" in clause (i) and inserting in lieu thereof "the Boat Safety Account in the Aquatic Resources Trust Fund";
(B) by striking out "the amount in the National Recreational Boating Safety and Facilities Improvement Fund" in clause (ii) and inserting in lieu thereof "the amount in the Boat Safety Account", and
(C) by striking out "NATIONAL RECREATIONAL BOATING SAFETY AND FACILITIES IMPROVEMENT FUND" in the subparagraph heading and inserting in lieu thereof "BOAT SAFETY ACCOUNT".
(2) Paragraph (4) of section 9503(c) is amended by redesignating subparagraph (C) as subparagraph (D) and by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:
"(B) $1,000,000 PER YEAR OF EXCESS TRANSFERRED TO LAND AND WATER CONSERVATION FUND.—
"(i) IN GENERAL.—Any amount received in the Highway Trust Fund—
"(I) which is attributable to motorboat fuel taxes, and
"(II) which is not transferred from the Highway Trust Fund under subparagraph (A),
shall be transferred (subject to the limitation of clause (ii)) by the Secretary from the Highway Trust Fund into the land and water conservation fund provided for in title I of the Land and Water Conservation Fund Act of 1965.
"(ii) LIMITATION.—The aggregate amount transferred under this subparagraph during any fiscal year shall not exceed $1,000,000.
"(C) EXCESS FUNDS TRANSFERRED TO SPORT FISH RESTORATION ACCOUNT.—Any amount received in the Highway Trust Fund—
"(i) which is attributable to motorboat fuel taxes, and
"(ii) which is not transferred from the Highway Trust Fund under subparagraph (A) or (B),
shall be transferred by the Secretary from the Highway Trust Fund into the Sport Fish Restoration Account in the Aquatic Resources Trust Fund."
(c) CONFORMING AMENDMENTS.
(1) Section 13107 of title 46, United States Code, is hereby repealed.
(2) The table of sections for chapter 131 of title 46, United States Code, is amended by striking out the item relating to section 13107.
(d) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 98 is amended by adding at the end thereof the following new item:

"Sec. 9504. Aquatic Resources Trust Fund."

(e) EFFECTIVE DATE.—
(1) IN GENERAL.—The amendments made by this section shall take effect on October 1, 1984.
(2) BOAT SAFETY ACCOUNT TREATED AS CONTINUATION OF NATIONAL RECREATIONAL BOATING SAFETY AND FACILITIES IMPROVEMENT FUND.—The Boat Safety Account in the Aquatic Resources Trust Fund established by the amendments made by this section shall be treated for all purposes of law as the continuation of the National Recreational Boating Safety and Facilities Improvement Fund established by section 13107 of title 46, United States Code. Any reference in any law to the National Recreational Boating Safety and Facilities Improvement Fund established by such section shall be deemed to include (wherever appropriate) a reference to such Boat Safety Account.

SEC. 1017. TAX ON CERTAIN ARROWS.

(a) GENERAL RULE.—Paragraph (1) of section 4161(b) (relating to bows and arrows) is amended to read as follows:
"(1) BOWS AND ARROWS.—There is hereby imposed on the sale by the manufacturer, producer, or importer—
"(A) of any bow which has a draw weight of 10 pounds or more, and
"(B) of any arrow which—
"(i) measures 18 inches overall or more in length, or
"(ii) measures less than 18 inches overall in length but is suitable for use with a bow described in subparagraph (A),
a tax equal to 11 percent of the price for which so sold."
(b) COORDINATION WITH TAX ON SPORT FISHING EQUIPMENT.—
(1) Subsection (b) of section 4161 is amended by adding at the end thereof the following new paragraph:
"(3) COORDINATION WITH SUBSECTION (a).—No tax shall be imposed under this subsection with respect to any article taxable under subsection (a)."
(2) Paragraph (2) of section 4161(b) is amended by striking out "(other than a fishing reel)".
(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to articles sold by the manufacturer, producer, or importer after September 30, 1984.

PART II—OTHER EXCISE TAXES

SEC. 1018. EXEMPTION FROM AVIATION EXCISE TAX FOR CERTAIN HELICOPTER OPERATIONS.

(a) EXEMPTION FROM FUEL TAX.—Paragraph (1) of section 4041(l) (relating to exemption for certain helicopter uses) is amended to read as follows:

"(1) transporting individuals, equipment, or supplies in—

"(A) the exploration for, or the development or removal of, hard minerals, or

"(B) the exploration for oil or gas, or".

(b) EXEMPTION FROM TAX ON TRANSPORTATION BY AIR.—Paragraph (1) of section 4261(e) (relating to exemption for certain helicopter uses) is amended to read as follows:

"(1) transporting individuals, equipment, or supplies in—

"(A) the exploration for, or the development or removal of, hard minerals, or

"(B) the exploration for oil or gas, or".

(c) EFFECTIVE DATE.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall take effect on April 1, 1984.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to transportation beginning after March 31, 1984, but shall not apply to any amount paid on or before such date.

SEC. 1018. TECHNICAL AMENDMENTS TO THE HAZARDOUS SUBSTANCE RESPONSE REVENUE ACT OF 1980.

(a) CLARIFICATION OF EXCEPTED SUBSTANCES.—

(1) IN GENERAL.—Subsection (b) of section 4662 (relating to definitions and special rules with respect to tax on certain chemicals) is amended by adding at the end thereof the following new paragraphs:

"(5) SUBSTANCES USED IN THE PRODUCTION OF MOTOR FUEL, ETC.—

"(A) IN GENERAL.—In the case of any chemical described in subparagraph (D) which is a qualified fuel substance, no tax shall be imposed under section 4661(a).

"(B) QUALIFIED FUEL SUBSTANCE.—For purposes of this section, the term 'qualified fuel substance' means any substance—

"(i) used in a qualified fuel use by the manufacturer, producer, or importer,

"(ii) sold for use by any purchaser in a qualified fuel use, or

"(iii) sold for resale by any purchaser for use, or resale for ultimate use, in a qualified fuel use.

"(C) QUALIFIED FUEL USE.—For purposes of this subsection, the term 'qualified fuel use' means—

"(i) any use in the manufacture or production of any motor fuel, diesel fuel, aviation fuel, or jet fuel, or

"(ii) any use as such a fuel.

"(D) CHEMICALS TO WHICH PARAGRAPH APPLIES.—For purposes of this subsection, the chemicals described in this subparagraph are acetylene, benzene, butylene, butadiene, ethylene, naphthalene, propylene, toluene, and xylene.

"(E) TAXATION OF NONQUALIFIED SALE OR USE.—For purposes of section 4661(a), if no tax was imposed by such section on the sale or use of any chemical by reason of subparagraph (A), the first person who sells or uses such chemical other than in a sale or use described in subparagraph (A) shall be treated as the manufacturer of such chemical.

"(6) SUBSTANCE HAVING TRANSITORY PRESENCE DURING REFINING PROCESS, ETC.—

"(A) IN GENERAL.—No tax shall be imposed under section 4661(a) on any taxable chemical described in subparagraph (B) by reason of the transitory presence of such chemical during any process of smelting, refining, or otherwise extracting any substance not subject to tax under section 4661(a).

"(B) CHEMICALS TO WHICH SUBPARAGRAPH (A) APPLIES.—The chemicals described in this subparagraph are—

"(i) barium sulfide, cupric sulfate, cupric oxide, cuprous oxide, lead oxide, zinc chloride, and zinc sulfate, and

"(ii) any solution or mixture containing any chemical described in clause (i).

"(C) REMOVAL TREATED AS USE.—Nothing in subparagraph (A) shall be construed to apply to any chemical which is removed from or ceases to be part of any smelting, refining, or other extraction process."

(2) CREDIT OR REFUND FOR USE AS QUALIFIED FUEL, ETC.—Subsection (d) of section 4662 (relating to refund or credit for certain uses) is amended by adding at the end thereof the following new paragraph:

"(3) USE AS QUALIFIED FUEL.—Under regulations prescribed by the Secretary, if—

"(A) a tax under section 4661 was paid with respect to any chemical described in subparagraph (D) of subsection (b)(5) without regard to subsection (b)(5), and

"(B) any person uses such chemical as a qualified fuel substance,

then an amount equal to the excess of the tax so paid over the tax determined with regard to subsection (b)(5) shall be allowed as a credit or refund (without interest) to such person in the same manner as if it were an overpayment of tax imposed by this section."

(3) METHANE AND BUTANE USED IN PRODUCTION OF SUCH FUEL, ETC.—Paragraph (1) of section 4662(b) is amended by inserting "or in the manufacture or production of any motor fuel, diesel fuel, aviation fuel, or jet fuel" after "than as a fuel".

(b) CLARIFICATION OF USE AS FERTILIZER.—

(1) IN GENERAL.—Paragraph (2) of section 4662(b) is amended by striking out subparagraphs (B) and (C) and inserting in lieu thereof the following:

"(B) QUALIFIED FERTILIZER SUBSTANCE.—For purposes of this section, the term 'qualified fertilizer substance' means any substance—

"(i) used in a qualified fertilizer use by the manufacturer, producer, or importer,

"(ii) sold for use by any purchaser in a qualified fertilizer use, or

"(iii) sold for resale by any purchaser for use, or resale for ultimate use, in a qualified fertilizer use.

"(C) QUALIFIED FERTILIZER USE.—The term 'qualified fertilizer use' means any use in the manufacture or production of fertilizer or for direct application as a fertilizer.

"(D) TAXATION OF NONQUALIFIED SALE OR USE.—For purposes of section 4661(a), if no tax was imposed by such section on the sale or use of any chemical by reason of subparagraph (A), the first person who sells or uses such chemical other than in a sale or use described in subparagraph (A) shall be treated as the manufacturer of such chemical."

(2) TECHNICAL AMENDMENTS.—

(A) Subparagraph (A) of section 4662(b)(2) is amended by striking out "qualified substance" and inserting in lieu thereof "qualified fertilizer substance".

(B) Subparagraph (B) of section 4662(d)(2) is amended to read as follows:

"(B) any person uses such substance as a qualified fertilizer substance,".

(c) CONFORMING AMENDMENT.—Subsection (c) of section 4662 (relating to use by manufacturer, etc., considered sale) is amended by striking out "If" and inserting in lieu thereof "Except as provided in subsection (b), if".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall take effect as if included in the amendments made by section 211(a) of the Hazardous Substance Response Revenue Act of 1980.

(2) WAIVER OF LIMITATION.—If refund or credit of any overpayment of tax resulting from the application of the amendments made by this section is prevented at any time before the date which for one year after the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the application of such amendments) may, nevertheless, be made or allowed if claim therefor is filed on or before the date which for one year after the date of the enactment of this Act.

SEC. 1019. FLOOR STOCK REFUND FOR CIGARETTES.

(a) IN GENERAL.—Where, before October 1, 1985, any article subject to tax under section 5701(b) of the Internal Revenue Code of 1954 has been sold by the manufacturer, producer, or importer and on such day is held for sale by any person (hereinafter in this section referred to as the "dealer"), there shall be credited or refunded (without interest) to the manufacturer, producer, or importer an amount equal to the excess of the tax paid by such manufacturer, producer, or importer on such article over the tax which would have been paid if such article were taxed at the rate in effect on October 1, 1985, if—

(1) claim for such credit or refund is filed with the Secretary before July 1, 1986, based on a request submitted to the manufacturer, producer, or importer before April 1, 1986, by the dealer who held the article in respect of which the credit or refund is claimed, and

(2) on or before July 1, 1986, reimbursement has been made to the dealer by the manufacturer, producer, or importer in an amount equal to such excess or written consent has been obtained from the dealer to the allowance of the credit or refund.

(b) LIMITATION ON ELIGIBILITY FOR CREDIT OR REFUND.—No manufacturer, producer, or importer shall be entitled to a credit or refund under subsection (a) unless he has in his possession such evidence of the inventories with respect to which the credit or refund is claimed as may be required by regulations prescribed by the Secretary.

(c) OTHER LAWS APPLICABLE.—All provisions of law, including penalties, applicable with respect to the taxes imposed by section 5701 of such Code shall, insofar as applicable and not inconsistent with subsections (a) and (b) of this section, apply in respect of the credits and refunds provided for in subsection (a) to the same extent as if the credits or refunds constituted overpayments of the tax.

(d) DEFINITIONS.—For purposes of this section—

(1) PERSON.—The term "person" includes any State or political subdivision thereof, or any agency or instrumentality of a State or political subdivision thereof.

(2) SECRETARY.—The term "Secretary" means the Secretary of the Treasury or his delegate.

Subtitle C—Estate and Gift Tax Provisions

SEC. 1021. DEFERRAL OF ESTATE TAXES FOR INTEREST IN HOLDING COMPANY WHICH OWNS STOCK IN CLOSELY HELD OPERATING COMPANY.

(a) GENERAL RULE.—Subsection (b) of section 6166 (relating to extension of time for payment of estate tax where estate consists largely of interests in closely held business) is amended by adding at the end thereof the following new paragraph:

"(8) STOCK IN HOLDING COMPANY TREATED AS BUSINESS COMPANY STOCK IN CERTAIN CASES.—

"(A) IN GENERAL.—If the executor elects the benefits of this paragraph, then—

"(i) HOLDING COMPANY STOCK TREATED AS BUSINESS COMPANY STOCK.—For purposes of this section, the portion of the stock of any holding company which represents direct ownership (or indirect ownership through 1 or more other holding companies) by such company in a business company shall be deemed to be stock in such business company.

"(ii) 5-YEAR DEFERRAL FOR PRINCIPAL NOT TO APPLY.—The executor shall be treated as having selected under subsection (a)(3) the date prescribed by section 6151(a).

"(iii) 4-PERCENT INTEREST RATE NOT TO APPLY.—Section 6601(j) (relating to 4-percent rate of interest) shall not apply.

"(B) ALL STOCK MUST BE NON-READILY-TRADABLE STOCK.—No stock shall be taken into account for purposes of applying this paragraph unless it is non-readily-tradable stock (within the meaning of paragraph (7)(B)).

"(C) APPLICATION OF VOTING STOCK REQUIREMENT OF PARAGRAPH (1)(C)(i).—For purposes of clause (i) of paragraph (1)(C), the deemed stock resulting from the application of subparagraph (A) shall be treated as voting stock to the extent that voting stock in the holding company owns directly (or through the voting stock of 1 or more other holding companies) voting stock in the business company.

"(D) DEFINITIONS.—For purposes of this paragraph—

"(i) HOLDING COMPANY.—The term 'holding company' means any corporation holding stock in another corporation.

"(ii) BUSINESS COMPANY.—The term 'business company' means any corporation carrying on a trade or business."

* *(b) DEFERRAL OF ESTATE TAXES NOT AVAILABLE FOR PASSIVE ASSETS.—Subsection (b) of section 6166 is amended by adding at the end thereof the following new paragraph:*

"(9) DEFERRAL NOT AVAILABLE FOR PASSIVE ASSETS.—

"(A) IN GENERAL.—For purposes of subsection (a)(1) and determining the closely held business amount (but not for purposes of subsection (g)), the value of any interest in a closely held business shall not include the value of that portion of such interest which is attributable to passive assets held by the business.

"(B) PASSIVE ASSET DEFINED.—For purposes of this paragraph—

"(i) In general.—The term 'passive asset' means any asset other than an asset used in carrying on a trade or business.

"(ii) STOCK TREATED AS PASSIVE ASSET.—The term 'passive asset' includes any stock in another corporation unless—

"(I) such stock is treated as held by the decedent by reason of an election under paragraph (8), and

"(II) such stock qualified under subsection (a)(1).

"(iii) EXCEPTION FOR ACTIVE CORPORATIONS.—If—

"(I) a corporation owns 20 percent or more in value of the voting stock of another corporation, or such other corporation has 15 or fewer shareholders, and

"(II) 80 percent or more of the value of the assets of each such corporation is attributal to assets used in carrying on a trade or business,

then such corporations shall be treated as 1 corporation. For purposes of applying subclause (II) to the corporation holding the stock of the other corporation, such stock shall not be taken into account.

* *(b) ACCELERATION OF PAYMENT.—Paragraph (1) of section 6166(g) (relating to disposition of interest; withdrawal of funds from business) is amended by adding at the end thereof the following new subparagraphs:*

"(E) CHANGES IN INTEREST IN HOLDING COMPANY.—If any stock in a holding company is treated as stock in a business company by reason of subsection (b)(8)(A)—

"(i) any disposition of any interest in such stock in such holding company which was included in determining the gross estate of the decedent, or

"(ii) any withdrawal of any money or other property from such holding company attributable to any interest included in determining the gross estate of the decedent,

shall be treated for purposes of subparagraph (A) as a disposition of (or a withdrawal with respect to) the stock qualifying under subsection (a)(1).

"(F) CHANGES IN INTEREST IN BUSINESS COMPANY.—If any stock in a holding company is treated as stock in a business company by reason of subsection (b)(8)(A)—

"(i) any disposition of any interest in such stock in the business company by such holding company, or

"(ii) any withdrawal of any money or other property from such business company attributable to such stock by such holding company owning such stock,

shall be treated for purposes of subparagraph (A) as a disposition of (or a withdrawal with respect to) the stock qualifying under subsection (a)(1)."

(c) UNDISTRIBUTED INCOME OF ESTATE.—Paragraph (2) of section 6166(g) (relating to undistributed income of estate) is amended by adding at the end thereof the following new subparagraph:

"(C) For purposes of this paragraph, if any stock in a corporation is treated as stock in another corporation by reason of subsection (b)(8)(A), any dividends paid by such other corportion to the corporation shall be treated as paid to the estate of the decedent to the extent attributable to the stock qualifying under subsection (a)(1)."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

(2) SPECIAL RULE.—

(A) IN GENERAL.—At the election of the executor, if—

(i) a corporation has 15 or fewer shareholders on June 22, 1984, and at all times thereafter before the date of the decedent's death, and

(ii) stock of such corporation is included in the gross estate of the decedent,

then all other corporations all of the stock of which is owned directly or indirectly by the corporation described in clauses (i) and (ii) shall be treated as one corporation for purposes of section 6166 of the Internal Revenue Code of 1954.

(B) EFFECT OF ELECTION.—Any executor who elects the application of this paragraph shall be treated as having made the election under paragraph (8) of section 6166(b) of such Code.

SEC. 1022. PERMANENT RULES FOR REFORMING GOVERNING INSTRUMENTS CREATING CHARITABLE REMAINDER TRUSTS AND OTHER CHARITABLE INTERESTS.

(a) GENERAL RULE.—Paragraph (3) of section 2055(e) (relating to disallowance of deductions in certain cases) is amended to read as follows:

"(3) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation.

"(B) QUALIFIED REFORMATION.—For purposes of this paragraph, the term 'qualified reformation' means a change of a governing instrument by reformation, amendment, construction, or otherwise which changes a reformable interest into a qualified interest but only if—

"(i) any difference between—

"(I) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and

"(II) the actuarial value (as so determined) of the reformable interest,

does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest,

"(ii) in the case of—

"(I) a charitable remainder interest, the nonremainder interest (before and after the qualified reformation) terminated at the same time, or

"(II) any other interest, the reformable interest and the qualified interest are for the same period, and

"(iii) such change is effective as of the date of the decedent's death.

A nonremainder interest (before reformation) for a term of years in excess of 20 years shall be treated as satisfying subclause (I) of clause (ii) if such interest (after reformation) is for a term of 20 years.

"(C) REFORMABLE INTEREST.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'reformable interest' means any interest for which a deduction would be allowable under subsection (a) at the time of the decedent's death but for paragraph (2).

"(ii) BENEFICIARY'S INTEREST MUST BE FIXED.—The term 'reformable interest' does not include any interest unless, before the remainder vests in possession, all payments to persons other than an organization described in subsection (a) are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property. For purposes of determining whether all such payments are expressed as a fixed percentage of the fair market value of the property, section 664(d)(3) shall be taken into account.

"(iii) SPECIAL RULE WHERE TIMELY COMMENCEMENT OF REFORMATION.—Clause (ii) shall not apply to any interest if a judicial proceeding is commenced to change such interest into a qualified interest not later than the 90th day after—

"(I) if an estate tax return is required to be filed, the last date (including extensions) for filing such return, or

"(II) if no estate tax return is required to be filed, the last date (including extensions) for filing the income tax return for the 1st taxable year for which such a return is required to be filed by the trust.

"(iv) SPECIAL RULE FOR WILL EXECUTED BEFORE JANUARY 1, 1979, ETC.—In the case of any interest passing under a will executed before January 1, 1979, or under a trust created before such date, clause (ii) shall not apply.

"(D) QUALIFIED INTEREST.—For purposes of this paragraph, the term 'qualified interest' means an interest for which a deduction is allowable under subsection (a).

"(E) LIMITATION.—The deduction referred to in subparagraph (A) shall not exceed the amount of the deduction which would have been allowable for the reformable interest but for paragraph (2).

"(F) SPECIAL RULE WHERE INCOME BENEFICIARY DIES.—If (by reason of the death of any individual, or by termination or distribution of a trust in accordance with the terms of the trust instrument) by the due date for filing the estate tax return (including any extension thereof) a reformable interest is in a wholly charitable trust or passes directly to a person or for a use described in subsection (a), a deduction shall be allowed for such reformable interest as if it had met the requirements of paragraph (2) on the date of the decedent's death. For purposes of the preceding sentence, the term 'wholly charitable trust' means a charitable trust which, upon the allowance of a deduction, would be described in section 4947(a)(1).

"(G) STATUTE OF LIMITATIONS.—The period for assessing any deficiency of any tax attributable to the application of this paragraph shall not expire before the date 1 year after the date on which the Secretary is notified that such reformation has occurred.

"(H) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this para-

* Act section 1021 seems to have two subsections (b).

graph, including regulations providing such adjustments in the application of the provisions of section 508 (relating to special rules relating to section 501(c)(3) organizations), subchapter J (relating to estates, trusts, beneficiaries, and decedents), and chapter 42 (relating to private foundations) as may be necessary by reason of the qualified reformation.

"(I) REFORMATIONS PERMITTED IN CASE OF REMAINDER INTERESTS IN RESIDENCE OR FARM, POOLED INCOME FUNDS, ETC.—The Secretary shall prescribe regulations (consistent with the provisions of this paragraph) permitting reformations in the case of any failure—

"(i) to meet the requirements of section 170(f)(3)(B) (relating to remainder interests in personal residence or farm, etc.), or

"(ii) to meet the requirements of section 642(c)(5)."

(b) INCOME TAX DEDUCTION.—Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding at the end thereof the following new paragraph:

"(7) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation (within the meaning of section 2055(e)(3)(B)).

"(B) RULES SIMILAR TO SECTION 2055(E)(3) TO APPLY.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(c) GIFT TAX DEDUCTION.—Subsection (c) of section 2522 is amended by adding at the end thereof the following new paragraph:

"(4) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation (within the meaning of section 2055(e)(3)(B)).

"(B) RULES SIMILAR TO SECTION 2055(E)(3) TO APPLY.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(d) TREATMENT OF CERTAIN CONTINGENCIES UNDER SECTION 664.—Section 664 (relating to charitable remainder trusts) is amended by adding at the end thereof the following subsection:

"(f) CERTAIN CONTINGENCIES PERMITTED.—

"(1) GENERAL RULE.—If a trust would, but for a qualified contingency, meet the requirements of paragraph (1)(A) or (2)(A) of subsection (d), such trust shall be treated as meeting such requirements.

"(2) VALUE DETERMINED WITHOUT REGARD TO QUALIFIED CONTINGENCY.—For purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account.

"(3) QUALIFIED CONTINGENCY.—For purposes of this subsection, the term 'qualified contingency' means any provision of a trust which provides that, upon the happening of a contingency, the payments described in paragraph (1)(A) or (2)(A) of subsection (d) (as the case may be) will terminate not later than such payments would otherwise terminate under the trust."

(e) EFFECTIVE DATE.—

(1) SUBSECTIONS (a), (b), AND (c).—The amendments made by subsections (a), (b), and (c) shall apply to reformations after December 31, 1978; except that such amendments shall not apply to any reformation to which section 2055(e)(3) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) applies. For purposes of applying clause (iii) of section 2055(e)(C) of such Code (as amended by this section), the 90th day described in such clause shall be treated as not occurring before the 90th day after the date of the enactment of this Act.

(2) SUBSECTION (d).—The amendment made by subsection (d) shall apply to transfers after December 31, 1978.

(3) STATUTE OF LIMITATIONS.—

(A) IN GENERAL.—If on the date of the enactment of this Act (or at any time before the date 1 year after such date of enactment), credit or refund of any overpayment of tax attributable to the amendments made by this section is barred by any law or rule of law, such credit or refund of such overpayment may nevertheless be made if claim therefor is filed before the date 1 year after the date of the enactment of this Act.

(B) NO INTEREST WHERE STATUTE CLOSED ON DATE OF ENACTMENT.—In any case where the making of the credit or refund of the overpayment described in subparagraph (A) is barred on the date of the enactment of this Act, no interest shall be allowed with respect to such overpayment (or any related adjustment) for the period before the date 180 days after the date on which the Secretary of the Treasury (or his delegate) is notified that the reformation has occurred.

SEC. 1022. ALTERNATE VALUATION ELECTION AVAILABLE ONLY WHERE IT RESULTS IN REDUCTION OF GROSS ESTATE AND ESTATE TAX.

(a) GENERAL RULE.—Section 2032 (relating to alternate valuation) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ELECTION MUST DECREASE GROSS ESTATE AND ESTATE TAX.—No election may be made under this section with respect to an estate unless such election will decrease—

"(1) the value of the gross estate, and

"(2) the amount of the tax imposed by this chapter (reduced by credits allowable against such tax)."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 1024. ALTERNATE VALUATION ELECTION AVAILABLE ON CERTAIN LATE RETURNS.

(a) GENERAL RULE.—Subsection (d) of section 2032 (relating to time of election), as amended by section 1023, is amended to read as follows:

"(d) ELECTION.—

"(1) IN GENERAL.—The election provided for in this section shall be made by the executor on the return of the tax imposed by this chapter. Such election, once made, shall be irrevocable.

"(2) EXCEPTION.—No election may be made under this section if such return is filed more than 1 year after the time prescribed by law (including extensions) for filing such return."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to estates of decedents dying after the date of the enactment of this Act.

(2) TRANSITIONAL RULE.—In the case of an estate of a decedent dying before the date of the enactment of this Act if—

(A) a credit or refund of the tax imposed by chapter 11 of the Internal Revenue Code of 1954 is not prevented on the date of the enactment of this Act by the operation of any law or rule of law,

(B) the election under section 2032 of the Internal Revenue Code of 1954 would have met the requirements of such section (as amended by this section and section 1023) had the decedent died after the date of enactment of this Act, and

(C) a claim for credit or refund of such tax with respect to such estate is filed not later than the 90th day after the date of the enactment of this Act,

then such election shall be treated as a valid election under such section 2032. The statutory period for the assessment of any deficiency which is attributable to an election under this paragraph shall not expire before the close of the 2-year period beginning on the date of the enactment of this Act.

SEC. 1025. MODIFICATION OF ELECTION OR AGREEMENT UNDER SECTION 2032A.

(a) IN GENERAL.—Section 2032A(d) (relating to election and agreement) is amended by adding at the end thereof the following new paragraph:

"(3) MODIFICATION OF ELECTION AND AGREEMENT TO BE PERMITTED.—The Secretary shall prescribe procedures which provide that in any case in which—

"(A) the executor makes an election under paragraph (1) within the time prescribed for filing such election, and

"(B) substantially complies with the regulations prescribed by the Secretary with respect to such election, but—

"(i) the notice of election, as filed, does not contain all required information, or

"(ii) signatures of 1 or more persons required to enter into the agreement described in paragraph (2) are not included on the agreement as filed, or the agreement does not contain all required information,

the executor will have a reasonable period of time (not exceeding 90 days) after notification of such failures to provide such information or agreements."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by this section shall apply to estates of decedents dying after December 31, 1976.

(2) REFUND OR CREDIT OF OVERPAYMENT BARRED BY STATUTE OF LIMITATIONS.—Notwithstanding section 6511(a) of the Internal Revenue Code of 1954 or any other period of limitation or lapse of time, a claim for credit or refund of overpayment of the tax imposed by such Code which arises by reason of this section may be filed by any person at any time within the 1-year period beginning on the date of the enactment of this Act. Sections 6511(b) and 6514 of such Code shall not apply to any claim for credit or refund filed under this subsection within such 1-year period.

SEC. 1026. NO GAIN RECOGNIZED FROM NET GIFTS MADE BEFORE MARCH 4, 1981.

"(a) IN GENERAL.—In the case of any transfer of property subject to gift tax made before March 4, 1981, for purposes of subtitle A of the Internal Revenue Code of 1954, gross income of the donor shall not include any amount attributable to the donee's payment of (or agreement to pay) any gift tax imposed with respect to such gift.

(b) GIFT TAX DEFINED.—For purposes of subsection (a), the term "gift tax" means—

(1) the tax imposed by chapter 12 of such Code, and

(2) any tax imposed by a State (or the District of Columbia) on transfers by gifts.

(c) STATUTE OF LIMITATIONS.—If refund or credit of any overpayment of tax resulting from subsection (a) is prevented on the date of the enactment of this Act (or at any time within 1 year after such date) by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to subsection (a)) may nevertheless be made or allowed if claim therefor is filed within 1 year after the date of the enactment of this Act.

SEC. 1027. MARITAL DEDUCTION FOR A USUFRUCT.

(a) IN GENERAL.—Subclause (I) of section 2056(b)(7)(B)(ii) (relating to qualifying income interest for life) is amended by inserting ", or has a usufruct interest for life in the property" after "intervals".

(b) LIMITATION ON DEDUCTIONS FROM GROSS ESTATE.—Paragraph (1) of section 2053(c) (relating to limitations on deductions for

expenses, indebtedness, and taxes) is amended by adding at the end thereof the following new subparagraph:

"(C) CERTAIN CLAIMS BY REMAINDERMEN.—No deduction shall be allowed under this section for a claim against the estate by a remainderman relating to any property described in section 2044."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the amendment made by section 403 of the Economic Recovery Tax Act of 1981.

SEC. 1028. CREDIT AGAINST ESTATE TAX FOR TRANSFERS TO TOIYABE NATIONAL FOREST.

(a) CREDIT ALLOWED.—Subject to the provisions of this section, and notwithstanding any period of limitation or lapse of time, the Secretary of the Treasury or his delegate shall allow credit against the tax imposed by chapter 11 of the Internal Revenue Code of 1954 (relating to the imposition of estate tax)—

(1) upon the estate of Nell J. Redfield for the conveyance by the estate of the United States of real property included in the gross estate and located within and adjacent to the boundaries of the Toiyabe National Forest; and

(2) upon the estate of Elizabeth Schultz Rabe for the conveyance by the estate to the United States of real property included in the gross estate and known as Parcel No. 4 containing 97.60 acres, more or less, located in the County of Douglas, State of Nevada, and described as follows:

The NE¼ of the SW¼, the NW¼ of the SE¼, and a portion of the SE¼ of the NW¼ of Section 23, Township 13 North, Range 18 East, M.D.B.&M., more particularly described as follows:

All that portion of the SE¼ of the NW¼ excepting therefrom the following:

Beginning at a United States Forest Service Brass Cap, being the C-N ¼16 corner of Section 23; thence South 0°45'24" West 500.00 feet to an iron pipe; thence South 44°50'02" West 945.42 feet to an iron pipe; thence North 89°46'12" West 301.78 to a point; thence tangent North 20°28'20" East on the arc of a circular curve to the left with a radius of 800 feet through a central angle of 40°44'50" an arc distance of 568.94 feet to a point; thence North 20°02'42" West 683.17 feet to a point; thence South 88°35'38" East 1206.29 feet to the Point of Beginning, containing 22.40 acres, more or less.

(b) AMOUNT OF CREDIT.—The amount allowed as a credit under subsection (a) shall be equal to the lesser of—

(1) the fair market value of the real property transferred by each estate as of the valuation date used for purposes of the tax imposed by chapter 11 of such Code, or

(2) the Federal estate tax liability (and interest thereon) of each estate.

(c) LIMITATIONS.—

(1) The provisions of this section shall apply only if the executor of each estate executes a deed (in accordance with the laws of the State in which such real property is situated) transferring title to the United States before the date which is 90 days after the date of the enactment of this Act, but only if such title is satisfactory to the Attorney General or his delegate.

(2) The provisions of this section shall apply only if the real property transferred is accepted by the Secretary of Agriculture and added to the Toiyabe National Forest. The lands shall be transferred to the Secretary of Agriculture without reimbursement or payment from the Department of Agriculture.

(3) Unless the Secretary of Agriculture determines and certifies to the Secretary of the Treasury that there has been an expeditious transfer of the real property under this section, no interest payable with respect to the tax imposed by chapter 11 of the Internal Revenue Code of 1954 shall be deemed to be waived by reasons of the provisions of this section.

Subtitle D—Charitable Contributions and Exempt Organizations

SEC. 1031. INCREASE IN CHARITABLE VOLUNTEER MILEAGE.

(a) IN GENERAL.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by redesignating subsections (j) and (k) as subsections (k) and (l), respectively, and by inserting after subsection (i) the following new subsection:

"(j) STANDARD MILEAGE RATE FOR USE OF PASSENGER AUTOMOBILE.—For purposes of computing the deduction under this section for use of a passenger automobile the standard mileage rate shall be 12 cents per mile."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 1032. CERTAIN ORGANIZATIONS PROVIDING CHILD CARE INCLUDED WITHIN THE DEFINITION OF TAX-EXEMPT ORGANIZATIONS.

(a) IN GENERAL.—Section 501 (relating to exemption from tax on corporations, certain trusts, etc.) is amended by redesignating subsection (k) as subsection (l) and inserting after subsection (j) the following new subsection:

"(k) TREATMENT OF CERTAIN ORGANIZATIONS PROVIDING CHILD CARE.—For purposes of subsection (c)(3) of this section and sections 170(c)(2), 2055(a)(2), and 2522(a)(2), the term 'educational purposes' includes the providing care of children away from their homes if—

"(1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and

"(2) the services provided by the organization are available to the general public."

(b) CROSS REFERENCES.—

"(1) Subsection (k) of section 170, as redesignated by section 1031 of this Act, is amended by redesignating paragraphs (1) through (8) as paragraphs (2) through (9), respectively, and by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) For treatment of certain organizations providing child care, see section 501(k)."

(2) Subsection (f) of section 2055 is amended by redesignating paragraphs (2) through (11) as paragraphs (3) through (12), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) For treatment of certain organizations providing child care, see section 501(k)."

(3) Subsection (d) of section 2522 is amended by redesignating paragraphs (1) and (2) as paragraphs (2) and (3), respectively, and by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) For treatment of certain organizations providing child care, see section 501(k)."

(c) EFFECTIVE DATES.—The amendments made by subsections (a) and (b) shall aply to taxable years beginning after the date of the enactment of this Act.

SEC. 1033. RESTRICTIONS ON CHURCH TAX INQUIRIES AND EXAMINATIONS.

(a) IN GENERAL.—Subchapter A of chapter 78 (relating to discovery of liability and enforcement of title) is amended by redesignating section 7611 as section 7612 and inserting after section 7610 the following new section:

"SEC. 7611. RESTRICTIONS ON CHURCH TAX INQUIRIES AND EXAMINATIONS.

"(a) RESTRICTIONS ON INQUIRIES.—

"(1) IN GENERAL.—The Secretary may begin a church tax inquiry only if—

"(A) the reasonable belief requirements of paragraph (2), and

"(B) the notice requirements of paragraph (3), have been met.

"(2) REASONABLE BELIEF REQUIREMENTS.—The requirements of this paragraph are met with respect to any church tax inquiry if an appropriate high-level Treasury official reasonably believes (on the basis of facts and circumstances recorded in writing) that the church—

"(A) may not be exempt, by reason of its status as a church, from tax under section 501(a), or

"(B) may be carrying on an unrelated trade or business (within the meaning of section 513) or otherwise engaged in activities subject to taxation under this title.

"(3) INQUIRY NOTICE REQUIREMENTS.—

"(A) IN GENERAL.—The requirements of this paragraph are met with respect to any church tax inquiry if, before beginning such inquiry, the Secretary provides written notice to the church of the beginning of such inquiry.

"(B) CONTENTS OF INQUIRY NOTICE.—The notice required by this paragraph shall include—

"(i) an explanation of—

"(I) the concerns which gave rise to such inquiry, and

"(II) the general subject matter of such inquiry, and

"(ii) a general explanation of the applicable—

"(I) administrative and constitutional provisions with respect to such inquiry (including the right to a conference with the Secretary before any examination of church records), and

"(II) provisions of this title which authorize such inquiry or which may be otherwise involved in such inquiry.

"(b) RESTRICTIONS ON EXAMINATIONS.—

"(1) IN GENERAL.—The Secretary may begin a church tax examination only if the requirements of paragraph (2) have been met and such examination may be made only—

"(A) in the case of church records, to the extent necessary to determine the liability for, and the amount of, any tax imposed by this title, and

"(B) in the case of religious activities, to the extent necessary to determine whether an organization claiming to be a church is a church for any period.

"(2) NOTICE OF EXAMINATION; OPPORTUNITY FOR CONFERENCE.—The requirements of this paragraph are met with respect to any church tax examination if—

"(A) at least 15 days before the beginning of such examination, the Secretary provides the notice described in paragraph (3) to both the church and the appropriate regional counsel of the Internal Revenue Service, and

"(B) the church has a reasonable time to participate in a conference described in paragraph (3)(A)(iii), but only if the church requests such a conference before the beginning of the examination.

"(3) CONTENTS OF EXAMINATION NOTICE, ET CETERA.—

"(A) IN GENERAL.—The notice described in this paragraph is a written notice which includes—

"(i) a copy of the church tax inquiry notice provided to the church under subsection (a),

"(ii) a description of the church records and activities which the Secretary seeks to examine,

"(iii) an offer to have a conference between the church and the Secretary in order to discuss, and attempt to resolve, concerns relating to such examination, and

"(iv) a copy of all documents which were collected or prepared by the Internal Revenue Service for use in such examination and the disclosure of which is required by the Freedom of Information Act (5 U.S.C. 552).

"(B) EARLIEST DAY EXAMINATION NOTICE MAY BE PROVIDED.—The examination notice described in subparagraph (A) shall not be provided to the church before the 15th day after the date on which the church tax inquiry notice was provided to the church under subsection (a).

"(C) OPINION OF REGIONAL COUNSEL WITH RESPECT TO EXAMINATION.—Any regional counsel of the Internal Revenue Service who receives an examination notice under paragraph (1) may, within 15 days after such notice is provided, submit to the regional commissioner for the region an advisory objection to the examination.

"(4) EXAMINATION OF RECORDS AND ACTIVITIES NOT SPECIFIED IN NOTICE.—Within the course of a church tax examination which (at the time the examination begins) meets the requirements of paragraphs (1) and (2), the Secretary may examine any church records or religious activities which were not specified in the examination notice to the extent such examination meets the requirement of subparagraph (A) or (B) of paragraph (1) (whichever applies).

"(c) LIMITATION ON PERIOD OF INQUIRIES AND EXAMINATIONS.—

"(1) INQUIRIES AND EXAMINATIONS MUST BE COMPLETED WITHIN 2 YEARS.—

"(A) IN GENERAL.—The Secretary shall complete any church tax status inquiry or examination (and make a final determination with respect thereto) not later than the date which is 2 years after the examination notice date.

"(B) INQUIRIES NOT FOLLOWED BY EXAMINATIONS.—In the case of a church tax inquiry with respect to which there is no examination notice under subsection (b), the Secretary shall complete such inquiry (and make a final determination with respect thereto) not later than the date which is 90 days after the inquiry notice date.

"(2) SUSPENSION OF 2-YEAR PERIOD.—The running of the 2-year period described in paragraph (1)(A) and the 90-day period in paragraph (1)(B) shall be suspended—

"(A) for any period during which—

"(i) a judicial proceeding brought by the church against the Secretary with respect to the church tax inquiry or examination is pending or being appealed,

"(ii) a judicial proceeding brought by the Secretary against the church (or any official thereof) to compel compliance with any reasonable request of the Secretary in a church tax examination for examination of church records or religious activities is pending or being appealed, or

"(iii) the Secretary is unable to take actions with respect to the church tax inquiry or examination by reason of an order issued in any judicial proceeding brought under section 7609,

"(B) for any period in excess of 20 days (but not in excess of 6 months) in which the church or its agents fail to comply with any reasonable request of the Secretary for church records or other information, or

"(C) for any period mutually agreed upon by the Secretary and the church.

"(d) LIMITATIONS ON REVOCATION OF TAX-EXEMPT STATUS, ET CETERA.—

"(1) IN GENERAL.—The Secretary may—

"(A) determine that an organization is not a church which—

"(i) is exempt from taxation by reason of section 501(a), or

"(ii) is described in section 170(c), or

"(B)(i) send a notice of deficiency of any tax involved in a church tax examination, or

"(ii) in the case of any tax with respect to which subchapter B of chapter 63 (relating to deficiency procedures) does not apply, assess any underpayment of such tax involved in a church examination,

only if the appropriate regional counsel of the Internal Revenue Service determines in writing that there has been substantial compliance with the requirements of this section and approves in writing of such revocation, notice of deficiency, or assessment.

"(2) LIMITATIONS ON PERIOD OF ASSESSMENT.—

"(A) REVOCATION OF TAX-EXEMPT STATUS.—

"(i) 3-YEAR STATUTE OF LIMITATIONS GENERALLY.—In the case of any church tax examination with respect to the revocation of tax-exempt status under section 501(a), any tax imposed by chapter 1 (other than section 511) may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, only for the 3 most recent taxable years ending before the examination notice date.

"(ii) 6-YEAR STATUTE OF LIMITATIONS WHERE TAX-EXEMPT STATUS REVOKED.—If an organization is not a church exempt from tax under section 501(a) for any of the 3 taxable years described in clause (i), clause (i) shall be applied by substituting '6 most recent taxable years' for '3 most recent taxable years'.

"(B) UNRELATED BUSINESS TAX.—In the case of any church tax examination with respect to the tax imposed by section 511 (relating to unrelated business income), such tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, only with respect to the 6 most recent taxable years ending before the examination notice date.

"(C) EXCEPTION WHERE SHORTER STATUTE OF LIMITATIONS OTHERWISE APPLICABLE.—Subparagraphs (A) and (B) shall not be construed to increase the period otherwise applicable under subchapter A of chapter 66 (relating to limitations on assessment and collection).

"(e) INFORMATION NOT COLLECTED IN SUBSTANTIAL COMPLIANCE WITH PROCEDURES TO STAY SUMMONS PROCEEDING.—

"(1) IN GENERAL.—If there has not been substantial compliance with—

"(A) the notice requirements of subsection (a) or (b),

"(B) the conference requirement described in subsection (b)(3)(A)(iii), or

"(C) the approval requirement of subsection (d)(1) (if applicable),

with respect to any church tax inquiry or examination, any proceeding to compel compliance with any summons with respect to such inquiry or examination shall be stayed until the court finds that all practicable steps to correct the noncompliance have been taken. The period applicable under paragraph (1) or subsection (c) shall not be suspended during the period of any stay under the preceding sentence.

"(2) REMEDY TO BE EXCLUSIVE.—No suit may be maintained, and no defense may be raised in any proceeding (other than as provided in paragraph (1)), by reason of any noncompliance by the Secretary with the requirements of this section.

"(f) LIMITATIONS ON ADDITIONAL INQUIRIES AND EXAMINATIONS.—

"(1) IN GENERAL.—If any church tax inquiry or examination with respect to any church is completed and does not result in—

"(A) a revocation, notice of deficiency, or assessment described in subsection (d)(1), or

"(B) a request by the Secretary for any significant change in the operational practices of the church (including the adequacy of accounting practices),

no other church tax inquiry or examination may begin with respect to such church during the applicable 5-year period unless such inquiry or examination is approved in writing by the Assistant Commissioner for Employee Plans and Exempt Organizations of the Internal Revenue Service or does not involve the same or similar issues involved in the preceding inquiry or examination. For purposes of the preceding sentence, an inquiry or examination shall be treated as completed not later than the expiration of the applicable period under paragraph (1) of subsection (c).

"(2) APPLICABLE 5-YEAR PERIOD.—For purposes of paragraph (1), the term 'applicable 5-year period' means the 5-year period beginning on the date the notice taken into account for purposes of subsection (c)(1) was provided. For purposes of the preceding sentence, the rules of subsection (c)(2) shall apply.

"(g) TREATMENT OF FINAL REPORT OF REVENUE AGENT.—Any final report of an agent of the Internal Revenue Service shall be treated as a determination of the Secretary under paragraph (1) of subsection 7428(a) and any church receiving such a report shall be treated for purposes of sections 7428 and 7430 as having exhausted the administrative remedies available to it.

"(h) DEFINITIONS.—For purposes of this section—

"(1) CHURCH.—The term 'church' includes—

"(A) any organization claiming to be a church, and

"(B) any convention or association of churches.

"(2) CHURCH TAX INQUIRY.—The term 'church tax inquiry' means any inquiry to a church (other than an examination) to serve as a basis for determining whether a church—

"(A) is exempt from tax under section 501(a) by reason of its status as a church, or

"(B) is carrying on an unrelated trade or business (within the meaning of section 513) or otherwise engaged in activities which may be subject to taxation under this title.

"(3) CHURCH TAX EXAMINATION.—The term 'church tax examination' means any examination for purposes of making a determination described in paragraph (2) of—

"(A) church records at the request of the Internal Revenue Service, or

"(B) the religious activities of any church.

"(4) CHURCH RECORDS.—

"(A) IN GENERAL.—The term 'church records' means all corporate and financial records regularly kept by a church, including corporate minute books and lists of members and contributors.

"(B) EXCEPTION.—Such term shall not include records acquired—

"(i) pursuant to a summons to which section 7609 applies, or

"(ii) from any governmental agency.

"(5) INQUIRY NOTICE DATE.—The term 'inquiry notice date' means the date the notice with respect to a church tax inquiry is provided under subsection (a).

"(6) EXAMINATION NOTICE DATE.—The term 'examination notice date' means the date the notice with respect to a church tax examination is provided under subsection (b) to the church.

"(7) APPROPRIATE HIGH-LEVEL TREASURY OFFICIAL.—The term 'appropriate high-level Treasury official' means the Secretary of the Treasury or any delegate of the Secretary whose rank is no lower than that of a principal Internal Revenue officer for an internal revenue region.

"(4) SECTION NOT TO APPLY TO CRIMINAL INVESTIGATIONS, ETC.—This section shall not apply to—

"(A) any criminal investigation,

"(B) any inquiry or examination relating to the tax liability of any person other than a church,

"(C) any assessment under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income taxes, etc),

"(D) any willful attempt to defeat or evade any tax imposed by this title, or

"(E) any knowing failure to file a return of tax imposed by the title."

(b) TECHNICAL AMENDMENT RELATING TO SUBPOENA POWER OF THE DISTRICT COURT FOR THE DISTRICT OF COLUMBIA.—Section 7428 (relating to declaratory judgments relating to status and classification of organizations under section 501(c)(3), etc.) is amended by adding at the end thereof the following new subsection:

"(d) SUBPOENA POWER FOR DISTRICT COURT FOR DISTRICT OF COLUMBIA.—In any action brought under this section in the district court of the United States for the District of Columbia, a subpoena requiring the attendance of a witness at a trial or hearing may be served at any place in the United States."

(c) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 7605 (relating to time and place of examination) is amended to read as follows: "(C) Cross Reference.—

"For provisions restricting church tax inquiries and examinations, see section 7611."

(2) The table of sections for subchapter A of chapter 78 is amended by striking out the item relating to section 7611 and inserting in lieu thereof the following:

"Sec. 7611. Restrictions on church tax inquiries and examinations.
"Sec. 7612. Cross reference."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to inquiries and examinations beginning after December 31, 1984.

SEC. 1034. ACQUISITION INDEBTEDNESS OF CERTAIN EDUCATIONAL INSTITUTIONS.

"(A) GENERAL RULE.—Paragraph (9) of section 514(c) (relating to unrelated debt-financed income) is amended to read as follows:

"(9) REAL PROPERTY ACQUIRED BY A QUALIFIED ORGANIZATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'acquisition indebtedness' does not, for purposes of this section, include indebtedness incurred by a qualified organization in acquiring or improving any real property.

"(B) EXCEPTIONS.—The provision of subparagraph (A) shall not apply in any case in which—

"(i) the price for the acquisition or improvement is not a fixed amount determined as of the date of the acquisition or the completion of the improvement;

"(ii) the amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from such real property;

"(iii) the real property is at any time after the acquisition leased by the qualified organization to the person selling such property to such organization or to any person who bears a relationship described in section 267(b) or 707(b) to such person;

"(iv) the real property is acquired by a qualified trust from, or is at any time after the acquisition leased by such trust to, any person who—

"(I) bears a relationship which is described in subparagraph (C), (E), or (G) of section 4975(e)(2) to any plan with respect to which such trust was formed, or

"(II) bears a relationship which is described in subparagraph (F) or (H) of section 4975(e)(2) to any person described in subclause (I);

"(v) any person described in clause (iii) or (iv) provides the qualified organization with financing in connection with the acquisition or improvement; or

"(vi) the real property is held by a partnership unless the partnership meets the requirements of clauses (i) through (v) and unless—

"(I) all of the partners of the partnership are qualified organizations, or

"(II) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation (within the meaning of section 168(j)(9)).

For purposes of clause (vi)(I), an organization shall not be treated as a qualified organization if any income of such organization would be unrelated business taxable income (determined without regard to this paragraph).

"(C) QUALIFIED ORGANIZATION.—For purposes of this paragraph, the term 'qualified organization' means—

"(i) an organization described in section 170(b)(1)(A) (ii) and its affiliated support organizations described in section 509(a); or

"(ii) any trust which constitutes a qualified trust under section 401.

"(D) OTHER PASS-THRU ENTITIES; TIERED ENTITIES.— Rules similar to the rules of subparagraph (B)(vi) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities."

(b) TREATMENT OF SEGREGATED ASSET ACCOUNTS.—Section 514 (relating to unrelated debt-financed income) is amended by adding at the end thereof the following new subsection:

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations to prevent the circumvention of any provision of this section through the use of segregated asset accounts."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to indebtedness incurred after the date of the enactment of this Act.

(2) EXCEPTION FOR INDEBTEDNESS ON CERTAIN PROPERTY ACQUIRED BEFORE JANUARY 1, 1985.—

(A) The amendment made by subsection (a) shall not apply to any indebtedness incurred before January 1, 1985, by a partnership described in subparagraph (B) if such indebtedness is incurred with respect to property acquired (directly or indirectly) by such partnership before such date.

(B) A partnership is described in this subparagraph if—

(i) before October 21, 1983, the partnership was organized, a request for exemption with respect to such partnership was filed with the Department of Labor, and a private placement memorandum stating the maximum account of interest in the partnership that would be offered had been circulated,

(ii) the interest in the property to be acquired, directly or indirectly (including through acquiring an interest in another partnership) by such partnership was described in such private placement memorandum, and

(iii) the marketing of partnership interests in such partnership is completed not later than 2 years after the later of the date of enactment of this Act or the date of publication in the Federal Register of such exemption by the Department of Labor and the aggregate amount of interests in such partnership sold does not exceed the amount described in clause (i).

(3) EXCEPTION FOR INDEBTEDNESS ON CERTAIN PROPERTY ACQUIRED BEFORE JANUARY 1, 1986.—

(A) The amendment made by subsection (a) shall not apply to any indebtedness incurred before January 1, 1986, by a partnership described in subparagraph (B) if such indebtedness is incurred with respect to property acquired (directly or indirectly) by such partnership before such date.

(B) A partnership is described in this paragraph if—

(i) before March 6, 1984, the partnership was organized and publicly announced, the maximum amount of interests which would be sold in such partnership, and

(ii) the marketing of partnership interests in such partnership is completed not later than the 90th day after the date of the enactment of this Act and the aggregate amount of interests in such partnership sold does not exceed the maximum amount described in clause (i).

For purposes of clause (i), the maximum amount taken into account shall be the greatest of the amounts shown in the registration statement, prospectus, or partnership agreement.

(C) BINDING CONTRACTS.—For purposes of this paragraph, property shall be deemed to have been acquired before January 1, 1986, if such property is acquired pursuant to a written contract which, on January 1, 1986, and at all times thereafter, required the acquisition of such property and such property is placed in service not later than 6 months after the date such contract was entered into.

SEC. 1035. TRANSITIONAL RULE RELATING TO THE DEFINITION OF QUALIFIED CONSERVATION CONTRIBUTIONS.

(a) IN GENERAL.—Subparagraph (B) of section 170(h)(5) (defining exclusively for conservation purposes) is amended to read as follows:

"(B) NO SURFACE MINING PERMITTED.—

"(i) IN GENERAL.—Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

"(ii) SPECIAL RULE.—With respect to any contribution of property in which the ownership of the surface estate and mineral interests were separated before June 13, 1976, and remain so separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to contributions made after the date of the enactment of this Act.

Subtitle E—Income Tax Credits

SEC. 1041. 1-YEAR EXTENSION OF TARGETED JOBS CREDIT.

(a) IN GENERAL.—Paragraph (3) of section 51(c) (defining wages qualifying for targeted jobs credit) is amended by striking out "December 31, 1984" and inserting in lieu thereof "December 31, 1985".

(b) ADDITIONAL AUTHORIZATION OF APPROPRIATIONS.—Paragraph (2) of section 261(f) of the Economic Recovery Tax Act of 1981 is amended by striking out "fiscal years 1983 and 1984" and inserting in lieu thereof "fiscal years 1983, 1984, and 1985".

(c) TARGETED JOBS CREDIT TECHNICAL AMENDMENTS.—

(1) TREATMENT OF SUCCESSOR EMPLOYERS; TREATMENT OF EMPLOYEES PERFORMING SERVICES FOR OTHER PERSONS.—Section 51 (relating to amount of targeted jobs credit) is

amended by adding at the end thereof the following new subsection:

"(j) TREATMENT OF SUCCESSOR EMPLOYERS; TREATMENT OF EMPLOYEES PERFORMING SERVICES FOR OTHER PERSONS.—

"(1) TREATMENT OF SUCCESSOR EMPLOYERS.—Under regulations prescribed by the Secretary, in the case of a successor employer referred to in section 3306(b)(1), the determination of the amount of the credit allowable under section 44B with respect to wages paid by such successor employer shall be made in the same manner as if such wages were paid by the predecessor employer referred to in such section.

"(2) TREATMENT OF EMPLOYEES PERFORMING SERVICES FOR OTHER PERSONS.—No credit shall be allowed under section 44B with respect to remuneration paid by an employer to an employee for services performed by such employee for another person unless the amount reasonably expected to be received by the employer for such services from such other person exceeds the remuneration paid by the employer to such employee for such services."

(2) SPECIAL RULE FOR CERTIFICATION.—Subparagraph (A) of section 51(d)(16) (relating to special rules for certifications) is amended by adding at the end thereof the following new sentence:

"For purposes of the preceding sentence, if on or before the day on which such individual begins work for the employer, such individual has received from a designated local agency (or other agency or organization designated pursuant to a written agreement with such designated local agency) a written preliminary determination that such individual is a member of a targeted group, then 'the fifth day' shall be substituted for 'the day' in such sentence."

(3) AGE REQUIREMENT FOR QUALIFIED SUMMER YOUTH EMPLOYEE.—Clause (ii) of section 51(d)(12)(A) (defining qualified summer youth employee) is amended by striking out "(as defined in paragraph (14))" and inserting in lieu thereof "(or if later, on May 1 of the calendar year involved)".

(4) TECHNICAL AMENDMENT.—Paragraph (2) of section 51(b) is amended by striking out "(or, in the case of a vocational rehabilitation referral, the day the individual begins work for the employer on or after the beginning of such individual's rehabilitation plan)".

(5) EFFECTIVE DATES.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by this section shall apply to individuals who begin work for the employer after the date of the enactment of this Act.

(B) SPECIAL RULE FOR EMPLOYEES PERFORMING SERVICES FOR OTHER PERSONS.—Paragraph (2) of section 51(j) of the Internal Revenue Code of 1954 (as added by this subsection) and the amendment made by paragraph (3) of this subsection shall apply to individuals who begin work for the employer after December 31, 1984.

SEC. 1042. INCREASE IN EARNED INCOME CREDIT.

(a) INCREASE IN RATE OF CREDIT.—Subsection (a) of section 32 (relating to earned income credit), as redesignated by title IV of this Act, is amended by striking out "10 percent" and inserting in lieu thereof "11 percent".

(b) ADJUSTMENT OF CREDIT PHASE-OUT.—Paragraph (2) of section 32(b) (as so redesignated) is amended to read as follows:

"(2) 12% percent of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds $6,500."

(c) CREDIT NOT ALLOWABLE TO TAXPAYERS SUBJECT TO ALTERNATIVE MINIMUM TAX.—Section 32 (as so redesignated) is amended by adding at the end thereof the following new subsection:

"(h) REDUCTION OF CREDIT TO TAXPAYERS SUBJECT TO ALTERNATIVE MINIMUM TAX.—The credit allowed under this section for the taxable year shall be reduced by the amount of tax imposed by section 55 (relating to alternative minimum tax for taxpayers other than corporations) with respect to such taxpayer for such taxable year."

(d) TECHNICAL AMENDMENTS.—

(1) Paragraph (1) of section 32(b) (as so redesignated is amended by striking out "$500" and inserting in lieu thereof "$550".

(2) Subparagraphs (A) and (B) of section 32(j)(2) (as so redesignated) are amended to read as follows:

"(A) for earned income between $0 and $11,000, and

"(B) for adjusted gross income between $6,500 and $11,000."

(3) Clauses (i) and (ii) of section 3507(c)(2)(B) are amended to read as follows:

"(i) of not more than 11 percent of the first $5,000 of earned income, which

"(ii) phases out between $6,500 and $11,000 of earned income, or".

(4) Clauses (i) and (ii) of section 3507(c)(2)(C) are amended to read as follows:

"(i) of not more than 11 percent of the first $2,500 of earned income, which

"(ii) phases out between $3,250 and $5,500 of earned income."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 1043. ALTERNATIVE TEST FOR DEFINITION OF QUALIFIED REHABILITATION BUILDING.

(a) IN GENERAL.—Paragraph (1) of section 48(g) (relating to qualified rehabilitated buildings) is amended by adding at the end thereof the following new subparagraph:

"(E) ALTERNATIVE TEST FOR DEFINITION OF QUALIFIED REHABILITATED BUILDING.—The requirement in clause (iii) of subparagraph (A) shall be deemed to be satisfied if in the rehabilitation process—

"(i) 50 percent or more of the existing external walls of the building are retained in place as external walls,

"(ii) 75 percent or more of the existing external walls of such buildings are retained in place as internal or external walls, and

"(iii) 75 percent or more of the existing internal structural framework of such building is retained in place."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to expenditures incurred after December 31, 1983, in taxable years ending such date.

Subtitle F—Miscellaneous Housing Provisions

SEC. 1051—DISASTER LOSS DEDUCTION WHERE TAXPAYER ORDERED TO DEMOLISH OR RELOCATE RESIDENCE IN DISASTER AREA BECAUSE OF DISASTER.

(a) GENERAL RULE.—Section 165 (relating to losses) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) TREATMENT AS DISASTER LOSS WHERE TAXPAYER ORDERED TO DEMOLISH OR RELOCATE RESIDENCE IN DISASTER AREA BECAUSE OF DISASTER.—In the case of a taxpayer whose residence is located in an area which has been determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974, if—

"(1) not later than the 120th day after the date of such determination, the taxpayer is ordered, by the government of the State or any political subdivision thereof in which such residence is located, to demolish or relocate such residence, and

"(2) the residence has been renderd unsafe for use as a residence by reason of the disaster,

any loss attributable to such disaster shall be treated as a loss which arises from a casualty and which is described in subsection (i)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1981, with respect to residences in areas determined by the President of the United States, after such date, to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.

SEC. 1052. ALLOCATION OF EXPENSES TO PARSONAGE ALLOWANCES.

With respect to any mortgage interest or real property tax costs paid or incurred before January 1, 1986, by any minister of the gospel who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before such date and subsequently owned and occupied such home), the application of section 265(1) of the Internal Revenue Code of 1954 to such costs shall be determined without regard to Revenue Ruling 83-3 (and without regard to any other regulation, ruling, or decision reaching the same result, or a result similar to the result, set forth in such Revenue Ruling).

SEC. 1053. ARMED FORCES OVERSEAS QUARTERS.

(a) IN GENERAL.—Subsection (h) of section 1034 (relating to rollover of gain on sale of principal residence) is amended to read as follows:

"(h) MEMBERS OF ARMED FORCES.—

"(1) IN GENERAL.—The running of any period of time specified in subsection (a) or (c) (other than the 2 years referred to in subsection (c)(4)) shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence, except that any such period of time as so suspended shall not extend beyond the date 4 years after the date of the sale of the old residence.

"(2) MEMBERS STATIONED OUTSIDE THE UNITED STATES OR REQUIRED TO RESIDE IN GOVERNMENT QUARTERS.—In the case of any taxpayer who, during any period of time the running of which is suspended by paragraph (1)—

"(A) is stationed outside of the United States, or

"(B) after returning from a tour of duty outside of the United States and pursuant to a determination by the Secretary of Defense that adequate off-base housing is not available at a remote base site, is required to reside in on-base Government quarters, any such period of time as so suspended shall not expire before the last day described in subparagraph (A) or (B), as the case may be, except that any such period of time as so suspended shall not extend beyond the date which is 8 years after the date of the sale of the old residence.

"(3) EXTENDED ACTIVE DUTY DEFINED.—For purposes of this subsection, the term 'extended active duty' means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to sales of old residences (within the meaning of section 1034 of the Internal Revenue Code of 1954) after the date of the enactment of this Act.

SEC. 1054. TREATMENT OF HOME WON IN LOCAL RADIO CONTEST AND SPECIALLY DESIGNED FOR HANDICAPPED FOSTER CHILD.

(a) IN GENERAL.—If the Federal income tax attributable to the receipt of the prize described in subsection (b) is paid no later than one year after the date of the enactment of this Act, such payment shall be treated for purposes of the Internal Revenue Code of 1954 as being in full satisfaction of such tax and all interest, additions to the tax, additional amounts, and penalties in respect of liability for such Federal income tax.

(b) DESCRIPTION OF PRIZE.—For purposes of subsection (a), the prize described in this subsection is a residence which—

(1) was won by the taxpayer in a local radio contest,

(2) was specially designated to meet the needs of a handicapped foster child of the taxpayer,

(3) is the principal residence (within the meaning of section 1034 of such Code) of the taxpayer, and

(4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

(c) TAX DETERMINED WITHOUT REGARD TO INTEREST, ETC.—For purposes of subsection (a), the Federal income tax attributable to the prize described in subsection (b) shall be determined without regard to interest, additions to the tax, additional amounts, and penalties.

Subtitle G—Extension of Existing Provisions and Transition Rules

SEC. 1061. EXTENSION OF PAYMENT-IN-KIND TAX TREATMENT ACT OF 1983 TO WHEAT FOR 1984 CROP YEAR.

(a) EXTENSION.—

(1) IN GENERAL.—Section 5 of the Payment-in-Kind Tax Treatment Act of 1983 (relating to definitions and special rules) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) EXTENSION TO WHEAT PLANTED AND HARVESTED IN 1984.—In the case of wheat—

"(1) any reference in this Act to the 1983 crop year shall include a reference to the 1984 crop year, and

"(2) any reference to the 1983 payment-in-kind program shall include a reference to any program for the 1984 year for wheat which meets the requirements of subparagraphs (A) and (B) of subsection (a)(1)."

(2) DEFINITION OF CROP YEAR.—Paragraph (2) of section 5(a) of such Act is amended to read as follows:

"(2) CROP YEAR.—The term '1983 crop year' means the crop year for any crop the planting or harvesting period for which occurs during 1983. The term '1984 crop year' means the crop year for wheat the planting and harvesting period for which occurs during 1984."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to commodities received for the 1984 crop year (as defined in section 5(a)(2) of the Payment-in-Kind Tax Treatment Act of 1983 as amended by subsection (a)).

SEC. 1062. EXTENSION OF INCREASED DEDUCTION FOR ELIMINATING ARCHITECTURAL AND TRANSPORTATION BARRIERS TO THE HANDICAPPED.

(a) EXTENSION.—

(1) IN GENERAL.—Subsection (d) of section 190 (relating to expenditures to remove architectural and transportation barriers to the handicapped and elderly) is amended to read as follows:

"(d) APPLICATION OF SECTION.—This section shall apply to—

"(1) taxable years beginning after December 31, 1976, and before January 1, 1983, and

"(2) taxable years beginning after December 31, 1983, and before January 1, 1986."

(2) CONFORMING AMENDMENT.—Subsection (c) of section 2122 of the Tax Reform Act of 1976 (26 U.S.C. 190 note) (relating to effective date for allowance of deduction for eliminating architectural and transportation barriers for the handicapped) is amended by striking out "and before January 1, 1983".

(b) INCREASE IN DEDUCTION.—Subsection (c) of section 190 (relating to limitation of deduction) is amended by striking out "$25,000" and inserting in lieu thereof "$35,000".

(c) EFFECTIVE DATE.—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1983.

SEC. 1063. PERMANENT DISALLOWANCE OF DEDUCTION FOR EXPENSES OF DEMOLITION OF CERTAIN STRUCTURES

(a) EXTENSION TO ALL STRUCTURES; DISALLOWANCE MADE PERMANENT.—Section 280B (relating to demolition of certain historic structures) is amended—

(1) by striking out all of subsection (a) which precedes paragraph (1) thereof and inserting in lieu thereof the following: "In the case of the demolition of any structure—"; and

(2) by striking out subsections (b) and (c).

(b) CONFORMING AMENDMENTS.—

(1) The heading for section 280B is amended by striking out "CERTAIN HISTORIC".

(2) The item relating to section 280B in the table of sections for part IX of subchapter B of chapter 1 is amended by striking out "certain historic".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

SEC. 1064. AMORTIZATION OF EXPENDITURES TO REHABILITATE LOW-INCOME RENTAL HOUSING.

Subsection (k) of section 167 (relating to depreciation of expenditures to rehabilitate low-income rental housing) is amended by striking out "January 1, 1984" each place it appears and inserting in lieu thereof "January 1, 1987".

SEC. 1065. RULES TREATING INDIAN TRIBAL GOVERNMENTS AS STATES MADE PERMANENT.

(a) IN GENERAL.—Section 208 of the Indian Tribal Governmental Tax Status Act of 1982 is amended—

(1) by striking out "and before January 1, 1985," each place it appears, and

(2) by striking out ", and shall cedse to apply at the close of December 31, 1984" in paragraph (5) thereof.

(b) TREATMENT AS STATE EXPANDED FOR CERTAIN PURPOSES.—Paragraph (6) of section 7871 (relating to Indian tribal governments treated as States for certain purposes) is amended by striking out subparagraphs (B) and (C) and inserting in lieu thereof the following:

"(B) section 105(e) (relating to accident and health plans),

"(C) section 117(b)(2)(A) (relating to scholarships and fellowship grants),

"(D) section 162(e) (relating to appearances, etc., with respect to legislation),

"(E) section 403(b)(1)(A)(ii) (relating to the taxation of contributions of certain employers for employee annuities), and

"(F) section 454(b)(2) (relating to discount obligations).

(c) EFFECTIVE DATE.—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1984.

SEC. 1066. TRANSITIONAL RULE FOR TREATMENT OF CERTAIN INCOME FROM S CORPORATIONS.

(a) IN GENERAL.—If—

(1) a corporation had an election in effect under subchapter S of the Internal Revenue Code of 1954 for the taxable years of such corporation beginning in 1982, 1983, and 1984, and

(2) a shareholder of such corporation makes an election to have this section apply, then any qualified income which such shareholder takes into account by reason of holding stock in such corporation for any taxable year of such corporation beginning in 1983 or 1984 shall be treated for purposes of section 163(d) of the Internal Revenue Code of 1954 as such income would have been treated but for the enactment of the Subchapter S Revision Act of 1982.

(b) QUALIFIED INCOME.—For purposes of subsection (a), the term "qualified income" means any income other than income which is attributable to personal services performed by the shareholder for the corporation.

(c) ELECTION.—The election under subsection (a)(2) shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 1067. SPECIAL LEASING RULES FOR CERTAIN COAL GASIFICATION FACILITIES.

(a) IN GENERAL.—Paragraph (3) of section 208(d) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new subparagraph:

"(G) COAL GASIFICATION FACILITIES.—

"(i) IN GENERAL.—Property is described in this subparagraph if such property—

"(I) is used directly in connection with the manufacture or production of low sulfur gaseous fuel from coal, and

"(II) would be described in subparagraph (A) if 'July 1, 1984' were substituted for 'January 1, 1983'.

"(ii) SPECIAL RULE.—For purposes of determining whether property described in this subparagraph is described in subparagraph (A), such property shall be treated as having been acquired during the period referred to in subparagraph (A)(ii) if at least 20 percent of the cost of such property is paid during such period.

"(iii) LIMITATION ON AMOUNT.—Clause (i) shall only apply to the lease of an undivided interest in the property in an amount which does not exceed the lesser of—

"(I) 50 percent of the cost basis of such property, or

"(II) $67,500,000.

"(iv) PLACED IN SERVICE.—In the case of property to which this subparagraph applies—

"(I) such property shall be treated as placed in service when the taxpayer receives an operating permit with respect to such property from a State environmental protection agency, and

"(II) the term of the lease with respect to such property shall be treated as being 5 years."

(b) SPECIAL RULE FOR SUBSECTION (a).—The amount of any recapture under section 47 of the Internal Revenue Code of 1954 with respect to the credit allowed under section 38 of such Code with respect to progress expenditures (within the meaning of section 46(d) of such Code) shall apply only to the percentage of the cost basis of the coal gasification facility to which the amendment made by subsection (a) applies.

(c) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if included in the provision of section

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc. (984)

208(d)(3) of the Tax Equity and Fiscal Responsibility Act of 1982.

Subtitle H—Additional Provisions

SEC. 1071. TAX TREATMENT OF REGULATED INVESTMENT COMPANIES.

(a) PERSONAL HOLDING COMPANIES PERMITTED TO BE REGULATED INVESTMENT COMPANIES.—

(1) IN GENERAL.—Subsection (a) of section 851 (defining regulated investment company) is amended by striking out "(other than a personal holding company as defined in section 542)".

(2) SPECIAL RULE FOR RATE OF TAX.—Paragraph (1) of section 852(b) (relating to imposition of tax on regulated investment companies) is amended by adding at the end thereof the following new sentence: "In the case of a regulated investment company which is a personal holding company (as defined in section 542), that tax shall be computed at the highest rate of tax specified in section 11(b)."

(3) REQUIREMENT THAT INVESTMENT COMPANY HAVE NO EARNINGS AND PROFITS ACCUMULATED IN YEAR FOR WHICH IT WAS NOT A REGULATED INVESTMENT COMPANY.—Subsection (a) of section 852 (relating to requirements applicable to regulated investment companies) is amended by striking out "and" at the end of paragraph (1), by striking out the period at the end of paragraph (2) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(3) either—

"(A) the provisions of this part applied to the investment company for all taxable years ending on or after November 8, 1983, or

"(B) as of the close of the taxable year, the investment company has no earnings and profits accumulated in any taxable year to which the provisions of this part (or the corresponding provisions of prior law) did not apply to it."

(4) PROCEDURES SIMILAR TO DEFICIENCY DIVIDEND PROCEDURES MADE APPLICABLE.—Section 852 is amended by adding at the end thereof the following new subsection:

"(e) PROCEDURES SIMILAR TO DEFICIENCY DIVIDEND PROCEDURES MADE APPLICABLE.—

"(1) IN GENERAL.—If—

"(A) there is a determination that the provisions of this part do not apply to an investment company for any taxable year (hereinafter in this subsection referred to as the 'non-RIC year'), and

"(B) such investment company meets the distribution requirements of paragraph (2) with respect to the non-RIC year,

for purposes of applying subsection (a)(3) to subsequent taxable years, the provisions of this part shall be treated as applying to such investment company for the non-RIC year.

"(2) DISTRIBUTION REQUIREMENTS.—

"(A) IN GENERAL.—The distribution requirements of this paragraph are met with respect to any non-RIC year if, within the 90-day period beginning on the date of the determination (or within such longer period as the Secretary may permit), the investment company makes 1 or more qualified designated distributions and the amount of such distributions is not less than the excess of—

"(i) the portion of the accumulated earnings and profits of the investment company (as of the date of the determination) which are attributable to the non-RIC year, over

"(ii) any interest payable under paragraph (3).

"(B) QUALIFIED DESIGNATED DISTRIBUTION.—For purposes of this paragraph, the term 'qualified designated distribution' means any distribution made by the investment company if—

"(i) section 301 applies to such distribution, and

"(ii) such distribution is designated (at such time and in such manner as the Secretary shall by regulations prescribe) as being taken into account under this paragraph with respect to the non-RIC year.

"(C) EFFECT ON DIVIDENDS PAID DEDUCTION.—Any qualified designated distribution shall not be included in the amount of dividends paid for purposes of computing the dividends paid deduction for any taxable year.

"(3) INTEREST CHARGE.—

"(A) IN GENERAL.—If paragraph (1) applies to any non-RIC year of an investment company, such investment company shall pay interest at the annual rate established under section 6621—

"(i) on an amount equal to 50 percent of the amount referred to in paragraph (2)(A)(i),

"(ii) for the period—

"(I) which begins on the last day prescribed for payment of the tax imposed for the non-RIC year (determined without regard to extensions), and

"(II) which ends on the date the determination is made.

"(B) COORDINATION WITH SUBTITLE F.—Any interest payable under subparagraph (A) may be assessed and collected at any time during the period during which any tax imposed for the taxable year in which the determination is made may be assessed and collected.

"(4) PROVISION NOT TO APPLY IN THE CASE OF FRAUD.—The provisions of this subsection shall not apply if the determination contains a finding that the failure to meet any requirement of this part was due to fraud with intent to evade tax.

"(5) DETERMINATION.—For purposes of this subsection, the term 'determination' has the meaning given to such term by section 860(e). Such term also includes a determination by the investment company filed with the Secretary that the provisions of this part do not apply to the investment company for a taxable year."

(5) EFFECTIVE DATES.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, the amendments made by this subsection shall apply to taxable years beginning after December 31, 1982.

(B) INVESTMENT COMPANIES WHICH WERE REGULATED INVESTMENT COMPANIES FOR YEARS ENDING BEFORE NOVEMBER 8, 1983.—In the case of any investment company to which the provisions of part I of subchapter M of chapter 1 of the Internal Revenue Code of 1954 applied for any taxable year ending before November 8, 1983, for purposes of section 852(a)(3)(B) of the Internal Revenue Code of 1954 (as amended by this subsection), no earnings and profits accumulated in any taxable year ending before January 1, 1984, shall be taken into account.

(C) INVESTMENT COMPANIES BEGINNING BUSINESS IN 1983.—In the case of an investment company which began business in 1983 (and was not a successor corporation), earnings and profits accumulated during its first taxable year shall not be taken into account for purposes of section 852(a)(3)(B) of such Code (as so amended).

(D) INVESTMENT COMPANIES REGISTERING BEFORE NOVEMBER 8, 1983.—In the case of any investment company—

(i) which, during the period after December 31, 1981, and before November 8, 1983—

(I) was engaged in the active conduct of a trade or business,

(II) sold substantially all of its operating assets, and

(III) registered under the Investment Company Act of 1940 as either a management company or a unit investment trust, and

(ii) to which the provisions of part I of subchapter M of chapter 1 of the Internal Revenue Code of 1954 applied for its first taxable year beginning after November 8, 1983,

for purposes of section 852(a)(3)(A) of such Code (as amended by paragraph (3)), the provisions of part I of subchapter M of chapter 1 of such Code shall be treated as applying to such investment company for its first taxable year ending after November 8, 1983. For purposes of the preceding sentence, all members of an affiliated group (as defined in section 1504(a) of such Code) filing a consolidated return shall be treated as 1 taxpayer.

(b) SHORT-TERM OBLIGATIONS ISSUED ON A DISCOUNT BASIS.—

(1) IN GENERAL.—Paragraph (2) of section 852(b) (defining investment company taxable income) is amended by adding at the end thereof the following new subparagraph—

"(F) The taxable income shall be computed without regard to section 454(b) (relating to short-term obligations issued on a discount basis) if the company so elects in a manner prescribed by the Secretary."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1978.

SEC. 1072. TECHNICAL MODIFICATIONS TO TIP REPORTING REQUIREMENTS.

(a) LOWER ALLOCATION OF GROSS RECEIPTS.—Subparagraph (C) of section 6053(c)(3) (relating to employee allocation of 8 percent of gross receipts) is amended—

(1) by striking out "The Secretary" and inserting in lieu thereof "Upon the petition of the employer or the majority of employees of such employer, the Secretary", and

(2) by striking out "5 percent" and inserting in lieu thereof "2 percent".

(b) RECORDKEEPING BY TIPPED EMPLOYEES.—The Secretary of the Treasury shall prescribe by regulations within 1 year after the date of the enactment of this Act the applicable recordkeeping requirements for tipped employees.

(c) 50 PERCENT OWNERS NOT TREATED AS EMPLOYEES FOR CERTAIN PURPOSES.—

(1) IN GENERAL.—Paragraph (4) of section 6056(c) (defining large food or beverage establishment) is amended by inserting before the period at the end of the last sentence the following: ", and an individual who owns 50 percent or more in value of the stock of the corporation operating the establishment shall not be treated as an employee".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to calendar years beginning after December 31, 1982.

SEC. 1073. TIPS TREATED AS WAGES FOR PURPOSES OF FEDERAL UNEMPLOYMENT TAX.

(a) GENERAL RULE.—Section 3306 (relating to definitions for purposes of Federal unemployment tax) is amended by adding at the end thereof the following new subsection:

"(s) TIPS TREATED AS WAGES.—For purposes of this chapter, the term 'wages' includes tips which are—

"(1) received while performing services which constitute employment, and

"(2) included in a written statement furnished to the employer pursuant to section 6053(a)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall take effect on January 1, 1986.

(2) EXCEPTION FOR CERTAIN STATES.—In the case of any State the legislature of which—

(A) did not meet in a regular session which begins during 1984 and after the date of the enactment of this Act, and

(B) did not meet in a session which began before the date of the enactment of this Act and remained in session for at least 25 calendar days after such date of enactment,

the amendment made by subsection (a) shall take effect on January 1, 1987.

SEC. 1074. EXCLUSION OF CERTAIN SERVICES FROM THE FEDERAL UNEMPLOYMENT TAX ACT.

Subsection (b) of section 822 of the Economic Recovery Tax Act of 1981 (26 U.S.C. 3306 note) is amended by striking out "and before January 1, 1983" and inserting in lieu thereof "and before January 1, 1985".

SEC. 1075. TAXATION OF UNEMPLOYMENT COMPENSATION NOT TO APPLY TO COMPENSATION PAID FOR WEEKS OF UNEMPLOYMENT ENDING BEFORE DECEMBER 1, 1978.

(a) GENERAL RULE.—Subsection (d) of section 112 of the Revenue Act of 1978 (relating to taxation of unemployment compensation benefits at certain income levels) is amended to read as follows:

"(d) EFFECTIVE DATE.—The amendments made by this section shall apply to payments of unemployment compensation made after December 31, 1978, in taxable years ending after such date; except that such amendments shall not apply to payments made for weeks of unemployment ending before December 1, 1978.".

(b) WAIVER OF STATUTE OF LIMITATIONS.—If credit or refund of any overpayment of tax resulting from the amendment made by subsection (a) is barred on the date of the enactment of this Act or at any time during the 1-year period beginning on the date of enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the amendment made by subsection (a)) may, nevertheless, be made or allowed if claim thereof is filed before the close of such 1-year period.

SEC. 1076. EXCLUSION FROM GROSS INCOME OF CANCELLATIONS OF CERTAIN STUDENT LOANS.

(a) IN GENERAL.—Section 108 (relating to income from discharge of indebtedness) is amended by adding at the end thereof the following new subsection:

"(f) STUDENT LOANS.—

"(1) IN GENERAL.—In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

"(2) STUDENT LOAN.—For purposes of this subsection, the term 'student loan' means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by—

"(A) the United States, or an instrumentality or agency thereof,

"(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or

"(C) a public benefit corporation—

"(i) which is exempt from taxation under section 501(c)(3),

"(ii) which has assumed control over a State, county, or municipal hospital, and

"(iii) whose employees have been deemed to be public employees under State law, or

"(D) any educational organization so described pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to discharges of indebtedness made on or after January 1, 1983.

SEC. 1077. MIGRATORY BIRD HUNTING STAMPS.

(a) IN GENERAL.—Section 5 of the Act of March 16, 1934 (48 Stat. 451, Chapter 71; 16 U.S.C. 718e) is amended by adding at the end thereof the following new subsection:

"(c) Notwithstanding the provisions of subsection (b), or the prohibition in section 474 of title 18, United States Code, or other provisions of law, the Secretary of the Interior may authorize, with the concurrence of the Secretary of the Treasury,

"(1) the color reproduction, or

"(2) the black and white reproduction, of migratory bird hunting stamps authorized by sections 1 through 4 and 6 through 9 of this Act, which otherwise satisfies the requirements of clauses (ii) and (iii) of section 504(1) of title 18, United States Code. Any such reproduction shall be subject to those terms and conditions deemed necessary by the Secretary of the Interior by regulation or otherwise and any proceeds received by the Federal Government as a result of such reproduction shall be paid into the migratory bird conservation fund established under section 4 of this Act."

(b) TECHNICAL AMENDMENTS.—

(1) Clause (i) of section 504(1)(D) of title 18, United States Code, is amended by inserting "and stamps issued under the Migratory Bird Hunting Stamp Act of 1934" after "foreign government".

(2) Clause (ii) of such section is amended by inserting "and illustrations of stamps issued under the "Migratory Bird Hunting Stamp Act of 1934 in color" after "postage stamps in color".

(3) Subsection (b) of section 5 of the Act referred to in subsection (a) is amended by striking out "No person" and inserting in lieu thereof "Except as provided in clauses (i) and (ii) of section 504(1)(D) of title 18, United States Code, no person".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 1078. EXCLUSION FROM GROSS INCOME OF PAYMENTS FROM THE UNITED STATES FOREST SERVICE AS A RESULT OF RESTRICTING MOTORIZED TRAFFIC IN THE BOUNDARY WATERS CANOE AREA.

(a) GENERAL RULE.—At the election of the taxpayer, for purposes of the Internal Revenue Code of 1954, gross income does not include the excludable portion of payments received from the United States Forest Service as a result of restricting motorized traffic in the Boundary Waters Canoe Area, pursuant to section 19(a) of "An Act to designate the Boundary Waters Canoe Area Wilderness, to establish the Boundary Waters Canoe Area Mining Protection Area, and for other purposes", approved October 21, 1978 (Public Law 95-495; 92 Stat. 1649).

(b) EXCLUDABLE PORTION.—For purposes of this section, the term "excludable portion" means that portion (or all) of a payment made to any taxpayer during the period after December 31, 1979, and before the later of the date which is 2 years after—

(1) the date of the enactment of this Act, or

(2) the date of such payment,

which payment is reinvested within such period in depreciable property used in a trade or business of such taxpayer as authorized by the Act referred to in subsection (a). In determining whether reinvestment has occurred, no direct tracing is required.

(c) ELECTION.—An election under subsection (a) shall identify such property for which such payment has been allocated. An election may be made at any time before the expiration of the period for making a claim for credit or refund of the tax imposed by chapter 1 of such Code for the taxable year in which the reinvestment occurred, and shall be made in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(d) BASIS OF PROPERTY.—

(1) IN GENERAL.—The basis of any property, with respect to which an allocation of any payment has been elected, shall be reduced by the amount of such payment.

(2) INCREASE DUE TO REPAYMENT.—The basis of any property described in paragraph (1) shall be increased by the amount of any repayments made to the United States Forest Service upon the sale of such property.

(e) DENIAL OF DOUBLE BENEFIT.—No deduction or credit shall be allowed under such Code with respect to any expenditure which is properly associated with any amount excluded from gross income under subsection (a).

(f) EFFECTIVE DATE; SPECIAL RULE.—

(1) EFFECTIVE DATE.—The amendments made by this section shall apply to payments made in taxable years beginning after December 31, 1979.

(2) ELECTIONS FOR PRIOR YEARS.—In the case of any taxable year ending before the date of the enactment of this Act.—

(A) the period for making the election under subsection (c) shall not expire before the date which is 1 year after the date of the enactment of this Act, and

(B) if, after the application of subparagraph (A), refund or credit of any overpayment of tax resulting from the application of this section is prevented at any time before the close of such 1-year period by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable the application of this section) may, nevertheless, be made or allowed if claim therefore is filed before the close of such 1-year period.

SEC. 1079. TAX EXEMPTION OF CORPORATIONS ORGANIZED UNDER ACTS OF CONGRESS.

Paragraph (1) of section 501(c) (relating to list of exempt organizations) is amended by striking out ", under such Act, as amended and supplemented," and inserting in lieu thereof "it is specifically provided in this title (or under such Act as amended and supplemented before the date of the enactment of the Tax Reform Act of 1984) that".

SUBTITLE I—STUDIES

SEC. 1081 STUDY OF ALTERNATIVE INCOME TAX SYSTEMS.

(a) IN GENERAL.—The Secretary of the Treasury or his delegate shall conduct a study covering the advisability of—

(1) replacing only the Federal individual income tax, or

(2) replacing both the Federal individual income tax and the Federal corporate income tax,

with an alternative tax system.

(b) CONTENTS OF STUDY.—Such study shall take into account the administrative complexity of the existing Federal income tax system and address the ramifications of replacing that system with an alternative tax system. Such study shall focus on (but not be limited to) the following factors:

(1) protecting the economically disadvantaged,

(2) increasing economic efficiency in both the private and public sectors of the economy,

(3) reducing paperwork and auditing requirements, reducing taxpayer fraud and evasion, and expediting resolution of tax disputes between taxpayers and the Federal Government,

(4) increasing economic incentives for capital formation and productivity,

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(5) removing economic distincentives to employment,

(6) excluding certain items, such as social security benefits, from gross income,

(7) equalizing the tax burden on taxpayers with equal ability to pay taxes, and

(8) achieving the appropriate burden of taxes for each income class of taxpayers.

Such study shall also identify the strengths and potential weaknesses of an alternative tax system and propose possible solutions for any such potential weakness.

(c) ALTERNATIVE TAX SYSTEM.—For purposes of this section, the term "alternative tax system" means a system based on—

(1) a simplified income tax based on gross income;

(2) a consumption tax;

(3) a consumption-based tax; or

(4) the broadening of the base and lowering of the rates of the current income tax.

(d) STUDY OF TAX SHELTERS TO BE INCLUDED.—The study conducted under subsection (a) shall include a study of the entire area of tax shelters and how they impact on the equity of the tax system.

(e) REPORTING DATE.—The report of the study required by subsection (a) shall be submitted to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate not later than December 31, 1984.

SEC. 1062. STUDY OF TAXATION BY FOREIGN COUNTRIES ON SERVICES PERFORMED IN THE UNITED STATES.

(a) STUDY.—The Secretary of the Treasury or his delegate shall conduct a study of the practices of foreign countries of taxing income on services performed within the United States, including, but not limited to—

(1) the status of treaty negotiations with such foreign countries with respect to such practices, and

(2) any options to alleviate the taxation of such income by more than 1 country without appropriate credit for taxes paid.

(b) REPORT.—The Secretary of the Treasury or his delegate shall report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives the results of the study conducted under subsection (a) no later than December 31, 1984.

Joint Explanatory Statement of the Committee of Conference
H.R. Rep. 98-861 (To Accompany H.R. 4170)

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the House to the amendments of the Senate to the bill (H.R. 4170) to provide for tax reform, and for other purposes, submit the following joint statements to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The joint statement of managers which follows was prepared by the committee of jurisdiction and is arranged by title of the conference agreement.

I. TAX FREEZE; TAX REFORMS GENERALLY

A. TAX FREEZE AND RELATED PROVISIONS

1. Postponement of finance lease provisions

Present law

Overview

The law contains rules (pre-safe harbor lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is entitled to claim tax benefits including cost recovery deductions and investment tax credits with respect to the property. The pre-safe harbor rules attempt to distinguish between true leases, in which the lessor owns the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owns the property for tax purposes. These rules generally are not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law is that the economic substance of a transaction, not its form, determines who is the owner of property for tax purposes. Thus, if a transaction is, in substance, simply a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under the pre-safe harbor lease rules, lease transactions cannot be used solely for the purpose of transferring tax benefits. They have to have nontax economic substance.

The Economic Recovery Tax Act of 1981 (ERTA) provided a new set of rules which represented a major departure from the pre-safe harbor rules. These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under these rules (safe-harbor lease rules), certain transactions involving tangible personal property were treated as leases for Federal income tax purposes regardless of their nontax economic substance. The pre-safe harbor leasing rules continued to apply for transactions not qualifying under the safe-harbor lease rules or when the safe harbor was not elected.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally repealed safe-harbor leasing. In its place, TEFRA substituted a liberalized form of pre-safe harbor leasing called finance leasing. The finance lease rules essentially provide that certain parts of the pre-safe harbor rules are not taken into account in determining whether an agreement with respect to a limited class of property is a lease for tax purposes. Thus, the pre-safe harbor rules apply when finance lease rules are unavailable, and, except to the extent not taken into account under the finance lease rules, they apply when the finance lease rules are available.

Pre-safe harbor leasing rules

Underlying principles

In general, the determination of lease treatment under the pre-safe harbor leasing rules requires a case-by-case analysis based on all the facts and circumstances. Although the determination of whether a transaction is a lease is inherently factual, a series of general principles is embodied in court cases, revenue rulings, and revenue procedures. These principles are used in determining the character of transactions not eligible for the safe-harbor lease rules.

For a transaction to be a lease under these rules, the lessee generally cannot hold title to or have a significant equity interest in the property. However, the fact that the lessor has title does not guarantee that the lessor is the owner for Federal income tax purposes. Both the courts and the IRS look to additional criteria in determining whether a transaction is a lease. These criteria focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive so long as the transaction also has a bona fide business purpose and the lessor retains sufficient burdens and benefits of ownership.[1]

To be entitled to depreciation deductions as the owner of the property, the lessor has to show that the property is being used by it for a business or other income-producing purpose. To have a business purpose, the person claiming ownership (i.e., the lessor) at least has to have a reasonable expectation that he will derive a profit from the transaction independent of tax benefits.[2] This requirement precludes lease treatment for a transaction intended merely to reduce the user's costs by utilizing the lessor's tax base. For a sale-leaseback, other nontax business motives have been considered in determining the substance of the transaction.

The fact that the lessor in a lease financing transaction can show a profit or business purpose, however, does not automatically result in lease treatment under pre-safe harbor lease rules, since a profit or business motive could also exist in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[3] Thus, lease treatment has been denied under pre-safe harbor lease rules if the user has the option to acquire the property at the end of the lease for a price that either is nominal in relation to the value of the property at the time when the option can be exercised (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total payments required to be made.

Where the residual value of the property to the lessor is nominal, the lessor has been viewed as having transferred full ownership of the property for the rental fee. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor may still be viewed as having transferred full ownership if the likelihood that the lessee will exercise the bargain purchase option is great.[4] Furthermore, if the lessor can force the lessee to purchase the property at the end of the lease (a put), the transaction might also be denied lease treatment under pre-safe harbor lease rules if the put eliminates the risk borne by owners of property that there may be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

The question of exactly what burdens and benefits of ownership have to be retained by the lessor under pre-safe harbor lease rules created some confusion and difficulty for people trying to structure leases that, at least in part, were motivated by tax considerations. To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the Service will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines generally apply only to leveraged leases of equipment. The general principles described above continue to govern nonleveraged leases and leases of real property. The guidelines are not a definitive statement of legal principles and are not intended for audit purposes. If less than all requirements of the guidelines are met, a transaction might still be considered a lease if, under all the facts and circumstances, the transaction is a lease under the general principles discussed previously. However, in practice, many taxpayers have taken into account the guidelines' requirements in structuring transactions. The guidelines may be viewed as a type of safe harbor.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property. This rule represents an attempt to ensure that the lessor experiences some significant loss if the property declines in value. By limiting the degree of nonrecourse leverage, this guideline also limits the pool of potentially

[1] See, *Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein); See generally, *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[2] See, *Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[3] See, *Frank Lyon Co.* v. *United States*, 435 (U.S. 561 (1978), rev'g 536 F.2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[4] See, Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[5] See, *M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

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transferable tax benefits from such transactions.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, when the property is first placed in service by the lessee, the lessor cannot have a contractual right to require the lessee or any other party to purchase the property, even at fair market value.

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bears the risk implicit in ownership,that no market or an unfavorable market will exist at the end of the lease. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test (described below). However, several courts have held that the mere existence of a fixed price purchase option does not prevent lease treatment so long as the lessor retains other significant burdens and benefits of ownership.[6]

Safe harbor leasing rules

The safe-harbor leasing provisions of ERTA were intended to permit owners of property who were unable to use depreciation deductions and investment credits to transfer those benefits to persons who were able to use them, without having to meet the pre-safe harbor lease requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operated by guaranteeing that, for Federal income tax purposes, qualifying transactions were treated as leases and that the nominal lessor was treated as the owner of the property, even though the lessee was in substance the owner of the property and the transaction otherwise would not have been considered a lease.[7]

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow from the transaction independent of tax benefits. These guidelines are based on the requirement, as previously mentioned, that lease transactions must have a business purpose independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could realistically use the property, the lessor has not retained any significant ownership interest.

The Tax Equity and Fiscal Responsibility Act of 1982 generally repealed safe-harbor leasing.

Finance lease provisions

TEFRA provided rules (finance leasing rules) which in two respects liberalized the pre-safe harbor leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee has an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor or (2) the property is readily usable only by the lessee (limited use property) is not taken into account in determining whether the agreement is a lease.

A qualified agreement must be a lease determined without taking into account the fact that it contains a 10-percent fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits. The lessor must reasonably expect to derive a profit independent of tax benefits. In addition, the transaction, without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property, must not otherwise be considered a financing arrangement or conditional sale.

The finance lease rules generally apply to agreements entered into after December 31, 1983, but three restrictions apply in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 may qualify for finance lease treatment. Second, a lessor may not use finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap does not apply to property placed in service after September 30, 1985 (in taxable years beginning after that date). Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, is only allowable ratably over 5 years, rather than entirely in the year the property is placed in service.

An exception to the general rule is provided for agreements relating to farm property. Finance lease rules are available for up to $150,000 of a lessee's farm property, for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of investment credit are inapplicable to this farm property.

No regulations have been issued under the finance lease provisions.

House bill

The House bill postpones for four years the effective dates of the finance lease rules. Thus, these rules generally apply only to agreements entered into after December 31, 1987, and the three restrictions currently scheduled to apply in 1984 and 1985 apply in 1988 and 1989. First, the 40-percent lessee cap is extended to cover property placed in service by a lessee during any calendar year beginning before 1990. Second, the 50-percent lessor cap is extended through September 30, 1989. Third, the 5-year spread of investment credit for property subject to a finance lease is extended to cover property placed in service on or before September 30, 1989. Present law rules relating to the availability of finance leasing for up to $150,000 of a lessee's farm property are extended to cover agreements entered into before 1988.

The House bill provides transitional rules which exempt certain property from the 4-year postponement described above. Under these rules, the postponement does not apply to property if, before March 2, 1984, (1) a binding contract to acquire or construct the property was entered into by the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee.

The House bill prohibits the Treasury from issuing, before 1988, regulations relating to the determination of whether a transaction is a lease. The prohibition does not apply to regulations which carry out the purposes of the bill with respect to tax-exempt entity leasing or of section 210 of TEFRA (relating to agreements covering certain motor vehicles).

Senate amendment

The Senate amendment is generally the same as the House bill. However, the Senate amendment substitutes March 7, 1984, for March 2, 1984, in the transitional rules, and does not include a provision prohibiting the Treasury from issuing leasing regulations. In addition, the Senate amendment exempts the following property from the 4-year postponement of finance leasing rules: (1) up to $150 million of a qualified lessee's automotive manufacturing property and (2) property that is part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates.

Conference agreement

The conference agreement generally follows the Senate amendment.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress permitted lease treatment, beginning in 1984, for agreements which would be appropriately treated as leases under current administrative rules and practices were it not for the fact that the agreement contained a fixed price purchase option or pertained to limited use property. The conference agreement postpones these relaxations of current administrative guidelines, and the conferees intend that those guidelines should not be relaxed by administrative action.

The conference agreement does not include the provision of the House bill which generally would have prohibited the Treasury Department from issuing leasing regulations before 1988. The conferees reached this decision on the basis of an understanding that the Treasury Department does not intend to liberalize significantly current administrative rules and practices for determining whether an agreement is a lease or a financing arrangement. The conferees also took into account the fact that a prohibition could have precluded perfecting modifications that may be shown to be necessary but that would not operate to liberalize current administrative guidelines in this area.

The conferees are concerned that agreements represented as leases are being used to transfer the tax benefits of ownership from persons who cannot utilize them to nominal lessors who can, when in substance the nominal lessor does not have a significant at-risk investment in the property itself. Current administrative rules and procedures are designed to check such tax benefit transfers. Therefore, the primary objective of the conferees is that there be no relaxation of administrative rules and practices that would result in lease treatment for financing transactions in which the purported lessor does not have a significant ownership interest in the property. While recognizing that in some cases special factors may need to be taken into account, the conferees believe that current administrative rules and practices, when applied to the broad range of conventional lease financing transactions, produce a satisfactory and ap-

[6] See, e.g., *Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974).

[7] For a discussion of the safe-harbor lease eligibility requirements, see the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the Staff of the Joint Committee on Taxation (December 31, 1982).

propriate differentiation between leases and financing arrangements.

2. Postponement of increase in amount of used property eligible for investment tax credit

Present law

The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment tax credit in a taxable year is $125,000. In the case of a married individual who files a separate return, the limit is $62,500. These limits are scheduled to increase to $150,000 and $75,000, respectively, for taxable years beginning after 1984.

House bill

The House bill maintains the maximum amount of used property eligible for the investment credit at its current level of $125,000 per year until taxable years beginning after 1987, when this limit is increased to $150,000.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and Senate amendment.

3. Postponement of increases in amount of property eligible for expensing

Present law

A taxpayer (other than a trust or estate) may elect, in lieu of capital cost recovery under the Accelerated Cost Recovery System, to deduct the cost of qualifying property in the taxable year it is placed in service. In general, qualifying property must be acquired by purchase for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable for the portion of the cost of property expensed under this rule.

For taxable years beginning in 1983, the dollar limitation on the amount that can be expensed is $5,000 a year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1984 and 1985, and to $10,000 for taxable years beginning after 1985. In each case, the limitation that applies to a married individual who files a separate return is one-half the dollar limitation described above.

House bill

The House bill postpones for four years the scheduled increases in the maximum amount of property that can be expensed. Thus, the dollar limitation on the amount that can be expensed will remain at $5,000 for taxable years beginning before 1988, increase to $7,500 for taxable years beginning in 1988 or 1989, and increase to $10,000 for taxable years beginning after 1989.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and Senate amendment.

4. Net interest exclusion

Present law

The Economic Recovery Tax Act of 1981 provides for an exclusion of 15 percent of net interest received, for up to $3,000 of net interest ($6,000 on a joint return). Net interest is generally interest received by the taxpayer in excess of interest paid (other than mortgage interest or business interest) by the taxpayer for which an income tax deduction is allowed.

The net interest exclusion is scheduled to take effect for taxable years beginning after 1984.

House bill

The House bill repeals the net interest exclusion.

Senate amendment

The Senate amendment postpones the effective date of the net interest exclusion to taxable years beginning after 1987.

Conference agreement

The conference agreement follows the House bill.

5. Postponement of increase in foreign earned income exclusion

Present law

The maximum amount of income earned abroad that is excludible from an individual's taxable income is $80,000 for 1983. This amount is scheduled to increase in $5,000 annual increments to a permanent level of $95,000 in 1986.

House bill

The House bill freezes the maximum amount of the foreign earned income exclusion at $80,000 until 1988 and increases it in $5,000 increments to $95,000 in 1990.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

6. Defer scheduled reductions in maximum gift and estate tax rates

Present law

The Economic Recovery Tax Act of 1981 (ERTA) enacted reductions in the maximum gift and estate tax rates, to take effect over a four-year period. The maximum rates before ERTA were 70 percent. Under ERTA, the maximum rates are 60 percent for gifts made and individuals dying in 1983; 55 percent in 1984, and 50 percent thereafter.

House bill

The House bill retains the 60-percent maximum gift and estate tax rates through 1987. The rate will be reduced to 55 percent in 1988 and 50 percent in 1989 and thereafter.

The provision applies to gifts made, and estates of individuals dying, after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with a modification that the maximum tax rate is 55 percent through 1987. The rate will decline to 50 percent for estates of individuals dying, and gifts made, after December 31, 1987.

7. Windfall profit tax rate on newly discovered oil

Present law

Present law imposes an excise tax on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification on one of three tiers.

Tier 1 oil (previously controlled oil) generally is taxed at a 70-percent rate; tier 2 oil (stripper oil and naval petroleum oil) generally is taxed at a 60-percent rate. A 50-percent rate applies to up to 1,000 barrels a day of tier 1 oil production by independent producers. In the case of tier 2 stripper oil, production by independent producers generally is exempt from tax.

Tier 3 oil is newly discovered oil, heavy oil, and incremental tertiary oil. Prior to 1982, all tier 3 oil was subject to tax at a 30-percent rate. Starting in 1982, the rate on newly discovered oil was reduced to 27-1/2 percent and to 25 percent in 1983. Under present law, the rate of windfall profit tax on newly discovered oil is 22.5 percent for 1984, 20 percent for 1985, and 15 percent for 1986 and later years.

House bill

Under the House bill, the rate of windfall profit tax on newly discovered oil would not be reduced to 22-1/2 percent in 1984. Instead, the tax rate would remain at 25 percent through 1987 and then be reduced to 22-1/2 percent for 1988, 20 percent for 1989, and 15 percent for 1990 and later years.

The provision applies with respect to domestic crude oil removed from the premises on which it was produced after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with an amendment providing that the windfall profit tax rate applicable to newly discovered oil will be 22.5 percent for 1984 through 1987, 20 percent for 1988, and 15 percent for 1989 and subsequent years.

8. Percentage depletion for secondary and tertiary production after 1983

Present law

In the Tax Reduction Act of 1975, Congress retained the percentage depletion allowance for limited quantities of oil and gas production. For oil production, effective January 1, 1984, the rate has declined to a permanent level of 15 percent and is limited to 1,000 barrels per day.

The 1975 amendment continued this percentage depletion allowance for secondary and tertiary production at a 22-percent rate but (because of an error) only through 1983.

Under the 1975 amendments, if an interest in any proven oil or gas property is transferred to another owner after 1974, no percentage depletion allowance applies to the property after the transfer unless one of the exceptions provided for in section 613(c)(9), or (10) applies. The proposed Treasury regulations, published in 1977, stated that the transfer restrictions would not apply to percentage depletion for secondary and tertiary production. This exception to the transfer rule resulted from the same 1975 drafting error that caused termination of that percentage depletion after 1983.

House bill

The House bill corrects the technical errors that occurred in the Tax Reform Act of 1975 with respect to depletion on secondary and tertiary depletion. The bill eliminates the distinction between primary and secondary or tertiary production after 1983. Thus, independent producers may claim percentage depletion in 1984 at a rate of 15 percent on up to 1,000 barrels of all their production. In addition, starting in 1984, percentage depletion on secondary and tertiary production will not be available after 1983 for production from proven properties transferred since 1974 unless one of the exceptions provided for in section 613A(c)(9) applies to the transfer.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

9. Modification of excise tax rates on cigarettes and distilled spirits

a. Cigarette excise tax

Present law

Present law imposes an excise tax on cigarettes manufactured in or imported into the United States. The rate of tax on small cigarettes is 16 cents per pack of 20 cigarettes. Higher rates apply to so-called "large" cigarettes, which are cigarettes weighing more than 3 pounds per thousand. Nearly all taxable cigarettes are small cigarettes. On October 1, 1985, the present tax rates are scheduled to decline by one-half.

House bill

The House bill provides an excise tax equal to 12 cents per pack of 20 cigarettes after September 30, 1985, and before January 1, 1988. A corresponding adjustment to the tax rate for large cigarettes is made.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the Senate amendment.

b. Distilled spirits excise tax

Present law

Present law imposes an excise tax at a rate of $10.50 per proof gallon on distilled spirits produced in or imported into the United States. A proof gallon is a U.S. gallon of liquid one-half of the volume of which consists of ethyl alcohol of a specified gravity.

House bill

The House bill increases the excise tax on distilled spirits by $3.75, to $14.25 per proof gallon, after September 30, 1985, and before January 1, 1988.

Senate amendment

The Senate amendment increases the excise tax on distilled spirits by $2.00, to $12.50 per proof gallon, effective after December 31, 1984.

Conference agreement

The conference agreement follows the House bill and the Senate amendment with modifications. Under the agreement, the increase in the tax rate is $2.00 per proof gallon as under the Senate amendment, and the increase is effective on October 1, 1985, as under the House bill.

The conference agreement clarifies and expands the Treasury Department regulatory authority to prescribe the time for payment of the special imposed on certain floor stocks held for sale on October 1, 1985, and to exempt certain small businesses from that tax. Under the agreement, the floor stocks tax generally will be due on April 1, 1986. Additionally, certain special de minimis provisions are included for small and middle sized wholesale and retail dealers. The de minimis exception provides the following:

(1) All persons holding distilled spirits for sale on October 1, 1985, are required to conduct a wine gallon inventory.

(2) Dealers whose wine gallon volume inventory is less than 500 gallons are exempt from the floor stocks tax.

(3) Dealers with an inventory of 500 liquid gallons or more are required to conduct a proof gallon inventory and to pay floor stocks tax on that inventory, but these dealers will receive a credit against the tax equal to $800 (the approximate tax on 500 wine gallons).

(4) All dealers whose gross sales from all products in the preceding taxable year did not exceed $500,000 are allowed to pay the floor stocks tax in three installments, one-third on each of April 1, 1986, July 1, 1986, and October 1, 1986.

10. Modification of time and manner of paying excise taxes on cigarettes and alcohol products

Present law

Time of payment

Cigarette and alcohol excise taxes generally are paid with respect to semimonthly periods; the taxes are due the following number of days after the last day of the semimonthly period when the taxable product is removed from bonded premises:

Cigarettes	25 days
Domestically produced and bulk imported distilled spirits	30 days
Bottled imported distilled spirits	15 days
Wine and beer	15 days

Method of payment

Present law generally requires payment of the cigarette and alcohol product excise taxes to accompany a return for each semimonthly period. There is no requirement of payment by electronic funds transfer.

House bill

No provision.

Senate amendment

Time of payment

The Senate amendment requires payment of the excise taxes on cigarettes and all alcohol products 14 days after the close of each semimonthly period. If the 14th day is a Saturday, Sunday, or Federal holiday, payment is required on the last preceding business day. This provision is effective with respect to semimonthly periods ending on and after June 30, 1984.

Method of payment

The Senate amendment requires payment of the excise taxes on cigarettes and all alcohol products by means of electronic funds transfer to a Federal reserve bank in the case of taxpayers whose gross tax liability with respect to the product involved was $5 million or more during the preceding calendar year. This provision is effective with respect to payments due on and after June 30, 1984.

Conference agreement

The conference agreement follows the House bill as to the time of payment and the Senate amendment as to the method of payment. The Senate amendment is modified, however, to delay the effective date of the electronic funds transfer provision until September 30, 1984.

11. Extension of excise tax on communications services

Present law

A 3-percent excise tax is imposed on amounts paid for local telephone service, toll (long-distance) telephone service, and teletypewriter exchange service. The tax is scheduled to terminate on January 1, 1986.

House bill

The House bill extends the 3-percent tax on communications services for two years, or through December 31, 1987.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

B. Leasing Provisions

1. Tax-exempt entity leasing

a. General rule

Present law

The rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and in revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits of the ownership of property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership. The applicable rules are discussed at length in the committee reports.

In general, the tax benefits of ownership of property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over relatively short periods. For most property, the ACRS recovery period is shorter than the actual useful life of the property. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investments in eligible property. Eligible property includes certain depreciable personal property. Special rules apply to certain energy property and to certain rehabilitations of older buildings or certified historic structures.

As a general rule, ACRS or other depreciation deductions and investment credits are not available for property owned by governmental units and tax-exempt organizations since they are not generally taxable. Moreover, no investment credit is allowed for property leased to or otherwise used (though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). The nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits. As a result, tax-exempt entities, by leasing property, may indirectly enjoy tax benefits that they could not have enjoyed had they owned the property instead.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, in general, ACRS deductions are reduced and no investment credit is allowed. There are a number of exceptions to this rule (sec. 48(a)(2)(B) and sec. 168(f)(2)(D)).

House bill

Numerous changes are made in the tax treatment of property leased to or otherwise used by a tax-exempt entity, as defined in the bill. The bill provides rules for determining cases in which property is to be treated as used by a tax-exempt entity for certain purposes, including cases in which property subject to a so-called service contract or other arrangement with or on behalf of a tax-exempt entity is to be treated as leased to that entity. The bill also provides rules for determining the tax treatment of property which is not tax-exempt use property under the general rules of the bill but which is owned by a partnership or other pass-through entity which has a tax-exempt entity as a partner or other beneficiary.

The provision is generally effective with respect to property place in service by the taxpayer after May 23, 1983, and to property placed in service by the taxpayer before May 24, 1983, and used by a tax-exempt entity pursuant to a lease entered into or renewed after May 23, 1983. Numerous transition rules are provided.

Senate amendment

The Senate amendment generally follows the House bill with several exceptions. In addition, the Senate amendment provides that the rules for distinguishing service contracts and other arrangements from leases are applicable for all income tax purposes. The Senate amendment also provides rules for determining the tax treatment of property leased to thrift institutions.

The provision generally has the same effective date as the provision in the House bill. However, the Senate amendment provides different transition rules.

Conference agreement

The conference agreement is discussed below.

b. Definition of tax-exempt entity

Present law

For purposes of the nontaxable use restriction applicable with respect to the investment credit, tax-exempt entities generally include organizations (other than farmers' cooperatives) exempt from income taxes (other than with respect to property used predominantly in an unrelated trade or business the income from which is subject to tax under sec. 511). Tax-exempt entities also include the United States, any State or political subdivision thereof, most international organizations, and any agency or instrumentality of any of the foregoing.

House bill

For all purposes of the bill, the term "tax-exempt entity" includes, in addition, U.S. possessions. The term also includes foreign governments, international organizations, any agency or instrumentality of any of the foregoing, and any person who is not a U.S. person (collectively, "foreign persons or entities"), but only with respect to property 50 percent or less of the gross income from the use of which for the taxable year is subject to U.S. income tax. The term also includes organizations which were tax-exempt at any time during the 5-year period ending on the date such organization first used the property involved.

The House bill also provides that a fully taxable corporate instrumentality of the United States or any State or political subdivision thereof is not to be treated as a tax-exempt entity only if a majority of its board of directors is not selected by the United States or any State or political subdivision thereof.

Senate amendment

The Senate amendment follows the House bill with certain exceptions. First, no foreign person or entity is treated as a tax-exempt entity with respect to property more than 20 percent of the gross income from the use of which is subject to U.S. income tax. For this purpose, income currently included under Subpart F in the income of a U.S. shareholder of a controlled foreign corporation is to be treated as subject to U.S. income tax.

Second, certain organizations (e.g., rural electric cooperatives) formerly exempt from tax under section 501(c)(12) at any time during the 5-year period preceding their first use of the property involved are not treated as tax-exempt entities if they agree to be fully taxable for the period beginning with the taxable year the property involved is placed in service and ending with the close of the 15th taxable year following the last taxable year of the recovery period for the property involved.

And third, fully taxable corporate instrumentalities of the United States or any State or political subdivision thereof are not treated as tax-exempt entities.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the conference agreement follows the House bill with respect to the (1) 50 percent threshold in the case of property used by a foreign person or entity, and (2) the treatment as tax-exempt entities of corporate instrumentalities of the United States or any State or political subdivision thereof. In addition, property leased to the Federal Home Loan Mortgage Corporation (which is made a taxable entity by the bill) is not to be treated as leased to a tax-exempt entity under the 5-year lookback rule.

Finally, under the conference agreement, certain former section 501(c)(12) organizations (e.g., rural electric cooperatives) are not subject to the 5-year lookback rule only if, in addition to complying with the Senate amendment, they comply with a transitional requirement added by the conference agreement. Under that requirement, the organization must elect to pay taxes on the exempt arbitrage profits it earns or has earned on that portion of the proceeds of any tax-exempt obligations associated with financing (e.g., acquisition or construction financing) by the organization of the property ultimately leased. The requirement is imposed because, in general, the conferees do not believe it appropriate that an organization should, as a tax-exempt entity, be able to earn arbitrage profits on tax-exempt obligations issued to finance property and then, after becoming a taxable entity, be entitled to benefit from tax provisions, through leasing property, available to the owner of the property. This is especially true in the case of cooperatives, which tend to have substantial tax planning flexibility.

This requirement applies with respect to all such exempt arbitrage profits, regardless of when earned, but only to the extent they are attributable to a period during which the organization was exempt from taxation. Under the conference agreement, those profits are taxed to the organization for the first taxable year in which it uses the property under the lease. They are treated as a separate basket of taxable income and taxed as such under section 11. No deductions are allowed against that separate basket of income. Neither are any credits allowed with respect to resulting tax liability.

"Exempt arbitrage profits" are the aggregate amount determined under the principles of sections 103(c)(6)(D)(i) and (ii) (relating to certain arbitrage profits), as amended by the bill, except that for this purpose, sections 103(c)(6)(F)(i)(II) (relating to certain earnings on a bona fide debt service fund) and 103(c)(6)(F)(ii) (relating to earnings on certain temporary investments) are disregarded. Furthermore, the principles of section 103(c)(6)(D)(i) are applicable for this purpose regardless of that section's general effective date. (Generally, that section applies to bonds issued after December 31, 1984.)

If new section 103(c)(6)(D)(i) in fact is applicable to the tax-exempt obligations there are, for purposes of this requirement, no exempt arbitrage profits. In general, if new section 103(c)(6)(D)(i) is applicable, certain arbitrage profits must be rebated to the United States. In such a case, taxation of "exempt arbitrage profits" is inappropriate.

c. Tax-exempt use property

Present law

For purposes of the investment credit (other than the rehabilitation credit), property used by a tax-exempt entity is treated as tax-exempt use property.

House bill

Personal property leased to or otherwise used by a tax-exempt entity is treated as tax-exempt use property. This rule applies for all credit purposes and for purposes of the depreciation provisions of the bill. Qualified films (as defined in sec. 48(k)(1)(B)) distributed to foreign persons or entities are not to be treated as used by such persons or entities.

Real property is treated as tax-exempt use property to the extent of disqualified uses, but only if the disqualified uses of the property exceed 20 percent of all uses of the property. A disqualified use is a lease to a tax-exempt entity if (1) the tax-exempt entity participates in financing the property through the issuance of tax-exempt obligations, (2) the use is pursuant to a lease containing a fixed or determinable purchase or sale option or the equivalent thereof, (3) the use is pursuant to a lease having a term exceeding 80 percent of the property's useful life, or (4) the use occurs after a sale by, lease from, or other transfer by the tax-exempt entity of property used by the tax-exempt entity prior to the transfer.

Senate amendment

The Senate amendment follows the House bill with four exceptions. First, real property is not treated as tax-exempt use property unless disqualified uses exceed 50 percent (35 percent in the case of disqualified use by a single tax-exempt entity). Second, the amendment treats real property used by a tax-exempt entity pursuant to a lease as a disqualified use if the lease term exceeds 20 years. Third, property leased by a tax-exempt entity within 3 months of the date it is placed in service by such tax-exempt entity (or a related party) is not treated as used in a disqualified use under the use after transfer rule. And fourth, sound recordings, as well as qualified films, distributed to foreign persons or entities are not treated as leased to them.

Conference agreement

The conference agreement generally follows the Senate amendment. However, under the conference agreement, real property is treated as tax-exempt use property to the extent of disqualified uses, but only if the disqualified uses of the property exceed 35 percent of all uses of the property. Furthermore, under the conference agreement, in the case of personal property, tax-exempt use property generally is only that portion of any tangible property leased to a tax-exempt entity. However, the 35-percent rule is not applicable with respect to personal property.

The conference agreement clarifies that, for purposes of the provision's depreciation rules, property owned by a tax-exempt entity is not to be treated as tax-exempt use property. Rather, only property leased to a tax-exempt entity is to be treated as used by that entity. For this purpose, the term "lease" includes any grant of a right to use property by one person to another. However, the conferees do not intend by this rule to preclude from treatment as tax-exempt use property any property not otherwise tax-exempt use property which is owned by a partnership or other pass-through entity which has a tax-exempt partner or other beneficiary. See the discussion of partnerships and other pass-through entities. Furthermore, property owned and used by a tax-exempt entity (or a related entity) for more than 3 months prior to a transfer of it by the tax-exempt entity (or a related entity) is to be treated as used by that entity before the transfer. (The general rule that only property "leased" to a tax-exempt entity is "used" by that entity for purposes of the bill's depreciation rules is not intended to change the rule of present law that a tax-exempt owner-lessor of property is not

able to pass on any credit to a lessee. See Treas. Reg. sec. 1.48-4(a)(1)(i).)

The conference agreement also clarifies that tax-exempt use property does not include any portion of a property if such portion is predominantly used by a tax-exempt entity directly, or for purposes of the bill's partnership rules, through a partnership of which the tax-exempt entity is a partner in an unrelated trade or business the income of which is subject to tax under section 511. For purposes of this rule, the conferees intend that property will not be treated as predominantly used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511 merely because the property is debt-financed property under section 514.

The conferees wish to clarify an example in the committee reports. Assume that a U.S. corporation leases equipment to a foreign corporation not subject to U.S. tax and the foreign corporation subleases the equipment to a branch of a U.S. corporation. The property is tax-exempt use property even though all income earned by the U.S. branch with respect to the use of the property is subject to U.S. tax. This result occurs without regard to the business reasons for the initial lease between the U.S. corporation and the foreign corporation. However, this result would not occur if, in view of the economic substance of the overall arrangement, the transaction is properly treated for U.S. tax purposes as a lease directly from the U.S. corporation to the U.S. branch, and not as a lease to and sublease from the foreign corporation.

d. Tax treatment of tax-exempt use personal property

Present law

No investment credit is allowed with respect to personal property leased to or otherwise used by a tax-exempt entity. Furthermore, in general, no investment tax credit is allowed with respect to personal property used predominantly outside the U.S. However, in general no restrictions are imposed with respect to the depreciation of personal property used by a tax-exempt entity, although restrictions are generally imposed on the depreciation of property used predominantly outside the U.S.

House bill

No investment credit is allowed with respect to personal property used by a tax-exempt entity. In addition, tax-exempt use personal property is to be depreciated on the straight-line method over the greater of (1) the property's ADR midpoint life (12 years if the property has no ADR midpoint life), or (2) the lease term. Under the House bill, investment credit may be recaptured with respect to property which becomes tax-exempt use sometime after having been placed in service. In addition, under the House bill, regulations are to be prescribed for the depreciation of property that either becomes or ceases being tax-exempt use property sometime after having been placed in service by the taxpayer.

Under the House bill, the Treasury is authorized to prescribe midpoint lives for personal property presently having no midpoint lives.

Senate amendment

The Senate amendment follows the House bill except that tax-exempt use personal property is to be depreciated on the straight-line method over the greater of (1) its ADR midpoint life (12 years in the absence of such a life), or (2) 125 percent of the lease term. In addition, no general authority is granted the Treasury to prescribe midpoint lives for property presently having none. Finally, the Senate amendment provides special rules for property used by foreign persons or entities. Under those rules: property placed in service before January 1, 1984, and used by a foreign person or entity under a lease entered into before January 1, 1984, is generally exempt from the provision; property placed in service in 1984, and used by a foreign person or entity under a lease entered into in 1984, is entitled to 50 percent of any investment credit otherwise allowable and may be depreciated under the 175-percent declining balance method over the longer of (1) its ADR midpoint life (12 years in the absence of such a life), or (2) 125 percent of the lease term; and other property used by a foreign person or entity is entitled to no investment credit but may be depreciated under the 150-percent declining balance method over its ADR midpoint life (12 years in the absence of such a life).

Conference agreement

The conference agreement generally follows the House bill except that tax-exempt use personal property cannot be depreciated over a period shorter than 125 percent of the lease term. Furthermore, under the conference agreement, the bill generally does not apply to property placed in service before January 1, 1984, and used by a foreign person or entity under a lease entered into before January 1, 1984, merely because of that lease.

The conferees wish to make it clear that if personal property is used by a tax-exempt entity (and the use is not pursuant to a short-term lease, as defined by the bill), investment credits are not available. This result follows even if the investment credit would be available under present law by virtue of section 48(a)(2)(B) (relating to exceptions from the denial of investment credit for certain property used predominantly outside the U.S.). For example, an aircraft leased to a foreign person or entity does not give rise to any investment credit even if it is operated to and from the U.S., if not more than 50 percent of the income derived by the foreign person or entity from the use of the aircraft is taxable in the U.S. Similarly, the bill's rules with respect to tax-exempt use property override section 168(f)(2) (relating to recovery deductions with respect to property used predominantly outside the U.S.). However, for a special rule for certain leases of aircraft to foreign persons or entities, see below under the discussion of the short-term lease exception.

e. Tax treatment of tax-exempt use real property

Present law

There are no restrictions on the depreciation of real property merely because it may be used by a tax-exempt entity. In addition, no rehabilitation credits are lost merely because such property may be used by a tax-exempt entity.

House bill

To the extent real property is tax-exempt use property, it must be depreciated on the straight-line method over the greater of (1) 40 years, or (2) 125 percent of the lease term. In addition, the rehabilitation credit is denied for tax-exempt use real property, but only to the extent the property is financed with tax-exempt obligations.

Senate amendment

The Senate amendment follows the House bill except that the rehabilitation credit is denied for all tax-exempt use property. For purposes of the rehabilitation credit, property which is reasonably expected to become tax-exempt use property is treated as tax-exempt use property. In addition, the Senate amendment's special rules for personal property used by foreign persons or entities apply to real property used by foreign persons or entities as well, treating the property's ADR midpoint life as 40 years.

Conference agreement

The conference agreement generally follows the House bill, with two exceptions. First, the rehabilitation credit is denied for all tax-exempt use real property (but only such property) subject to the bill's general depreciation provisions. For this purpose, property which is reasonably expected to become tax-exempt use property is treated as tax-exempt use property, as under the Senate amendment. And second, the bill does not apply to real property placed in service before January 1, 1984, and used by a foreign person or entity under a lease entered into before January 1, 1984.

f. Depreciation of certain short-lived property

Present law

No special provision.

House bill

The House bill's depreciation provisions do not apply to certain high-technology property (i.e., computers and peripherals, high-technology telephone station equipment, and high-technology medical equipment) (1) leased to a tax-exempt entity for 5 years or less (if the lease term exceeds 5 years, the property must be depreciated under the straight-line method over 5 years), or (2) used predominantly outside the United States. These rules are not applicable if the property was previously used by the tax-exempt entity (or a related entity), was financed with tax-exempt obligations, or is used by the United States or any agency or instrumentality thereof.

The Treasury is directed to determine whether the present ADR midpoint lives for such property are appropriate and to report its conclusions to Congress by July 1, 1984.

Senate amendment

The Senate amendment's depreciation provisions do not apply to property having an ADR midpoint life of 6 years or less so long as the lease term does not exceed 75 percent of the property's ADR midpoint life (5 years in the case of property having an ADR midpoint life of 6 years). While high-technology medical equipment is treated as having an ADR midpoint life of 6 years for purposes of this provision, the Treasury, prospectively only, may prescribe by regulations that it has a midpoint life of more than 6 years.

Conference agreement

The conference agreement generally follows the House bill except that the provision requiring the Treasury to report regarding ADR midpoint lives is eliminated. Furthermore, under the conference agreement, only property owned and used by a tax-exempt entity (or a related entity) for more than 3 months prior to a transfer of it by the tax-exempt entity (or a related entity) is to be treated as having been used by the tax-exempt entity before the transfer. Finally, in the case of property used predominantly outside the U.S. under a lease with a term of more than 5 years, the bill's general depreciation rules apply. That is, such property is depreciable on a straight-line basis over the longer of its ADR midpoint life or 125 percent of the lease term.

In addition, the conference agreement authorizes the Treasury to provide, by prospective regulations only, that any high-technology telephone station equipment or medical equipment (both as generally defined in the bill) is to be depreciated under the bill's general depreciation rules rather than the special rules for short-lived property. The conferees intend that the Treasury

so provide only if it determines that such property cannot reasonably be expected to become technologically obsolete substantially before the expiration of its physical useful life.

g. Short-term lease exception

Present law

Property leased to a tax-exempt entity pursuant to a casual or short-term lease (determined under all the facts and circumstances) is not subject to investment credit denial.

House bill

The House bill makes no change in the regular investment credit rule of present law. However, it provides that no rehabilitation credit is to be denied for property leased to a tax-exempt entity under a lease with a term of less than 1 year.

In addition, the bill's depreciation provision does not apply to personal property when the lease term is less than (1) 1 year, or (2) 30 percent of the property's ADR midpoint life. However, in no case will this exception apply if the lease has a term exceeding three years. For real property, the bill's depreciation provision does not apply if the lease term is less than 3 years.

Senate amendment

The regular investment credit provision of the Senate amendment generally does not apply if the lease term is less than 6 months. However, in the case of certain offshore oil and gas drilling equipment leased for a term not in excess of 2.25 years (1.8 years in the case of certain containers and related equipment), the regular investment credit provision of the amendment does not apply. No rehabilitation credit is to be denied for property used pursuant to a lease having a term not exceeding 3 years.

The depreciation provision does not apply to personal property leased pursuant to a lease having a term not exceeding one year or, if longer, 30 percent of the property's midpoint life. However, in no case will this exception apply if the lease has a term exceeding 3 years. For real property, the depreciation provision does not apply if the use is pursuant to a lease having a term not in excess of 3 years.

Conference agreement

The conference agreement generally follows the House bill except that for purposes of the rehabilitation credit, a lease is a short-term lease only if its term is less than 3 years. Furthermore, the conference agreement generally follows the Senate amendment with respect to investment credits (other than the rehabilitation credit). In addition, the conference agreement adopts the special investment credit rules in the Senate amendment regarding certain offshore oil and gas drilling equipment and containers and related equipment.

The conference agreement provides a special investment credit rule for certain aircraft leased to a foreign person or entity before January 1, 1990. Under section 47(a)(7), use under certain leases predominantly outside the U.S. of certain aircraft will not trigger investment credit recapture until the aircraft has been so used for more than 3-½ years. Absent a special rule, under the bill, leases of such aircraft to a foreign person or entity for 6 months or more would generally trigger investment credit recapture. Under the conference agreement, leases described in section 47(a)(7) to a foreign person or entity of aircraft described in section 47(a)(7) will not trigger investment credit recapture if those leases do not exceed three years. However, if such aircraft is thereafter disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person or entity.

h. Lease term

Present law

No special Code provision.

House bill

For purposes of the House bill, the term of a lease includes all options to renew as well as certain successive leases.

Senate amendment

The Senate amendment generally follows the House bill. However, in the case of real property, the lease term does not include renewal options at fair rental values.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the committee report indicates that the length of a lease term is also to be determined under all the facts and circumstances. See, e.g., *Hokanson v. Commissioner*, 84-1 USTC Par. 9217 (9th Cir. 1984). The conferees intend that the *Hokanson* rule and similar rules take precedence over the rule regarding fair rental renewal options with respect to real property so that, under all the facts and circumstances, the term of a fair rental value renewal option may be treated as a part of the original lease term.

The conference agreement also clarifies that successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property are to be treated as one lease.

i. Thrift institutions

Present law

Property owned by a thrift institution is limited to one-half of any investment tax credit (including any rehabilitation credit) otherwise available because special bad debt deductions available to such an institution effectively reduce the rate of tax applicable to its income. There is no special provision regarding credits with respect to property leased to a thrift institution.

House bill

No provision.

Senate amendment

The lessor of property to a thrift institution is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property.

Conference agreement

The conference agreement generally follows the Senate amendment. (For this purpose, property used by a thrift institution under a short-term lease (as defined in the bill) is not subject to the rule.) However, the conference agreement permits a thrift institution to avoid this rule by electing to waive its rights to claim deductions for additions to bad debt reserves under any method other than the experience method. Any such election would be irrevocable and would apply for all taxable years of the electing thrift institution (and any successor engaged in substantially similar activities) beginning with the taxable year for which made.

j. Service contracts

Present law

No special Code provision. However, case law (*Xerox Corp. v. U.S.*, 656 F. 2d 659 (Ct. Cl. 1981)), revenue rulings, and private letter rulings (which are not to be cited as precedent) provide guidance in distinguishing leases and other arrangements from service contracts. In general, property subject to a service contract with a tax-exempt entity is not treated as used by that entity in determining eligibility for the investment credit.

House bill

For all purposes of the provision, property subject to a so-called service contract or other arrangement with a tax-exempt entity is treated as leased to that entity if the arrangement more nearly resembles a lease of the property. In determining whether a so-called service contract or other arrangement with a tax-exempt entity more nearly resembles a lease of the property involved, all relevant factors are to be taken into account, including whether (1) the service recipient is in physical possession of the property, (2) the service recipient controls the property, (3) the service recipient has a significant economic or possessory interest in the property, (4) the service provider bears any significant economic risk if there is nonperformance, (5) there is concurrent use of the property by the service provider to provide significant service to others, and (6) the contract price under the service contract or other arrangement substantially exceeds the rental value of the property.

Special rules are provided with respect to certain waste-to-energy property.

Senate amendment

The Senate amendment generally follows the House bill. However, the Senate amendment provides a different set of special rules applicable to contracts for the provision of solid waste, energy, energy conservation or energy management, and clean water facilities. In general, such contracts are not to be treated as leases unless the service recipient (1) bears significant financial burdens if there is nonperformance, (2) operates the facility, (3) receives significant financial benefits if operating costs are less than projected, or (4) has a fixed or determinable purchase price option (other than at fair market value) or may be required to purchase the facilities.

The factors used to distinguish service contracts and other arrangements from leases are applicable for all income tax purposes.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the conference agreement makes it clear that a contract which purports to be a service contract is to be treated as a lease (rather than a conditional sale or similar arrangement) only if such contract is more properly to be treated as a lease under all the facts and circumstances, including those enumerated in the bill. The Senate committee report contains an example regarding applicability of the general service contract rules (i.e., those not applicable with respect to certain facilities) in the case of certain school buses (Example (6)). The conferees agree with that example. Under the conference agreement, the special rules under the Senate amendment relating to certain facilities are not applicable to any contract or arrangement for the provision of energy conservation or energy management services. However in the case of a binding contract with respect to any such services entered into before May 1, 1984, present law (rather than the bill's general services contract rules) applies.

Under the conference agreement, low-income residential property operated by or for an organization described in section 501(c)(3) or section 501(c)(4) is not subject to the service contract or other arrangement rules of the bill. Thus, for example, the leasing of units in such property to occupants is not treated as use by or on behalf of such an organization. For purposes of

this rule, low-income residential property means property described in section 1250(a)(1)(B)(i), (ii), (iii), or (iv), but only if 80 percent or more of the units are leased to low-income tenants, determined in a manner consistent with section 167(k)(3)(B).

k. Partnerships and other pass-through entities

Present law

No special Code provision.

House bill

Property which is not used by a tax-exempt entity may be owned by a partnership or other pass-through entity having both taxable and tax-exempt entities as partners or other beneficiaries. Unless all allocations to each tax-exempt entity partner or other beneficiary are qualified allocations, such partner's proportionate share of the pass-through entity's property is treated as tax-exempt use property for all purposes of the provision.

For purposes of this rule, a qualified allocation means any allocation to a tax-exempt entity which is consistent with such entity's being allocated the same percentage share of each item of income, gain, loss, deduction, credit, and basis of the partnership during the period such entity is a partner or beneficiary. Furthermore, no allocation is qualified unless it meets the substantial economic effect test of section 704(b). However, items allocated under section 704(c) (relating to contributed property) are not taken into account.

A tax-exempt entity partner's or other beneficiary's proportionate share of property of a pass-through entity equals such partner's or other beneficiary's share of the pass-through entity's distributions or items of income or gain (excluding gain allocated under section 704(c)), whichever produces the highest result. If the tax-exempt entity partner's or other beneficiary's share of distribution or items of income or gain (excluding gain allocated under section 704(c)) varies during the period it is a partner or other beneficiary, its share of any such item shall be the highest share it may receive.

Senate amendment

The Senate amendment generally follows the House bill.

Conference agreement

The conference agreement generally follows the House bill and the Senate amendment but makes certain clarifications and additions. For example, the conference agreement amends the rule regarding the determination of a tax-exempt entity partner's proportionate share of partnership property to exclude references to such entity's share of partnership distributions.

The conferees wish to clarify that this rule applies notwithstanding any other provision of the bill. For example, assume that a partnership owns a building which is leased to a taxable entity. The partnership has one tax-exempt entity as a partner, and its proportionate share is 10 percent. Unless the partnership's allocations to the tax-exempt entity are qualified, 10 percent of the building is tax-exempt use property, notwithstanding the 35-percent threshold otherwise applicable in the case of real property. However, this rule does not apply to the extent the property is predominantly used by the tax-exempt entity, through the partnership, in an unrelated trade or business the income of which is subject to tax under section 511 (determined without regard to the debt-financed income rules of section 514).

The conferees also wish to clarify the consequences of property being treated as tax-exempt use property under this rule. If a portion of a partnership's depreciable property is tax-exempt use property, allowable depreciation deductions with respect to that property will be reduced. The partnership's total depreciation deductions will be allocated under the partnership agreement among one or more of the partners in accordance with the provisions of section 704(b).

In addition, the conferees wish to clarify that property may be tax-exempt use property under both the general provisions of the bill and the special partnership provision. For example, a tax-exempt entity may be a partner in a partnership owning a building 60 percent of which is leased to a tax-exempt entity under a long-term lease. Sixty percent of the building is tax-exempt use property under the general provisions. The status of the other 40 percent would depend on whether the allocations with respect to it are qualified.

The conferees also wish to clarify that the reference to allocations of basis in determining whether an allocation is a qualified allocation pertains to allocations of basis of oil and gas properties under section 613A(c)(7)(D) and "section 38 property" under the investment credit rules.

The conference agreement authorizes the Treasury to prescribe regulations dealing with the effect of guaranteed payments (as defined in sec. 707(c)) under this rule. Under those regulations, priority cash distributions to partners that constitute guaranteed payments should not disqualify an otherwise qualified allocation so long as the priority cash distributions are reasonable in amount (e.g., equal to the most appropriate Federal rate) and are made to all partners in proportion to their capital in the partnership. On the other hand, the conferees expect that the regulations will prevent partnerships from avoiding the qualified allocation rules by making disproportionately large guaranteed payments to its tax-exempt partners for the use of their capital.

The conference agreement also authorizes the Treasury to prescribe regulations pursuant to which, in appropriate cases, particular items may be excluded or segregated in determining whether there is a qualified allocation. One example that has come to the conferees' attention involves a U.S. corporation and a foreign country are equal partners in a partnership created under the laws of that foreign country. Under those laws, the U.S. corporation's share of the partnership's profits are taxed, but not the foreign government's share. However, the tax is imposed on and paid by the partnership rather than the U.S. corporation partner directly. Under the partnership agreement, all partnership items are allocated equally between the two partners except that the tax expense is allocated to the U.S. corporation, and cash distributions to the partners reflect that allocation. Assuming those allocations possess substantial economic effect, the conferees do not intend that the partnership agreement be treated as containing an unqualified allocation.

Another situation those regulations might address involves a partnership which, in substance, consists of several partnerships formed to explore for, develop, and produce oil and gas. Typically, a partner in such a partnership may select to what extent he wishes to participate in a particular well, and his interest in the income, gain, loss, deduction, credit, and basis may differ from well-to-well. For example, a partner, consistent with the partnership agreement, may contribute 75 percent of the cost of one well and 50 percent of the cost of a second well and be allocated 75 percent of all tax items from the first well and 50 percent of all tax items from the second. If instead of using one partnership to invest in several wells, a separate partnership were used for each well, the allocation formula used for each well could be different from the others and yet each could satisfy the qualified allocation rules. The conferees anticipate that the regulations will grant relief in this and similar non-abusive situations.

Similarly, the conferees expect that the regulations will provide that an allocation will not disqualify an otherwise qualified allocation on the basis that it does not have substantial economic effect in cases where such allocation is not governed by the substantial economic effect rules (e.g., an allocation of basis of an oil and gas property) or cannot, by its nature, satisfy those rules (e.g., an allocation of credits, deductions attributable to nonrecourse debt, and percentage depletion in excess of basis), provided such allocation complies with the relevant section of the Code or the regulations (e.g., section 613A(c)(7)(D) and proposed regulations section 1.704-1(b)(4)).

Furthermore, the regulations might provide a procedure for taxpayers to seek rulings that an allocation will be treated as qualified in cases not specifically addressed by the regulations.

The conference agreement also provides other special rules for partnerships and other pass-through entities. First, property leased to a foreign partnership or other foreign pass-through entity is not, solely by reason of that lease, to be treated as tax-exempt use property. Second, property leased to any partnership or other pass-through entity, domestic or foreign, having as a partner or other beneficiary a tax-exempt entity is to be treated as leased to each such partner or other beneficiary in an amount equal to its proportionate share of such property (as determined under the conference agreement). Unless the taxpayer establishes otherwise, it is to be presumed for purposes of this rule that all partners of a foreign partnership (and all beneficiaries of any other foreign pass-through entity) are foreign persons or entities.

Finally, rules similar to the foregoing are to apply in the case of tiered partnerships and other tiered pass-through entities.

l. International Maritime Organization and International Satellite Communications Organization

Present law

Intelsat and Inmarsat, which, as foreign partnerships, are international organizations, are not treated as international organizations for purposes of the investment credit nontaxable use restriction under section 48(a)(5).

House bill

The House bill contains special rules applicable to Intelsat and Inmarsat.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement eliminates the special rules for Intelsat and Inmarsat. They are unnecessary in view of the general rules regarding partnerships and other pass-through entities described above, which apply to Intelsat and Inmarsat as well as other partnerships or pass-through entities.

The conferees request the Treasury to conduct a study of the satellite industry and to report the findings to Congress by no later than April 1, 1985. The conferees request that the study focus on the following issues. First, whether and to what extent domestic satellite companies are now able to, and in the future may be expected to be able to, compete successfully with foreign satellite operations for both domestic and foreign business. Second, whether domestic

satellite companies are now able to, and in the future may be expected to be able to, compete with each other on fair and equitable terms. Third, what role do tax benefits play in permitting satellite companies to compete with each other on fair and equitable terms. And fourth, whether Federal tax laws should be changed, and, if so, in what respect, to assure fair and open competition among all satellite companies.

m. Related parties

Present law

No special Code provision.

House bill

The House bill contains numerous rules relating to the treatment of tax-exempt entities and related parties as one entity for various purposes. The bill also defines related parties.

Senate amendment

The Senate amendment generally is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

n. General effective date

House bill

The bill is generally effective with respect to property placed in service by the taxpayer after May 23, 1983, and to property placed in service by the taxpayer before that date which is leased to a tax-exempt entity pursuant to a lease entered into after that date.

Senate amendment

The Senate amendment follows the House bill except that for property used by the U.S. Postal Service, May 23, 1983, is changed to October 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment. In addition, the conference agreement provides that certain improvements to property are not to be treated as separate property for purposes of the general effective date rules or the transitional rules. Under this provision, if the bill does not apply to the property improved, it will not apply to the improvements either. Improvements covered are those which would not be substantial improvements under section 168(f)(1)(C)(ii) if 20 percent were substituted for 25 percent.

o. Transition rules

(1) Leases, subleases, and renewals

House bill

The provision does not apply if the tax-exempt use is pursuant to (a) a lease entered on or before May 23, 1983 (or a sublease under such a lease), or (b) any renewal or extension of a lease entered into on or before May 23, 1983, pursuant to an option in such a lease exercisable by the tax-exempt entity.

Senate amendment

The Senate amendment is the same as the House bill except that for property used by the U.S. Postal Service, May 23, 1983, is changed to October 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

(2) Binding contracts

House bill

The provision does not apply to property leased to a tax-exempt entity if such lease is pursuant to certain binding contracts which, on May 23, 1983, required acquisition, construction, reconstruction, or rehabilitation of the property involved and its use by the tax-exempt entity.

Senate amendment

The Senate amendment follows the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment. The conferees wish to clarify that, for purposes of this rule, a written contract award made by the United States or an agency or instrumentality thereof on or before May 23, 1983, is to be treated as a binding contract.

(3) Binding contracts and firm plans, etc.

House bill

The provision does not apply to certain property acquired or constructed (or subject to a binding contract to acquire or construct) if (a) a contract entered into before January 1, 1984, requires the tax-exempt entity to use the property, or (b) on May 23, 1983, there was a firm written plan for the tax-exempt entity to enter into a contract for its use.

Senate amendment

No provision.

Conference agreement

The conference agreement generally follows the House bill with modifications.

Under the conference agreement, for property used by a tax-exempt entity (other than a foreign person or entity), the provision does not apply to property that (1) the taxpayer (or a predecessor in interest in or under the contract) or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate pursuant to a contract that was binding on May 23, 1983 (or has commenced, but not completed, construction, reconstruction, or rehabilitation by that date), (2) the taxpayer or the tax-exempt entity acquired after June 30, 1982, and before May 24, 1983, or (3) the taxpayer or the tax-exempt entity completed construction, reconstruction, or rehabilitation of which after December 31, 1982, and before May 24, 1983, but only if, in any such case, such tax-exempt entity enters into a binding contract to use the property before January 1, 1985. Requirement (1), above, is not satisfied if the tax-exempt entity used the property before May 24, 1983.

(4) Governmental action, etc.

House bill

The provision does not apply in certain cases where there was certain governmental action with respect to the project involved on or before May 23, 1984, specified sums were spent on the project involved on or before that date, and a contract requiring the tax-exempt entity to use the property was entered into before January 1, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with modifications.

The provision does not apply in certain cases where there was governmental action with respect to the property involved on or before November 1, 1983, and a contract requiring the tax-exempt entity to use the property is entered into before January 1, 1985.

In determining whether sufficient governmental action occurred on or before November 1, 1983, the conferees intend that this provision be interpreted in a manner consistent with the similar provision in the House bill. However, in addition to the actions that are described in the report of the Committee on Ways and Means, the following actions constitute significant governmental action: the enactment of a State law authorizing the sale, lease, or construction of the property; the appropriation of funds for the property or authorization of a feasibility study or a development services contract with respect to it; the approval of financing arrangements by a regulatory agency; the enactment of a State law designed to provide funding for a project; or the endorsement of the application for a certification of need with respect to a medical facility by a regulatory agency other than the agency empowered to issue such a certificate.

(5) Certain property

House bill

The provision does not apply to certain mass commuting vehicles, certain boilers and turbines of rural electric cooperatives, and certain sewage or solid waste facilities with respect to which a ruling request was filed on or before May 23, 1983.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

(6) Specified projects

House bill

No provision.

Senate amendment

The Senate amendment specifies certain projects with respect to which the provision is not to apply.

Conference agreement

The conference agreement generally follows the House bill with modifications.

Under the conference agreement, transitional rules are provided for specific projects involving (1) substantial rehabilitations or new construction of buildings where a qualifying action occurred before November 1, 1983, and (2) the rehabilitations of certain educational facilities with respect to which there was substantial reliance on present law.

Under the conference agreement, the provision does not apply to property described in section 168(c)(1)(D) (relating to 15-year real property) if:

(a) the property is leased to a university and houses a basketball arena and university offices, and, on June 16, 1983, the Board of Administrators of the university adopted a resolution approving the rehabilitation of the property in connection with an overall campus development program,

(b) the property is leased to a charitable organization, the organization acquired the property on August 21, 1981, and, on June 12, 1982, an arson fire caused substantial damage to the property, delaying the planned rehabilitation,

(c) the property is leased to a corporation described in section 501(c)(3) (relating to certain organizations exempt from tax), pursuant to a contract that was entered into on August 2, 1983, and under which the corporation first occupied the property on December 22, 1983,

(d) the property is leased to an educational institution and used as an arts and humanities center, an architect was engaged to design a planned renovation in November of 1982, a demolition contract was entered into in December of 1983, and a renovation contract was entered into in March of 1984,

(e) the property was acquired by a college in October of 1981 for use as a dormitory, renovation plans were delayed because of a zoning dispute, and, in May of 1982, the court of highest jurisdiction in the State in which the college is located resolved the zoning dispute in favor of the college,

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(f) the property is a fraternity house; in August of 1982, the related university retained attorneys to advise the university regarding the rehabilitation of the property; on January 21, 1983, the governing body of the university established a committee to develop rehabilitation plans; on January 10, 1984, the governor of the State in which the university is located approved historic district designation for an area that includes the property; and on February 2, 1984, historic preservation certification applications for the property were filed with an historic landmarks commission,

(g) the property is leased to a retirement community with respect to which, on January 5, 1977, a certificate of incorporation was filed, and on November 22, 1983, the board of trustees of the retirement community adopted a resolution evidencing an intention to begin immediate construction of the property,

(h) the property is used by a university, in July of 1982, the board of trustees of the university adopted a master plan for the financing of the property, and, as of August 1, 1983, at least $60,000 in private expenditures had been expended in respect of the project,

(i) the property is leased by a university for use as a fine arts center, and the board of trustees of such university authorized a sale-leaseback agreement with respect to such property on March 7, 1984,

(j) the property is used as an international trade center and, prior to January 1, 1982, an environmental impact study for such property was completed; on June 24, 1981, a developer made a written commitment to provide one-third of the financing for the development of such property; and on October 20, 1983, such developer was approved by the board of directors of the tax-exempt entity,

(k) the property is leased to a university of osteopathic medicine and health sciences and, on or before December 31, 1983, the board of trustees of such university approved the construction of such property,

(l) with respect to the property, there existed on May 23, 1983, architectural plans and specifications (within the meaning of section 48(g)(1)(C)(ii)); the property is leased to a tax-exempt entity after substantial improvements are made; and prior to May 23, 1983, at least ten percent of the total estimated cost of such improvements was paid or incurred, or

(m) the property is used as a convention center and, on June 2, 1983, the city in which the property is located provided for over $6 million for the project.

(7) Express appropriations

House bill

No provision.

Senate amendment

The provision is not to apply to certain property leased to or used by the United States if, among other things, an express appropriation for rentals was made for the 1983 fiscal year before May 23, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

(8) Containers

House bill

No provision.

Senate amendment

Containers and certain related equipment placed in service before 1984, and used by foreign persons or entities before 1984, are exempted from investment credit recapture by reason of use by foreign persons or entities until 1985.

Conference agreement

The conference agreement follows the Senate amendment.

(9) Partnerships

House bill

Certain partnerships organized before October 21, 1983, are exempted, with respect to certain property, from the rules regarding the treatment of property owned or to be acquired by partnerships having taxable and tax-exempt entities as partners.

Senate amendment

The Senate amendment exempts, with respect to certain property, additional partnerships.

Conference agreement

The conference agreement generally follows the Senate amendment but expands the transitional rules applicable with respect to property owned by a partnership. Thus, for example, the provisions do not apply to property placed in service by a partnership before October 21, 1983.

(10) Service contracts for all income tax purposes; thrift institutions; rehabilitation credits

House bill

No special provision.

Senate amendment

The provision's service contract rules, insofar as they relate to persons other than tax-exempt entities, are generally not effective for arrangements entered into before November 5, 1983.

Conference agreement

The conference agreement generally follows the Senate amendment. In addition, the rule regarding thrift institutions is made generally effective with respect to leases entered into after November 5, 1983. A special transitional rule is also provided with respect to the rehabilitation credit.

(11) Certain sewage facilities

House bill

A special transition rule applies to certain sewage facilities.

Senate amendment

No provision.

Conference agreement

The conference agreement includes the House bill provision.

(12) Property used by foreign persons or entities

House bill

No special provision.

Senate amendment

No special provision.

Conference agreement

For property used by foreign persons or entities (other than certain aircraft for which a special rule is provided), the provision does not apply to property that (1) the taxpayer or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate pursuant to a contract that was binding on May 23, 1983 (or has commenced but not completed the activity by that date), (2) the taxpayer or the tax-exempt entity acquired after December 31, 1982, and before May 23, 1983, or (3) construction, reconstruction, or rehabilitation of which was completed after December 31, 1982, and before May 24, 1983, but only if in any such case, such foreign person or entity entered into a binding contract to use the property before January 1, 1984. Requirement (1), above, is not satisfied if the foreign person or entity used the property before May 24, 1983.

Under a special rule for wide-body, four-engine, commercial passenger aircraft, the provisions do not apply to aircraft with respect to which the foreign person or entity entered into a written binding contract to acquire the aircraft on or before November 1, 1983, and which is placed in service prior to January 1, 1986.

2. Treatment of certain motor vehicle operating agreements as leases

Present law

Nominal lease agreements covering motor vehicles often contain terminal rental adjustment clauses. A terminal rental adjustment clause generally permits or requires an upward or downward adjustment in rent to make up for any difference between the value of the vehicle at the end of the lease term as projected when the lease was entered into and its actual value at the end of the lease term.

The Internal Revenue Service has taken the position, and one court has agreed, that the presence of a terminal rental adjustment clause in a nominal motor vehicle lease causes the transaction to be treated as a conditional sale, rather than a lease, for tax purposes. If the transaction is a conditional sale, the nominal lessor is entitled to no depreciation deductions or investment tax credits with respect to the vehicle. Nor is the nominal lessee entitled to any rent deductions.

TEFRA prohibits the IRS from denying, with respect to nominal leases entered into before the issuance of regulations, lease treatment for certain nominal motor vehicle leases merely by reason of the fact that those nominal leases contain terminal rental adjustment clauses. In November, 1982, proposed regulations were issued to the effect that nominal leases of motor vehicles would be treated as conditional sales rather than leases if they contained terminal rental adjustment clauses.

House bill

No provision.

Senate amendment

The presence of a terminal rental adjustment clause in a nominal motor vehicle lease shall not be taken into account in determining whether the transaction is to be characterized as a lease for tax purposes. The provision applies whether the lessee uses the motor vehicle for business or personal purposes. However, the provision does not apply if the nominal lessor finances its ownership of the vehicle with nonrecourse debt.

The provision is effective for agreements entered into before, on, or after the date of enactment.

Conference agreement

Under the conference agreement, a qualified motor vehicle operating agreement containing a terminal rental adjustment clause is treated as a lease if, but for that clause, it would be treated as a lease. The provision applies only to qualified agreements with respect to a motor vehicle (including a trailer). No lessee under a qualified agreement is, under the agreement, to be treated as the tax owner of any property for any period during which such agreement is in effect.

To be a qualified agreement, the nominal lessor must be personally liable for the repayment of all amounts borrowed to finance the acquisition of the motor vehicle involved or must pledge property, other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for all amounts borrowed to finance the acquisition of the motor vehicle involved. In addition, the nominal lessee must certify, in a separate written statement separately signed, under the penalties of perjury, that it intends that

more than 50 percent of the use of the property involved will be in a trade or business of the nominal lessee. That signed certification must also state, clearly and legibly, that the nominal lessee has been advised that it will not be treated as owner of the property for Federal income tax purposes. Furthermore, the nominal lessor must not know that the nominal lessee's certification is inaccurate in any material respect.

The nominal lessor is treated as the tax owner of the property involved under a qualified agreement so long as the agreement, but for the terminal rental adjustment clause, is properly characterized as a lease for tax purposes, regardless of the actual use of the motor vehicle by the nominal lessee. The nominal lessee is not to be treated as the tax owner of the property involved under a qualified agreement even if under the agreement, but for the terminal rental adjustment clause, the nominal lessee would be treated as the tax owner. As a result, the nominal lessee is not entitled to depreciation or interest deductions under the agreement which might be available to it if it were treated as the tax owner of the property. Any rent deductions for the nominal lessee are determined under general Code provisions, including provisions added by the bill.

A special rule is provided for lessee-dealers.

The provision is effective for leases entered into after 90 days after the date of enactment. The TEFRA provision is made inapplicable to agreements entered into 90 days after the date of enactment. The Treasury is not to issue regulations under the TEFRA provision with respect to leases entered into before 90 days after the date of enactment.

No inference is intended that a motor vehicle operating agreement containing a terminal rental adjustment clause is, merely by reason of the presence of that clause, to be treated as a lease for tax purposes. Nor is any inference intended that any nominal lease agreement, involving property other than a motor vehicle, which contains a provision similar to a terminal rental adjustment clause is to be treated as a lease for tax purposes.

C. Treatment of Bonds and Other Debt Instruments

1. Definitions and technical amendments

Present law

Under present law, the retirement of a debt obligation that is issued by a corporation or governmental unit and is a capital asset is treated as a sale or exchange.

Present law also provides rules requiring the annual inclusion and deduction of original issue discount (OID). OID is defined as the difference between the issue price of an obligation and its stated redemption price at maturity. OID is allocated over the term of an obligation through a series of adjustments to the issue price for each "bond period" (defined below). The adjustment to the issue price for each bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the obligation's yield to maturity, and then subtracting the interest payable during the bond period.

Exception for short-term government obligations

An exception to the rule requiring annual inclusion is provided for acquisition discount with respect to government obligations with a maturity of one year or less. Acquisition discount is defined as the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation. Treasury regulations provide a similar exception for OID with respect to obligations other than government obligations.

Definition of "bond period"

Except as otherwise provided by regulations, the accrual period for determining the amount of OID that is allocable to a period is an annual period ending on each anniversary of the date on which the bond was issued. Thus, the yield to maturity of a bond is determined on the basis of annual compounding.

Acquisition premium

When a taxpayer purchases a bond for a price that exceeds the adjusted issue price, the excess (or premium) is allowed as an offset to the remaining OID on a straight-line basis over the remaining term of the bond. Under this rule, the amount of premium allowable as an offset may exceed the OID accrued in some years.

Definition of "purchase"

The term "purchase" is defined to exclude the purchase of a bond the basis of which is determined by reference to the basis of the bond in the hands of the transferor or under section 1014(a) (relating to property acquired from a decedent).

Definition of "issue price"

The issue price of bonds registered with the Securities and Exchange Commission ("SEC") is the initial price to the public at which a substantial amount of the debt instruments were sold.

Stripped bonds

For purposes of the rules that require the annual inclusion of OID, a stripped bond (*i.e.*, a bond issued with interest coupons where there is a separation in ownership between the bond and any unpaid coupon) or a stripped coupon (any coupon related to a stripped bond) is treated as a bond originally issued by a corporation on the purchase date, and as having OID equal to (i) the stated redemption price at maturity or the amount payable on the due date of such coupon, respectively, over (ii) such bond's or coupon's ratable share of the purchase price (determined by reference to their respective fair market values on the purchase date).

House bill

Various technical amendments are made to the OID provisions. In addition, clarifying amendments are made to specific provisions of present law.

Retirement of a debt obligation

The retirement of a debt obligation is treated as a sale or exchange without regard to whether the instrument is a capital asset.

Short-term obligations

The statutory exception from the periodic inclusion rules for government short-term obligations is extended to nongovernment obligations.

Definition of bond period

The accrual period with respect to which OID is computed and compounded is defined as each six-month period determined by reference to the maturity date of the bond and the date six months before such maturity date (or the shorter period from the date of issue). This treatment corresponds to the prevalent method of calculating yield to maturity in the financial community (based on semiannual compounding).

Acquisition premium

Acquisition premium is amortized by reducing the OID that would otherwise accrue by a constant fraction determined at the time of purchase. The numerator of the fraction is the total amount of premium to be amortized and the denominator is the aggregate amount of unaccrued OID at the time of purchase. This rule is intended to prevent situations in which the amortization of the acquisition premium exceeds accrual of OID and to provide better matching between the two.

Definition of purchase

The acquisition of a bond from a decedent is treated as a purchase for purposes of the OID provisions, including the rules applicable to stripped bonds and stripped coupons.

Definition of issue price

The issue price rule applicable to bonds registered with the SEC is extended to all publicly traded issues (other than bonds issued for property). The bill authorizes the issuance of regulations to require the furnishing of the amount of OID, the issue date, and other appropriate information. A penalty of one percent of the issue price is imposed for failures to comply without reasonable cause; the maximum penalty with respect to any one issue of bonds is not to exceed $50,000.

Stripped bonds

Under a technical amendment, a stripped bond or stripped coupon is treated as originally issued on the purchase date; the statutory reference to issuance by a corporation is deleted.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill, with a technical amendment relating to stripped bonds.

Stripped bonds

The provision that creates OID with respect to stripped bonds applies for all purposes of part V of subchapter P of chapter 1 of the Code (relating to special rules for bonds and other debt instruments, as added by the bill).

2. Market discount

Present law

Capital gain treatment is accorded to the appreciation in value attributable to market discount on an obligation issued by a corporation or governmental unit and held for more than one year. In many cases, interest on indebtedness incurred to purchase or carry a market discount bond is deductible currently against ordinary income, even though the income eventually generated by the investment is taxed on a deferred basis at capital gain rates.

House bill

Accrued market discount characterized as ordinary income

The House bill provides that, generally, gain on disposition of a market discount bond is recognized as interest income. The term "market discount bond" is defined to mean any bond having market discount, subject to exceptions for (1) certain short-term bonds with fixed maturities, (2) bonds the interest on which is exempt from tax without regard to the identity of the holder, and (3) U.S. savings bonds. Market discount is defined as the excess of the stated redemption price of a bond over the adjusted basis immediately after its acquisition by the taxpayer. The interest-characterization provision applies to obligations issued after the date of enactment.

Deferral of interest deductions

The House bill limits a taxpayor's ability to take current deductions for interest on indebtedness incurred or continued to purchase or carry a market discount bond. The taxpayer's net direct interest expense is al-

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lowed as a deduction only to the extent that the expense exceeds the amount of market discount allocable to the days during the taxable year on which the taxpayer held the bond. The term "net direct interest expense" is defined as the excess of the interest paid or accrued by the taxpayer over the interest (including OID) included in gross income for the taxable year with respect to a market discount bond. Deferred interest expense is allowed as a deduction for the taxable year in which the taxpayer disposes of the market discount bond. The interest-deferral provision applies to obligations acquired after the date of enactment.

Senate amendment

The Senate amendment includes the same provisions as the House bill, with two modifications.

Accrued market discount characterized as ordinary income

For market discount bonds that are subject to the interest-deferral rule but not the interest-characterization rule (because the bond was issued before the date of enactment but acquired after such date), gain on disposition is recognized as interest income to the extent of the disallowed interest expense that is allowed as a deduction at that time.

Deferral of interest deductions

Under a special rule for financial institutions, the interest-deferral rule is applied by treating a portion of all interest paid or accrued as being attributable to market discount bonds, allocated by reference to the ratio of the basis of market discount bonds to the basis of all assets held by the financial institution.

Conference agreement

The conference agreement follows the Senate amendment with two modifications.

Accrued market discount characterized as ordinary income

Definition of market discount bond.—The conferees intend that regulations to be prescribed by the Secretary will clarify that the term "market discount bond" does not include an obligation that was demand debt when issued.

Deferral of interest deductions

The conferees intend that interest the deduction for which is deferred as interest on indebtedness incurred or continued to purchase or carry market discount bonds will not be taken into account for purposes of computing the disallowance of interest under section 265(2) (relating to interest on indebtedness incurred or continued to purchase or carry tax-exempt securities).

Short sales.—Under the conference agreement, the deduction of short sale expense is deferred where short sales of property are used to generate funds for the purchase of market discount bonds. This rule will apply in the same manner as the new rule that treats short sale expense as interest for purposes of section 265(2).

Election with respect to deferred interest expense.—The conference agreement provides an election under which deferred interest expense with respect to a market discount bond can be deducted in a taxable year prior to the year in which such bond is disposed of in cases where, subsequently, there is net interest income from the bond. If the election is made, any deferred interest expense with respect to a market discount bond is treated as paid or accrued to the extent that interest included in gross income exceeds interest that was actually paid or accrued with respect to the bond for a taxable year. Any deferred interest expense that remains after application of the elective provision is deductible on disposition of the market discount bond. The election is to be made on a bond-by-bond basis.

3. Discount on short-term obligations

Present law

There is a statutory exception to the rule requiring the periodic inclusion of acquisition discount on short-term government obligations payable without interest at a fixed maturity not exceeding one year. A similar exception is provided by Treasury regulations for OID on short-term obligations other than government obligations. In many cases, interest on indebtedness incurred to purchase or carry obligations eligible for an exception can be deducted currently against ordinary income to generate a one-year tax deferral.

House bill

Definition of short-term obligation

The term "short-term obligation" is defined as any bond, debenture, note, certificate, or other evidence of indebtedness that has a fixed maturity date not more than one year from the date of issue.

Mandatory accrual of OID or acquisition discount

Under the House bill, taxpayers are required to accrue OID or acquisition discount currently with respect to short-term obligations that (i) are held by a taxpayer using an accrual method of accounting, (ii) held by a bank, (iii) held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or (iv) identified by the taxpayer as being part of a hedging transaction. This provision is effective for obligations acquired after the date of enactment.

Short-term obligations other than government obligations

Taxpayers who acquire short-term obligations other than government obligations can elect to apply the rules described above to acquisition discount on such obligations rather than OID.

Deferral of interest deductions

The House bill also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry obligations that are not subject to the rule for mandatory accrual. The interest-deferral rule does not apply if the taxpayer elects to accrue discount currently. The provision is effective for obligations acquired after the date of enactment.

Election

The House bill provides an election to accrue acquisition discount or OID currently for all short-term obligations held during the taxable year that includes the date of enactment. If this election is made, the application of the accrual rule is treated as a change in the taxpayer's method of accounting, subject to the rules of section 481 (relating to adjustments required by changes in method of accounting). Adjustments required by section 481 are to be taken into account over a ten-year period.

Senate amendment

The Senate amendment includes the provision in the House bill that limits the ability to take interest deductions on indebtedness attributable to obligations eligible for an exception. The Senate amendment does not, however, include the provision that requires certain taxpayers to accrue discount currently.

Special rule for certain financial institutions

The Senate amendment also contains a special rule for certain financial institutions, under which a portion of all interest paid or incurred is treated as being attributable to the purchase or carrying of obligations eligible for the exceptions; the portion treated under the special rule is determined by reference to the ratio of the basis of short-term obligations eligible for the exceptions to the basis of all assets held by the financial institution.

Election

The Senate amendment provides an election to apply the interest-deferral rule to all short-term obligations held during the taxable year that includes the date of enactment. If this election is made, taxpayers obtain a five-year pay-in period for additional tax liability attributable to income that was deferred from taxable years prior to the year that includes the date of enactment. Interest is charged on any unpaid installments.

Conference agreement

The conference agreement follows the House bill with several modifications.

Definition of short-term obligation

The conference agreement contemplates that a stripped coupon or a stripped bond may be treated as an evidence of indebtedness within the meaning of the definition of short-term obligation. Thus, because a stripped coupon or stripped bond is treated as originally issued on the purchase date, the mandatory accrual and interest-deferral rules will apply to a stripped coupon or stripped bond that is payable not more than one year from the date of purchase.

Mandatory accrual of OID or acquisition discount

The conference agreement expands the scope of the provision requiring current inclusion of OID or acquisition discount to any short-term obligation held by (i) a regulated investment company ("RIC"), (ii) a common trust fund maintained by a bank, (iii) a partnership, S corporation, trust, or other pass-through entity more than 20 percent of the value of which is owned—for 90 days or more of the entity's taxable year—by taxpayers who are subject to the rule for mandatory accrual, and (iv) any pass-through entity that is formed or availed of to avoid the application of the rule for mandatory accrual. If the more-than-20-percent test is satisfied during any 90-day period of a pass-through entity's taxable year, then the rule for mandatory accrual is applied with respect to obligations acquired on or after the first day of the entity's taxable year.

Taxpayers using a hybrid method of accounting.—The conferees intend that the rule for mandatory accrual will apply to short-term obligations held by any taxpayer who uses an accrual method of accounting in combination with any other method of accounting.

Optional accrual for RICs.—Under a provision of the House bill, RICs are permitted to elect to currently accrue discount with respect to short-term government obligations. This election is available for taxable years beginning after December 31, 1978. Because the conference agreement applies the rule for mandatory accrual to all short-term obligations acquired by RICs after the date of enactment, the optional accrual rules will only apply for taxable years beginning after December 31, 1978, and ending prior to the taxable year that includes the effective date of the rule for mandatory accrual.

Deferral of interest deductions

The conferees intend that interest on indebtedness incurred or continued to purchase or carry short-term obligations subject to the interest deferral rule not be taken into account for purposes of comput-

ing the disallowance of interest under section 265(2).

Short-term obligations other than government obligations

The conferees intend that the election to apply the rules described above to acquisition discount rather than OID apply regardless of whether the obligation was acquired after original issue.

Election

The conference agreement provides an election to accrue discount for all short-term obligations held during the taxable year that includes the date of enactment. The election is available only to taxpayers subject to the rule for mandatory accrual of discount on short-term obligations. The conference agreement clarifies that this election is available only with respect to the taxpayer's first taxable year ending after the date of enactment. If the election is made, the application of the accrual rule is treated as a change in the taxpayer's method of accounting. The net adjustments to income required by section 481 are to be made over a five-year period beginning with the year for which the election is made (the "spread period"). The net adjustments will normally be the income that would be included in the taxable year including the date of enactment under cash basis accounting but that is not included under accrual basis accounting.

The amount of the adjustment to be taken into account in the first year of the spread period (the taxable year including the date of enactment) is the sum of (1) one-fifth of the net adjustments, and (2) the excess (if any) of (a) the cash basis income over the accrual basis income over (b) one-fifth of the net adjustments. The term "cash basis income" means the cumulative amount of acquisition discount or OID with respect to short-term obligations that would be includible in gross income for the current taxable year and the preceding taxable years in the spread period if the rule for mandatory accrual were not applicable. "Accrual basis income" is defined as the cumulative amount of acquisition discount or OID includible in gross income for the current taxable year and the preceding taxable years in the spread period under the rule for mandatory accrual. The requirement that the first year income inclusion be no less than the excess of cash basis over accrual basis income prevents the transition rule from producing a tax reduction relative to present law (which would arise where the excess of cash basis income over accrual basis income exceeds one-fifth of the net adjustments). The conferees intend that the 5-year spread be a mitigation of the tax increase provided by the bill, not a tax reduction.

For each year after the first year of the spread period, the amount of the adjustment to be taken into account is the sum of (1) the balance of the net adjustments divided by the number of taxable years remaining in the spread period (including the year for which the determination is being made), and (2) the excess (if any) of (a) the cash basis income over the accrual basis income over (b) one-fifth of the net adjustments, multiplied by five and minus the number of years remaining in the spread period (not including the year for which the determination is being made). In computing the excess of cash basis income over accrual basis income for a year subsequent to the first year of the spread period, such excess is reduced by any amount that gave rise to an income inclusion in excess of the amount of the net adjustment allocable to a prior year of the spread period. This formula is also intended to ensure that the five-year spread does not permit taxpayers to receive a tax reduction relative to present law.

The conferees intend that, in determining the net adjustments required under section 481 to prevent the omission of amounts, the cash basis income (as defined above) is computed as if such income had accrued in the preceding taxable year and, thereby, resulted in an increase in the basis of the related short-term obligations. Absent this treatment, there would be no omission from income to which section 481 could apply.

4. Original issue discount on tax-exempt obligations

Present law

Under Internal Revenue Service rulings, tax-exempt OID is apportioned among the original holder and subsequent holders of an instrument on a straight-line basis over the term of the obligation.

House bill

Tax-exempt OID is accrued in the same manner as that provided for OID on obligations issued by corporations and other juridical entities, under the economic constant interest method.

The provision is effective for obligations issued after September 3, 1982, and acquired after March 1, 1984.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment. In the case of tax-exempt obligations with a maturity of less than one year, interest will be computed in the same manner as for short-term taxable obligations.

D. Corporate Tax Provisions

1. Dividends received deductions for debt-financed portfolio stock

Present law

A corporate shareholder generally can deduct 85 percent of dividends received from other corporations. If the corporate shareholder is financing an investment in stock with borrowed funds, interest on the indebtedness is generally also deductible. Together, these rules permit corporations to deduct amounts paid or incurred to earn tax-favored dividend income.

House bill

The House bill reduces tax benefits with respect to certain dividend-paying stock the ownership of which is financed by debt. Generally, under the House bill, the corporate taxpayer must determine the percentage of the cost of an investment in stock which is financed with borrowed money. The amount of any dividends received deduction with respect to any dividends received on that stock which would otherwise be available is then reduced by that percentage. The rules are intended to determine what portion of the investment is debt-financed and to limit the availability of double deductions accordingly.

Under the House bill, the dividends received deduction is limited to a percentage determined by computing the product of 85 percent, and 100 percent minus the average portfolio indebtedness. Under regulations, the average portfolio indebtedness is the percentage obtained by dividing the average amount of the portfolio indebtedness with respect to the stock by the taxpayer's average adjusted basis in the stock during the base period. A special rule is provided for cases in which the taxpayer does not hold the portfolio stock for the entire base period. Under regulations, any reduction in the amount of the dividends received deduction is not to exceed the amount of any interest deduction (including any deductible short sale expenses) allocable to the dividend involved.

The term "debt-financed portfolio stock" means any stock of a corporation if, (a) as of the beginning of the ex-dividend date for the dividend involved, the taxpayer does not own (1) stock of such corporation possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) at least 50 percent of the total number of shares of all other classes of stock of such corporation, and (b) at some time during the "base period" there is portfolio indebtedness with respect to such stock.

The term "base period" means, with respect to any dividend, the shorter of (1) the period between the ex-dividend date for the dividend involved and the ex-dividend date for the immediately preceding dividend, or (2) the one-year period ending on the day before the ex-dividend date for the dividend in question.

The term "portfolio indebtedness" means indebtedness directly attributable to investment in the portfolio stock. For this purpose, proceeds of any short sale are treated as indebtedness for the period between the short sale and the closing of the short sale.

To illustrate these rules, assume that Corporation A pays a dividend of $1 per share each quarter. The ex-dividend dates are January 15, April 15, July 15, and October 15. On January 16, 1985, Corporation B buys 1,000 shares of Corporation A for a total cost of $100,000. Assume further that Corporation B borrows 60 percent, or $60,000, of the purchase price, that the interest rate on the loan is 14 percent per year, and that the stock is portfolio stock. On April 15, 1985, when the $60,000 debt is still outstanding, Corporation B receives dividends on the stock totalling $1,000. Corporation B then sells the stock on April 16, 1985, for $100,000. Under present law, Corporation B would generally be entitled to a dividends received deduction of 85 percent of $1,000, or $850. Under the House bill, since 60 percent of the cost of the stock was debt-financed, 60 percent of the dividends received deduction is disallowed. As a result, Corporation B is entitled to a dividends received deduction of only 40 percent of $850, or $340. Since interest expense allocable to the dividend is $2,100 ($60,000 times 14 percent times 1/4), the special rule limiting the reduction to the amount of interest expense allocable to the dividend is not applicable.

The provision does not apply with respect to dividends eligible for the 100-percent dividends received deduction (generally determined under section 243(b)), or to dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

The provision generally applies to stock the holding period for which commences after the date of enactment.

Senate amendment

The Senate amendment generally follows the House bill. However, proceeds of a short sale are not treated as indebtedness if no deduction is allowed to the party effecting the short sale for payments in lieu of dividends under section 263(h) (as added by the bill).

The provision generally applies to stock the holding period for which commences after the date of enactment. The conference agreement generally follows the House bill, except as noted below. The rule in the Senate amendment regarding proceeds of a short sale is viewed as no different from the rule in the House bill.

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Conference agreement

The conference agreement generally follows the House bill, except as noted below. The rule in the Senate amendment regarding proceeds of a short sale is viewed as not different from the rule in the House bill.

Portfolio stock

Under the conference agreement, the term "portfolio stock" is redefined. Stock of a corporation is portfolio stock unless specifically excluded. Under the conference agreement, stock of a corporation is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote of such corporation, and (2) having a value equal to at least 50 percent of the value of all the stock (disregarding certain preferred stock) of such corporation.

In addition, stock of a corporation is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, (1) the taxpayer owns stock of such corporation possessing at least 20 percent of the voting power and value of all the stock (disregarding certain preferred stock) of such corporation, and (2) five or fewer corporate shareholders own, directly, stock of such corporation possessing at least 50 percent of the voting power and value of all the stock (disregarding certain preferred stock) of such corporation. This rule exempts certain corporate joint ventures from the provision.

Finally, stock of a bank or a bank holding company is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer (1) owns stock having a value equal to at least 80 percent of the value of all the stock (disregarding certain preferred stock) of the corporation, and (2) holds options to acquire stock possessing at least 50 percent of voting power of all classes of stock of such corporation.

Directly attributable

The reports of the House and Senate committees contain examples, which the conferees endorse, of indebtedness which is treated as directly attributable to investment in stock and of indebtedness which is generally not so treated. However, the conferees wish to clarify that indebtedness of a taxpayer is not directly attributable to portfolio stock held by a corporation all or substantially all of the stock of which is acquired by the taxpayer if the portfolio stock is held by the acquired company in the active conduct of a trade or business. This rule applies only in cases in which the practice of making portfolio stock investments is an integral part of the acquired corporation's trade or business. Thus, for example, if the taxpayer makes a 100 percent debt-financed acquisition of all of the stock of a life insurance company, and such company uses its capital and surplus to make investments in portfolio stock of other corporations, the provision is not to apply because the taxpayer is really acquiring an active business, not portfolio stock. In contrast, however, if the taxpayer makes a debt-financed acquisition of 100 percent of the stock of a mere investment company, the provision is applicable.

Also, the conferees wish to clarify that the provision may be applied where indebtedness is directly attributable to the carrying of portfolio stock as well as where the indebtedness is directly attributable to the acquisition of portfolio stock. Thus, assume that an acquisition of stock is entirely equity-financed. Assume also that the purchaser, at a later date, obtains funds through a borrowing secured by the portfolio stock in a case in which the purchaser could reasonably have been expected to sell the portfolio stock rather than incur the indebtedness. The provision is applicable.

Portfolio indebtedness

The conferees wish to clarify that purchase money indebtedness is treated as portfolio indebtedness for purposes of the provision. Thus, if a corporation buys stock, issuing its own debt obligation to the seller, that obligation is portfolio indebtedness.

The provision operates on the dividends received deduction instead of the interest deduction. However, under the conference agreement, the Treasury is granted authority to issue regulations providing, in lieu of reducing the dividends received deduction, for the disallowance of the interest deduction, or other appropriate treatment, where the obligor is a person other than the person receiving the dividend. The conferees anticipate that these regulations, for example, would apply in a case in which two corporations, A and B, acquire all of the stock of a third corporation, C, with A using debt to acquire 30 percent of the C stock and B using equity funds to acquire the remaining 70 percent. If the money borrowed by A is directly attributable to investment in dividend-paying portfolio stock by C, under such regulations, there would be no reduction in C's dividends received deduction. Rather, interest expense paid or accrued by A on the debt incurred to acquire the C stock would be disallowed, or other appropriate treatment (e.g., the equivalent of a recapture of interest deductions) provided. This result is more appropriate than a reduction in C's dividends received deduction because such a reduction would, in effect, penalize both A and B even though B's investment was not debt-financed.

2. Certain dividends from regulated investment companies

Present law

Domestic corporations are generally entitled to an 85-percent dividends received deduction with respect to dividends from other corporations. No similar deduction is available with respect to their interest income. Individuals are generally entitled to exclude from gross income up to $100 of dividend income. No similar rule applies with respect to their interest income.

Mutual funds, or regulated investment companies ("RICs"), are generally not subject to tax if they distribute their income to their shareholders. That income is generally taxed to the shareholders directly. If less than 75 percent of a RIC's gross income for a taxable year consists of dividends from domestic corporations, then its taxable distributions (other than capital gain distributions) to its shareholders are treated as dividend income in an amount based on the ratio of the RIC's gross income constituting dividend income to all its gross income for the year. However, if 75 percent or more of the RIC's gross income for a taxable year consists of dividends from domestic corporations, then all the RIC's such distributions for the year are treated as dividend income to its shareholders.

For purposes of the foregoing rules, it is not clear whether a dividend received by a RIC is treated as a dividend if the RIC, had it been a regular corporation, would not have been entitled to a dividends received deduction with respect to it. Furthermore, it may be unclear whether a RIC's short-term capital gain income from the sale of stock or securities is treated as gross income for this purpose. See Rev. Rul. 80-345, 1980-2 C.B. 204 (holding that it is to be treated as a part of gross income for this purpose).

House bill

With respect to corporate shareholders of a RIC, 100 percent, rather than 75 percent, of the RIC's gross income must constitute dividend income before all its distributions (other than capital gain distributions) are to be treated as dividend income eligible for the dividends received deduction in the hands of domestic corporate shareholders. Furthermore, for this purpose, no dividend received by a RIC is treated as a dividend unless, had the RIC been a regular corporation, it would have been entitled to a dividends received deduction with respect to it. If less than 100 percent of the RIC's gross income constitutes dividend income, the proration rule of present law applies.

The provision is effective for RIC taxable years beginning after the date of enactment.

Senate amendment

The Senate amendment follows the House bill with certain exceptions. First a 95-percent, rather than a 100-percent, threshold applies. Second, except for the rule requiring that the RIC be entitled to a dividends received deduction, the provision applies for purposes of the dividend exclusion for individuals as well as the dividends received deduction for corporations. Third, the amendment makes it clear that short-term capital gain from the sale of stock or securities is treated as gross income for purposes of the provision. Fourth, if the 95-percent threshold is not met, the amount of the RIC's distributions to be treated as dividends to its corporate shareholders is to be as designated by the RIC. However, the RIC cannot designate as dividends an amount in excess of its aggregate dividends for the taxable year involved which would have been eligible for a dividends received deduction had the RIC been an ordinary corporation.

The provision is effective for RIC taxable years beginning after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment with three exceptions. First, the conference agreement adopts the 100-percent threshold of the House bill for purposes of the dividends-received deduction for corporate shareholders (but accepts the 95-percent threshold of the Senate amendment for purposes of the dividend exclusion for individual shareholders). Second, the conference agreement provides that net short-term capital gains from dispositions of stock or securities in excess of long-term capital losses from dispositions of stock or securities are treated as gross income for purposes of the provision. Third, the basic designation requirement is extended to the dividend exclusion in cases in which less than 95 percent of the RIC's income consists of dividend income. The conferees intend that each share of stock of the RIC outstanding for the entire taxable year (or any portion thereof) have the same designation of income made with respect to it. That is, for example, the RIC cannot designate the same quarterly dividend as being from dividend income for some shareholders and from tax-exempt interest for others.

3. Corporate shareholder's basis in stock reduced by reason of extraordinary dividends

a. Basis

Present law

A corporation owning stock of another corporation generally is allowed a deduction equal to 85 percent of the amount of any distribution received with respect to that stock which qualifies as a dividend. Receipt of the dividend generally has no effect on the shareholder's basis in the stock. Under

section 301(c)(2), if the distribution is not a dividend, the shareholder's basis in the stock generally is reduced by the amount of the distribution. To the extent such amount exceeds the shareholder's basis in the stock, the excess is treated as gain from a sale of the stock. For these purposes, if the distribution is of property rather than cash, the amount of the distribution, in the case of certain corporate shareholders, is the lesser of (1) the property's fair market value, or (2) the property's adjusted basis in the hands of the distributing corporation, increased by any gain recognized to it on the distribution.

House bill

A corporate shareholder's basis in any share of stock which is held for one year or less is reduced by the non-taxed portion of any extraordinary dividend received with respect to that stock. Extraordinary dividends which, in amount, equal or exceed 10 percent (5 percent in the case of a share of stock preferred as to dividends) of the corporate shareholder's basis (determined without regard to the provision) in the share of stock with respect to which the dividend is received. All dividends received with respect to a share of stock which have ex-dividend dates within a period of 85 days are treated as one dividend. Furthermore, all dividends received with respect to a share of stock which have ex-dividend dates within a period of 365 days are treated as extraordinary if their amounts exceed 20 percent of the corporate shareholder's basis (determined without regard to the provision) in such share.

Solely for purposes of the provision, the amount of a dividend is, in the case of a distribution of property other than cash, its net fair market value. The non-taxed portion of the dividend is the amount of the dividend, as so determined, less any portion thereof includible in income which is not offset by a dividends received deduction.

A distribution which, had it qualified as a dividend, would have been treated as an extraordinary dividend, is to be treated as an extraordinary dividend even though the distributing corporation has no earnings and profits (or an amount of earnings and profits that is less than the amount of the distribution). In such a case, the amount of the distribution (as determined under the provision) is reduced by the amount of any reduction in stock basis resulting from the application of section 301(c)(2) of present law.

In determining whether the more than one-year holding period requirement has been satisfied, the general holding period suspension rules applicable to the dividends received deduction, as amended by the House bill, are applicable.

The Treasury is authorized to prescribe regulations applying the provision in the case of stock dividends, stock splits, reorganizations, and other similar transactions.

The provision is effective with respect to distributions after March 1, 1984.

Senate amendment

The Senate amendment follows the House bill except that the Senate amendment applies to distributions after the date of enactment.

Conference agreement

The conference agreement follows the House bill. In addition, the conference agreement clarifies that if the amount of the extraordinary dividend (as determined under the provision) exceeds the corporate shareholder's basis in the stock with respect to which the distribution was made, the excess will be taxed to the corporate shareholder under section 301(c)(3)(A). Furthermore, in determining whether the more than one-year holding period is satisfied, the bill makes provision for tolling the running of the holding period in certain instances. Finally, the conferees wish to make clear their intention that if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed.

b. Suspension of holding period for dividends - received deduction

Present Law

The 85-percent dividends received deduction is disallowed unless the taxpayer satisfies a 16-day holding period with respect to the dividend-paying stock (91 days in the case of dividends on certain preferred stock). The 16-day and 91-day holding periods do not include periods during which the taxpayer reduces or eliminates the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell substantially identical stock or securities.

House bill

The House bill expands the scope of the provision that suspends the holding period of stock to include (1) any period during which the taxpayer is the grantor of an option to buy substantially identical stock or securities, subject to an exception for a qualified covered call (as defined for purposes of the provisions relating to tax straddles and (2) any period during which the taxpayer holds one or more other positions that substantially diminish the risk of loss from holding the stock.

Senate amendment

The Senate amendment generally is the same as the House bill except that (1) in lieu of the "substantial diminution" standard in the House bill, the holding period of stock is suspended during any period when the taxpayer has reduced the risk of loss from holding the stock by reason of holding one or more positions in substantially similar property, prospectively only, as regulations may provide, and (2) an exception is provided for broker dealers with respect to ordinary income or loss property.

Conference agreement

The conference agreement follows the House bill with several modifications.

Substantially similar or related standard

Under the conference agreement, the 85-percent dividends received deduction is disallowed unless the taxpayer satisfies a 46-day holding period requirement. The 46-day holding period does not include any period when the taxpayer reduces the risk of loss by reason of holding one or more other positions in substantially similar or related property. The conference agreement does not provide an exception for broker dealers.

The following transactions are examples of the types of transactions that are within the scope of the rule for substantially similar or related property: (1) a short sale of common stock when the taxpayer holds convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related (the same result would obtain in the case of a short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock, or a short sale of convertible preferred stock while holding common stock); and (2) the acquisition of a short position in a regulated futures contract ("RFC") on a stock index (or the acquisition of an option to sell the RFC or the stock index itself, or the grant of a deep-in-the-money option to buy the RFC or the stock index) while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or, alternatively, while holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index). The conference agreement contemplates that regulations setting forth the application of the rule for substantially similar or related property to the transactions identified above will be generally effective as of the date of enactment of the bill, but that such regulations will be applied to other transactions on a prospective basis. The conferees intend no inference regarding the circumstances under which the dividends received deduction would be disallowed under present law where taxpayers write in-the-money calls with respect to stock they hold. In addition, no inference is intended regarding what situations are covered under the present-law rule applicable to substantially identical stock or securities.

Ordinarily, common stock in one corporation would not be viewed as substantially similar or related to common stock of another corporation. Where stocks of similar companies are involved, however, a short sale of preferred stock of one corporation while holding preferred stock of the other corporation may result in application of the risk reduction rule.

The substantially similar standard is not satisfied merely because the taxpayer (1) holds a single instrument that is designed to insulate the holder from market risks (*e.g.*, adjustable rate preferred stock that is indexed to the Treasury bill rate), or (2) is an investor with diversified holdings and acquires an RFC or option on a stock index to hedge general market risks. The conferees intend that an investment in preferred stock coupled with an option to sell the stock will not be treated as a single instrument, for purposes of applying the substantially similar standard, without regard to whether the option trades separately from the stock.

4. Non-liquidating distributions by corporations of appreciated property

a. Recognition

Present law

A corporation generally does not recognize income on the distribution, with respect to its stock, of appreciated property. There are exceptions to this rule. First, such a distribution will generally trigger recapture income, as under section 1245 (relating to depreciable personal property). Second, the distribution of LIFO inventory generally will generate income in an amount equal to the LIFO reserve with respect to such inventory. Third, if a corporation distributes property which is subject to a liability, or the shareholder assumes a liability in connection with the distribution, gain is generally recognized to the distributing corporation to the extent the liability exceeds the adjusted basis of the distributed property in the hands of the distributing corporation. Fourth, if a corporation distributes property in a redemption to which sections 301 through 307 apply, gain is generally recognized in an amount equal to the excess of the distributed property's value over its adjusted basis in the hands of the distributing corporation. If gain is recognized to a distributing corporation in a redemption distribution, neither the LIFO inventory rule nor the liability rule applies.

However, gain is not always recognized to the distributing corporation with respect to redemption distributions to which sections

301 through 307 apply. For example, gain is not recognized with respect to redemption distributions to certain corporate shareholders. Furthermore, gain is not recognized with respect to redemption distributions to certain noncorporate shareholders if the distribution qualifies as a partial liquidation. Finally, sections 311(d)(2)(C) through (F) provide additional exceptions to the general rule that gain is recognized to the distributing corporation in a redemption distribution.

House bill

Under the House bill, gain (but not loss) is generally recognized to the distributing corporation on any non-liquidating distribution of appreciated property to which sections 301 through 307 apply as if such property had been sold by the corporation for its fair market value rather than distributed. The general rule applies whether or not the distribution qualifies as a dividend.

The general rule also applies whether or not the distribution is a redemption distribution. However, if the distribution is a redemption distribution, the present-law exceptions to gain recognition remain, with two exceptions. First, gain is recognized if the distribution in redemption is to a corporate shareholder unless such shareholder owns, at the time of the distribution, stock possessing at least 80 percent of the total combined voting power and at least 80 percent of the total number of all other classes of stock (disregarding certain preferred stock) of the distributing corporation. However, the corporate shareholder is not to be treated as an 80-percent or more shareholder for this purpose unless its basis in the distributed property is determined with reference to the property's adjusted basis in such property under section 301(d)(2). Second, gain is not recognized if the distribution (1) qualifies as a partial liquidation under section 302(b)(4) and is made to certain noncorporate shareholders, or (2) is a qualified dividend (described below).

If the distribution is not a redemption distribution, gain is recognized in full unless (1) the distribution is to an 80-percent or more corporate shareholder (as determined above), or (2) section 311(d)(2)(C) of present law (relating to certain distributions of stock or obligations of certain controlled corporations) applies.

In the case of a distribution which is not a redemption distribution, gain is not recognized to the distributing corporation with respect to property distributed to certain noncorporate shareholders to the extent the distribution is a qualified dividend. A qualified dividend is a distribution of property which is (1) a dividend, (2) of property used by the distributing corporation immediately before the distribution in the active conduct of a trade or business, and (3) not property described in section 1221(1) (relating to inventory and certain order property) or section 1221(4) (relating to certain accounts and notes receivable). Furthermore, the distribution must be with respect to qualified stock, as defined in section 311(e).

The rules relating to LIFO inventory and liabilities in excess of basis are to be applied before any of the other recognition provisions.

The provision is effective with respect to distributions declared after the date of enactment. A transitional rule is provided for distributions before February 1, 1986, by certain corporations of royalty trust property with respect to which a royalty trust proposal was submitted by certain groups.

Senate amendment

The Senate amendment generally is the same as the House bill. However, it is effective with respect to distributions declared after March 15, 1984. The provision does not apply to any distributions before February 1, 1986, by corporations referred to in the transitional rule under the House bill. Nor does it apply to certain distributions of partnership interests traded on a national securities exchange on March 7, 1984, by certain corporations owning more than 80 percent of such interests on March 7, 1984. Finally, it does not apply to certain distributions declared before the date of enactment of not more than 51 percent of the stock of corporations controlled by certain corporations pursuant to proposals considered before February 15, 1982.

Conference agreement

The conference agreement follows the Senate amendment with some exceptions.

Eighty-percent corporate shareholders

Under the conference agreement, the rule exempting the distributing corporation with respect to distributions to 80-percent corporate shareholders that take a basis in the distributed property determined under section 301(d)(2) is eliminated. Thus, an ordinary, non-liquidating distribution of appreciated property by a 100-percent subsidiary to its corporate parent is a taxable event to the distributing corporation. Generally, the corporate parent takes a fair market value basis in the distributed property (sec. 301(d)(2)).

Under present law, such a distribution would generally not be taxable to the distributing corporation, and the corporate parent would inherit the distributing corporation's adjusted basis in (and holding period for) the property. As a result, when the parent sells the property, gain "accruing" during the period of time the property was held by the subsidiary would be taxed to the parent, rather than the subsidiary, and the character of that gain (as capital or ordinary) would likely be determined with reference to the character of the property in the parent's, rather than the subsidiary's hands. In general, the conferees think that such a shifting of tax liability is inappropriate in the case of ordinary, non-liquidating distributions. Furthermore, the conferees do not believe that such a distribution should permit corporate taxpayers to be able to change the character of the income involved, as present law may permit. Furthermore, the theory of section 311 and the provision is that the distribution of appreciated property to a shareholder is a realization event and, therefore, an appropriate time to impose tax liability. The conferees are not persuaded that a different rule is appropriate merely because the shareholder may be an 80-percent corporate shareholder. If the two corporations are not filing a consolidated return, they should be treated as separate taxpayers, just as they are when one sells property to, or performs services for, the other. The conferees are also aware of cases under present law in which an acquiring corporation can sell, indirectly, built-in-loss assets of an acquired corporation and recognize the loss while selling, indirectly, built-in-gain assets of the acquired corporation without having to take any of that gain into income. Finally, the conferees are aware of transactions in which one corporation buys all the stock of another, has the acquired corporation distribute appreciated property to it, and then sells the stock and recognizes a tax loss. The conference agreement addresses these concerns.

The conferees anticipate that the Treasury will promptly consider what changes, if any, are necessary or appropriate under the consolidated return regulations by reason of this rule.

Effective dates

Under the conference agreement, the provision is generally effective for distributions declared on or after June 14, 1984. However, the rule applying the provision with respect to a distribution to an 80-percent corporate shareholder that takes a basis in the distributed property determined under section 301(d)(2) generally applies only to distributions after December 31, 1984. In addition, the rule applying the provision to such an 80-percent corporate shareholder does not apply to certain distributions before September 1, 1986. The September 1, 1986, rule applies only in the case of distributions by a corporation (or by any member of a group of corporations, of which such corporation was the common parent, which files a consolidated return for the period which includes June 14, 1986) (1) control of which, as defined in sec. 368(c), is acquired other than in a tax-free reorganization after January 1, 1984, but before January 1, 1985, and (2) a tender offer for the shares of which was commenced on May 23, 1984, and amended on May 24, 1984. Furthermore, the September 1, 1986, rule applies only if the distributing corporation and the distributee corporation are members of the same group filing consolidated returns for the period which includes the date of the distribution. Finally, the September 1, 1986, rule applies only if the distributed property consists of stock of a corporation which on June 14, 1984, was a member of the affiliated group of which the corporation referred to in (1) above was the common parent.

Under the conference agreement, if the distributing corporation and the distributee corporate shareholder are part of the same affiliated group of corporations filing a consolidated return for the period which includes the date of distribution, the aggregation rules of Treas. reg. section 1.1502-34 are applicable in determining whether the 80-percent corporate shareholder exception applies.

The conferees intend that in the case of a redemption distribution to a corporate shareholder, that shareholder is not to be treated as an 80-percent corporate shareholder unless it is an 80-percent corporate shareholder after the distribution, as well as before (applying the rule of Treas. reg. sec. 1.1502-34).

The conference agreement also retains two of the three transitional rules contained in the Senate amendment.

b. Holding period for property distributed by one corporation to another

Present law

Section 301(d)(2) provides rules to determine the basis in the hands of certain corporate shareholders of property distributed to them by a distributing corporation with respect to their stock. That basis is the lesser of (1) the distributed property's fair market value, under section 301(d)(2)(A), or (2) the distributed property's adjusted basis in the hands of the distributing corporation, increased by any gain recognized to the distributing corporation on the distribution, under section 301(d)(2)(B). If section 301(d)(2)(B) applies, then, under section 1223(2), the corporate shareholder's holding period for the property includes the period during which it was held by the distributing corporation. If section 301(d)(2)(A) applies, the corporate shareholder's holding period in the distributed property begins on the date of the distribution.

Under section 1248(f)(1), if certain domestic corporations distribute the stock of certain foreign corporations in a transaction to which section 311 applies, the distributing corporation will have included in its gross

income as a dividend an amount equal to certain earnings and profits of the foreign corporation. Under section 1248(f)(2), the rule of section 1248(f)(1) does not apply if, among other things, the distribution is to a domestic corporate shareholder which includes in its holding period for the distributed stock the period such stock was held by the distributing corporation.

House bill

If section 301(d)(2)(B) applies, the House bill provides that the corporate shareholder's holding period for the distributed property begins not earlier than the date the stock with respect to which the distribution was made was acquired.

The provision applies to distributions declared after the date of enactment.

Senate amendment

The Senate amendment generally is the same as the provision in the House bill except that the Senate amendment applies to distributions after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the conference agreement explicitly clarifies that if the distributing corporation recognizes gain on the distribution under section 311, as amended by the bill, the corporate shareholder's basis in the distributed property is determined under section 301(d)(2)(A) (and not section 301(d)(2)(B)) so that its holding period in the property begins on the date of the distribution. The conferees are aware that under this rule after section 311, as amended by the bill, becomes fully effective, a corporate shareholder's holding period for property distributed to it by another corporation will generally begin on the date of the distribution.

Under the conference agreement, the provision does not apply for purposes of section 1248(f)(2). However, the amendments to section 311 do apply. Thus, the distribution of appreciated stock of a foreign corporation by one domestic corporation to another may trigger gain recognition (some of which may be dividend income under section 1248(a)) to the distributing corporation. On the other hand, the distribution may not trigger gain recognition to the distributing corporation if the distributee shareholder is an 80-percent corporate shareholder and if the distribution occurs before January 1, 1985. If gain recognition is not triggered, and if the conditions of section 1248(f)(2)(B) are satisfied, then section 1248(f)(1) does not apply, and the distributing corporation has no dividend income by reason of the distribution. The conferees are aware that after section 311, as amended by the bill, becomes fully effective, such a distribution will trigger gain recognition (and dividend income under section 1248(a)) to the distributing corporation.

5. Capital gains distributions from regulated investment companies and real estate investment trusts

Present law

Generally, regulated investment companies ("RICs") that distribute their income are not subject to tax. Rather, that income is taxed directly to their shareholders.

RICs frequently realize long-term capital gain income. That income is generally treated as long-term capital gain to the shareholders. If the stock with respect to which a long-term capital gain distribution is made (or treated as having been made) is held by a shareholder for less than 31 days, any loss on the sale or exchange of that stock is treated as a long-term capital loss to the extent of any long-term capital gain distribution by the RIC with respect to such stock.

Similar rules apply with respect to real estate investment trusts ("REITs").

House bill

If stock with respect to which a long-term capital gain distribution is made by a RIC or a REIT is held by a shareholder for 6 months or less, any loss on the sale or exchange of the stock is treated as a long-term capital loss to the extent of the long-term capital gain distribution. An exception is provided for dispositions of stock pursuant to a periodic redemption plan.

The provision is applicable to losses incurred on stock acquired after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment. In determining whether stock has been held for 6 months or less, the bill amends provisions tolling the running of the holding period in certain instances.

6. Certain expenses incurred in connection with short sales

Present law

Treatment of short sales of stock

In a "short sale", the taxpayer sells borrowed property (such as stock or securities) and later closes the short sale by returning identical property to the lender. Gain or loss on the closing of a short sale is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer. Where the property sold short is stock, and a dividend is distributed with respect to the stock, the taxpayer is required to pay an amount equal to the value of the distribution to the lender of the stock. The Internal Revenue Service has ruled that this payment in lieu of a dividend is deductible currently against ordinary income.

When a dividend is paid with respect to stock, the stock can be expected to decline in value by an amount that approximates the value of the dividend distribution. Taxpayers can effectively convert ordinary income to capital gain by entering into a short sale of stock just before the ex-dividend date, deducting the dividend-substitute payment against ordinary income, and realizing an offsetting capital gain upon closing the short sale.

When a taxpayer borrows property for use in a short sale, the taxpayer may receive a rebate fee—taxable as ordinary income—with respect to short sale proceeds deposited with the lender as collateral. This rebate fee compensates the taxpayer for the lender's use of the short sale proceeds during the period before the short sale is closed and property is returned.

Investment interest limitation

Section 163(d) limits deductions for interest by an individual or other noncorporate taxpayer on indebtedness to purchase or carry an investment. The deduction for investment interest is limited to the taxpayer's net investment income plus $10,000. Disallowed interest deductions are carried over and may be allowed in future years.

Interest related to tax-exempt income

In general, section 265(2) provides that no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations.

In the case of a securities dealer who borrows money for the purpose of conducting a business that includes the holding of tax-exempt obligations, but whose borrowings cannot be traced to the purchase or continued holding of such obligations, section 265(2) is applied on the basis of an allocation. (See Rev. Proc. 72-18, 1971-1 C.B. 1; and *Leslie v. Commissioner*, 413 F.2d 636 (2d Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970).) The amount of interest allocated to tax-exempt obligations is determined by multiplying the taxpayer's total interest expense by a fraction, the numerator of which is the average adjusted basis of the tax-exempt obligations held during the taxable year and the denominator of which is the average adjusted basis of the total assets held during the year. Interest on debt that is traceable entirely to tax-exempt obligations and interest which is not subject to disallowance under section 265(2) is excluded from this computation. The Internal Revenue Service has ruled that section 265(2) does not apply to disallow interest deductions with respect to indebtedness that is collateralized by tax-exempt securities held for the accounts of customers, and that the securities dealer is required to segregate pursuant to rules promulgated under the Securities and Exchange Act of 1934. Rev. Rul. 74-294, 1974-1 C.B. 71.

House bill

Treatment of short sales of stock

Payments in lieu of dividends are not deductible unless the short sale is held open for at least 16 days (more than one year in the case of payments in lieu of extraordinary dividends). The amount disallowed as a deduction is required to be capitalized (i.e., added to the basis of the stock used to close the short sale).

In determining whether the short sale is held open for the required 16-day (or more-than-one-year) holding period, there is not to be included any period during which the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities, or there is otherwise a substantial diminution of the taxpayer's risk of loss from the short sale by reason of holding one or more other positions.

Investment interest

For purposes of the restriction on the deductibility of investment interest, the definition of interest is expanded to include any amount allowable as a deduction in connection with personal property used in a short sale.

Interest related to tax-exempt income

For purposes of the provision that disallows interest deductions related to tax-exempt income, the definition of interest is expanded to include any amount paid or incurred in connection with personal property used in a short sale.

The provisions of the House bill are effective for short sales entered into after the date of enactment.

Senate amendment

Treatment of short sales of stock

The Senate amendment is similar to the House bill. In applying the risk reduction rule for purposes of determining whether a short sale is held open for the required period, under regulations, there is not to be included any period during which the taxpayer diminishes the risk of loss from the short sale by reason of holding one or more other positions with respect to substantially similar property.

In addition, except with respect to extraordinary dividends, the Senate amendment permits the deduction of dividend-substitute payments to the extent of ordinary income that is received from the person providing the stock used in the short sale as

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

compensation for the use of collateral. Earnings on the collateral establish an appropriate measure of the portion of the dividend-substitute payment that represents a current charge for the use of the property sold short, as distinguished from dividends that had accrued economically prior to the short sale.

Interest related to tax-exempt income

The Senate amendment also includes additional rules for the application of the provision extending the rule that disallows interest deductions related to tax-exempt income. First, section 265(2) does not apply to disallow a deduction for short sale expenses incurred by a taxpayer who acts as a conduit in a short sale transaction executed in a customer's account.

Second, the Senate amendment makes clear that section 265(2) applies to amounts paid by the person providing the personal property used in a short sale as compensation for use of collateral with respect to the property (*e.g.*, a rebate fee).

Third, in applying section 265(2) to a taxpayer whose business includes buying and selling tax-exempt obligations, short sale expenses (and the short sale proceeds) are treated separately, in a manner analogous to the treatment accorded broker loans collateralized with customer securities under present law (the situation covered by Rev. Rul. 74-294, 1974-1 C.B. 71), unless the short sale proceeds can be directly traced to the purchase or carrying of tax-exempt obligations. Thus, section 265(2) would not apply to disallow a deduction for short sale expenses incurred in a transaction in which the short seller did not receive the short sale proceeds (*e.g.*, because the funds were deposited as collateral).

Conference agreement

The conference agreement follows the House bill with several modifications.

Treatment of short sales of stock

Under the conference agreement, payments in lieu of dividends are not deductible unless the short sale is held open for at least 46 days (more than one year in the case of payments in lieu of extraordinary dividends). In applying the risk reduction rule for purposes of determining whether a short sale is held open for the required period, under regulations, there is not to be included any period during which the taxpayer diminishes the risk of loss from the short sale by reason of holding one or more other positions with respect to "substantially similar or related property" (as that term is defined for purposes of the holding period requirements for the dividends-received deduction).

The conference agreement clarifies that, in the case of any short sale, the provision relating to short sale expenses applies before section 263(g) (relating to interest and carrying costs in the case of straddles).

Interest related to tax-exempt income

The conference agreement does not include the provision of the Senate amendment relating to brokers who act as conduits in short sales executed for customers. This result occurs under present law without a statutory provision. Thus, the conference agreement contemplates that the provision expanding the scope of section 265(2) to apply to short sale expense will not apply to a broker who acts as a conduit. The conference agreement does not provide for the separate treatment of short sale expenses and short sale proceeds. Under the conference agreement, section 265(2) will not apply to disallow a deduction for short sale expense if the taxpayer (1) deposits cash as collateral for the property used in the short sale, and (2) does not earn a material return on the cash so deposited.

7. Nonrecognition of gain or loss by corporations on options with respect to their stock (warrants)

Present law

Corporations frequently issue for a consideration options to third parties to acquire from it shares of its own stock (warrants). Sometimes those warrants expire unexercised, or lapse. On other occasions, they may be repurchased by the issuing corporation for more or less than they were originally issued for. The tax consequences to the issuing corporation of a lapse of warrants or of a repurchase of warrants it has issued is unclear.

House bill

Under the House bill, a corporation does not recognize gain or loss on any lapse or repurchase of a warrant it issued to acquire from it shares of its own stock.

The provision applies to warrants repurchased or lapsing after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

8. Accumulated earnings tax

Present law

An accumulated earnings tax is imposed on corporations that are formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits of the corporation to accumulate instead of being distributed. Where applicable, the tax is imposed at a rate of 27½ percent of the first $100,000 of accumulated taxable income for the taxable year and at a rate of 38½ percent on accumulated taxable income in excess of $100,000.

The term "accumulated taxable income" means taxable income, with certain adjustments, reduced by a deduction for dividends paid. In determining accumulated taxable income, a corporation is permitted a deduction for net capital losses during the year in question. A corporation is also permitted a deduction for net capital gains during the year, determined without regard to capital loss carryovers or carrybacks, less certain taxes.

The Internal Revenue Service takes the position that the accumulated earnings tax can be imposed on widely-held corporations, even one not controlled by a few shareholders or groups of shareholders. The issue has not been resolved definitely by the courts.

House bill

Under the House bill, the mere fact that a corporation is widely held does not exempt it from the accumulated earnings tax. This rule applies to operating companies, as well as mere holding or investment companies, regardless of how concentrated the ownership of their stock may be.

Changes are also made in the determination of accumulated taxable income. In general, the deduction from accumulated taxable income for net capital gains, less certain taxes, remains. However, in determining net capital gains for this purpose, net capital losses for any taxable year are treated as short-term capital losses during the next taxable year. The deduction for net capital losses also generally remains. However, that deduction is reduced by any deduction from accumulated taxable income for net capital gains, less certain taxes, for preceding years beginning after the date of enactment. No such net capital gains, less certain taxes, are to be used to reduce the deduction for net capital losses more than once.

Certain different rules apply to mere holding or investment companies. For example, they are allowed no deduction from accumulated taxable income for net capital losses. On the other hand, net capital losses are not to be treated as a carryover in determining accumulated taxable income.

The provision applies to all taxable years beginning after the date of enactment.

Senate amendment

The Senate amendment is the same as House bill.

Conference agreement

The conference agreement generally follows the House bill and the Senate amendment.

The conferees agree with the statement in the Senate committee report to the effect that while a section 531 tax avoidance purpose may be inferred in an appropriate case, as a practical matter it may be difficult to establish such a purpose in the case of a widely-held operating company when no individual or small group of individuals has legal or effective control of the company.

The conference agreement clarifies that, in the case of corporations other than mere holding or investment companies, net capital loss carryovers are to be used only once in determining accumulated taxable income. In addition, mere holding or investment companies are allowed a deduction from accumulated taxable income for net short-term capital gains, but only to the extent of any previously unused capital loss carryovers to the year in question.

9. Repeal of stock for debt exception for purposes of determining income from discharge of indebtedness

Present law

Generally, income from discharge of indebtedness is realized when the taxpayer's debts are satisfied at less than their face amount (sec. 61(a)(12)). However, cases have held that a corporation does not realize income from discharge of indebtedness when its debts are satisfied with its own stock, notwithstanding that the value of the stock is less than the amount of the debt. This stock-for-debt rule is subject to two statutory exceptions (sec. 108(e)(8)).

House bill

The House bill provides that a debtor corporation realizes income from discharge of indebtedness when it satisfies its debt with stock having a fair market value less than the principal of the debt. This rule applies where the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt. It does not apply where payments are simply deferred. (Section 1032 does not prevent the recognition of this income from the discharge of indebtedness.)

The repeal of the stock-for-debt exception does not apply if the discharge occurs pursuant to a title 11 (bankruptcy) case or to the extent the debtor is insolvent; in these cases, present law continues to apply.

The provision applies to transfers after date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement generally follows the House bill, but provides transitional rule exceptions to the general effective date (transfers after the date of enactment) and also makes the provision inapplicable (as of January 1, 1986) to certain "workouts".

Under the first transitional rule, the provision in the bill will not apply to any transfer pursuant to a written binding contract or option (including a convertible debenture) which was in effect at all times on the day of June 7, 1984, and which remains in effect at all times thereafter. Thus, the provision applies to transfers pursuant to contracts or options entered into on or after June 7, 1984, since in such a case, the contract or option will not have been in effect at all times on June 7, 1984. This exception will apply only if the holder of the debt on June 7, 1984, also was the party to the contract or held the option on that date. A transfer pursuant to a written contract must be completed before January 1, 1985. The conversion of debt pursuant to an option or conversion right outstanding at all times on June 7, 1984, and thereafter will be covered by the transitional rule regardless of whether conversion is after 1984. Under the second transitional rule, the provision in the bill will not apply to a transfer of stock before January 1, 1985, to a corporation which owned at least 75 percent of the stock of the debtor corporation on June 7, 1984, and which owns more than 80 percent of the stock of that corporation after the transfer. Finally, a transfer before January 1, 1985, pursuant to a debt restructuring agreement entered into in November, 1983, for which a registration statement was filed with the Securities and Exchange Commission in March, 1984, will not be subject to these new rules.

A stock-for-debt transaction does not give rise to debt discharge income under the "workout" exception if (1) the transfer of stock is made (pursuant to a plan) because of cash flow and credit problems which will cause the debtor corporation difficulty in meeting its liabilities during the next 12 months to such an extent that there is a substantial threat of an involuntary bankruptcy or insolvency proceeding, (2) the corporation notifies its stockholders of this financial difficulty and that it is engaged in a workout, (3) at least 25 percent of the total debt of the corporation is extinguished by transfers of stock pursuant to the plan, and (4) holders of more than 50 percent of the total indebtedness of the debtor corporation outstanding on the date of transfer approve the plan. The workout definition will be satisfied only if it is reasonably related to the objective of avoiding a likely insolvency or bankruptcy proceeding.

The "workout" exception will become effective on the date on which the amendments made to section 382 by the Tax Reform Act of 1976 become effective. Under the bill, this will occur on January 1, 1986. This delayed effective date is adopted to allow the Congress to consider the appropriate treatment of stock-for-debt exchanges in the case of financially troubled corporations while the Congress is reexamining generally the treatment of net operating loss limitations. A stock-for-debt exchange in the case of a financially troubled corporation is a change of ownership event which the Congress may decide is an appropriate occasion for the reduction of net operating losses either under rules of a revised section 382 or by reason of the creation of income from the discharge of indebtedness. It is anticipated that any reconsideration of the exceptions to stock-for-debt rules will include consideration of the rules relating to the use of preferred or limited stock, stock of a parent corporation, and stock of a party to a reorganization, and related technical issues.

10. Affiliated groups

Present law

Includible corporations which are members of an affiliated group of corporations are generally entitled (or required) to file consolidated Federal income tax returns. Section 1504(b) defines the term "includible corporation" to mean any corporation, with several exceptions (e.g., exempt organizations, certain insurance companies, foreign corporations, and regulated investment companies). Certain other tax consequences also depend on whether two corporations are members of the same affiliated group (e.g., the 100-percent dividends received deduction under sec. 243(b)).

Under section 1504, an affiliated group means one or more chains of includible corporations connected through stock ownership with a common parent which is an includible corporation if (1) stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each includible corporation (except the common parent) is owned directly by one or more other includible corporation, and (2) the common parent owns directly at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations. For purposes of the definition, nonvoting stock which is limited and preferred as to dividends is disregarded, as is certain stock held under tax credit employee stock ownership plans or employee stock ownership plans.

Once the above stock ownership requirements cease to be met with respect to any one corporation, it can no longer be included in the consolidated return of its former affiliated group. However, there are generally no restrictions on its rejoining that group or joining any other group.

House bill

Under the House bill, two includible corporations are not eligible to begin filing a consolidated return with respect to any taxable year unless at the beginning of that year one owns stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of the fair market value of all outstanding stock of the other. For purposes of this definition, certain preferred stock is ignored, as is stock held under certain employee stock ownership plans. A similar rule applies in determining whether another corporation may begin being included in the consolidated return of that group.

Once two corporations are properly included in a valid consolidated return, they will continue being an affiliated group for consolidated return purposes unless one ceases to own stock, determined as above, (1) possessing at least 80 percent of the voting power of all classes of stock, or (2) having more than 50 percent of the fair market value of all outstanding stock, of the other. A similar rule applies in determining whether any other corporation continues to be a member of that group. Once a corporation has ceased being a member of an affiliated group filing consolidated returns, restrictions are imposed on its ability to reconsolidate with that group or to consolidate with certain other groups.

The Treasury is granted broad regulatory authority to carry out the purposes of the provision to prevent abuses.

The provision is effective for taxable years beginning after December 31, 1984. A permanent transition rule is provided for corporations which are members of an affiliated group under present law on March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill. However, stock held under tax credit employee stock ownership plans or other employee stock ownership plans is not ignored. In addition, the Treasury, by regulations, is authorized to provide relief in appropriate cases from the rule requiring ownership by one corporation of at least 80 percent of the fair market value of all outstanding stock of another corporation before the two may commence filing a consolidated return. The Senate amendment also clarifies the rule regarding consolidation or reconsolidation after deconsolidation.

The provision is effective for taxable years beginning after December 31, 1984. However, for taxable years beginning before January 1, 1988, the provision is not applicable to corporations filing a valid consolidated return under present law for the taxable year which includes April 11, 1984.

Conference agreement

The conference agreement follows the Senate provision with several exceptions.

All income tax purposes

Under the conference agreement, the definition of affiliated group is to be applied in determining whether an affiliated group exists for all purposes of subtitle A. The conferees see no reason to have a unique definition of affiliated group for consolidated return purposes. Under the definition, one corporation is not part of an affiliated group with another corporation unless one owns stock (1) possessing at least 80 percent of the total combined voting power, and (2) having a value equal to at least 80 percent of the total fair market value of the stock (disregarding certain preferred stock) of the other. Similar rules apply in determining whether any other corporation is also a member of the group.

No inference regarding present law is intended.

Continuation of status

The conference agreement drops the provision in the House bill and the Senate amendment to the effect that once a consolidated return is validly filed by two corporations, affiliated group status is to be treated as continuing so long as one corporation owns stock (1) possessing at least 80 percent of the total voting power, and (2) having a value equal to more than 50 percent of the total fair market value of the stock (disregarding certain preferred stock) of the other. The conferees believe that such a rule would permit the common parent to dispose of too much of the value of the stock of the other without requiring deconsolidation. As a result, the conference agreement generally treats affiliated group status as continuing only if one corporation continues to own 80 percent of the total voting power and 80 percent of the value of the other. However, nothing in the bill is intended to overturn the position set forth in Rev. Rul. 78-119, 1978-1 C.B. 277 (holding that a corporation which has been a member of a group filing consolidated returns is not deconsolidated merely because its parent has temporarily lost its power to vote such corporation's stock by virtue of a court order issued during the pendency of litigation).

The conferees are also aware that, absent a special rule, the provision would cause affiliated group status to terminate if, merely by reason of changes in relative values of different classes of stock of a corporation, one corporation ceased to own 80 percent in value of the stock of the other corporation. Where the changes in relative value are not large and not intentionally generated, the conferees believe disaffiliation to be inappropriate. Accordingly, under the conference agreement, the Treasury is authorized to prescribe regulations pursuant to which

inadvertent changes in relative values of different classes of stock are to be disregarded in determining whether affiliated group status continues.

Preferred stock

The conference agreement also specifies the kind of stock to be ignored in testing for affiliated group status and the continuation thereof. The stock to be ignored is stock which (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's paid-in capital or par value (except for a reasonable redemption premium), and (4) is not convertible into any other class of stock. Thus, for example, preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored.

Consolidation after deconsolidation

The conference agreement amends the rules of the Senate amendment regarding consolidation after deconsolidation. In general, if a corporation is included in a consolidated return filed by an affiliated group for a taxable year which includes any period after December 31, 1984, and such corporation ceases under the bill to be a member of such group for a taxable year beginning after December 31, 1984, then such corporation (and any successor) may not be included in any consolidated return filed by that group or any other group having the same common parent (or a successor) before the 61st month after the cessation.

The Treasury is authorized to waive the rule prohibiting consolidation after deconsolidation for any period subject to such conditions as the Treasury may prescribe. The rule is an anti-abuse rule, and the conferees expect the Treasury to so apply it. For example, assume that operating corporation A owns all the stock of operating corporation X and that the two file a consolidated return. On July 1, 1986, A merges into unrelated operating corporation B in a transaction qualifying under section 368(a)(1)(A). Assume that the transaction is not a reverse acquisition. Absent other factors, X should be able to join in filing a consolidated return with the group of which B is the common parent for the period beginning July 1, 1986, and regulations should so provide.

Regulations

Regulatory authority is granted to the Treasury to disregard transfers of stock within an affiliated group in determining whether affiliated group status is broken. For example, assume that corporation A owns 100 percent of the only class of stock of corporation B, and corporation B owns 100 percent of the only class of stock of corporation C. It is contemplated that a transfer by A of 30 percent of the stock of B to C will not break the status of A, B, and C as an affiliated group. Furthermore, the authority of the Treasury to prescribe regulations permitting affiliated group status to be treated as commencing or continuing if there was reliance on a good faith but erroneous determination of value is clarified.

The conference agreement contains rules similar to those in the House bill and the Senate amendment authorizing the Treasury to prescribe anti-abuse regulations to carry out the purposes of the provision. For example, the Treasury is authorized to prescribe regulations pursuant to which warrants to acquire stock are to be treated as stock and options to acquire stock are to be treated as having been exercised. Thus, assume that corporation A's common stock is worth $40 a share. Assume further that corporation B, the owner of all of A's common stock, grants corporation C an option to acquire that stock for $20 a share at a date beginning 3 years from the date of the grant. The facts indicate that A and C are likely to be loss corporations but that B is profitable. If it can reasonably be expected that C will exercise the option, the regulations may treat the option as having been exercised, for purposes of the new provision.

The Treasury is also authorized to prescribe regulations under which obligations convertible into stock (and similar interests) are treated as stock and stock (like "puttable" stock) is not treated as stock. Finally, the Treasury, by regulations is authorized to disregard changes in voting power to the extent such changes are disproportionate to related changes in value.

Effective date

Except as noted below, the provision is effective for taxable years beginning after December 31, 1984. The provision does not apply to a corporation validly included in a consolidated return of an affiliated group under present law for the taxable year which includes June 22, 1984, until the taxable year beginning after December 31, 1987. However, if (1) at any time after June 22, 1984, more than a de minimis amount of stock of any such corporation is sold or exchanged (including by redemption), or such corporation issues more than a de minimis amount of stock other than in the ordinary course of its business, and (2) thereafter the bill's provision as to ownership of stock of such corporation is not satisfied (even though before December 31, 1984), then the provision will apply to such corporation for its taxable year beginning after December 31, 1984, or if later, the date such stock is sold, exchanged, or issued, as the case may be. For purposes of this rule, generally stock issued to employee stock ownership plans, stock issued upon the exercise of employee stock options, and similar issuances of stock are to be treated as issuance in the ordinary course of the corporation's business.

For example, assume that Corporation B has only 300 shares of class A common stock and 100 shares of class B common stock outstanding. Shares of each class are identical except that each share of class A common stock has three votes whereas each share of class B common stock has one vote. Corporation A owns all the class A common stock, which represents 90 percent of the voting stock and 75 percent of the value of all the stock of Corporation B, at all times during 1984. A and B file a valid consolidated return for calendar year 1984. On June 30, 1985, A sells 20 shares of the class A common stock of B to a third party. After the sale, A owns 84 percent of B's voting stock and 70 percent of the value of all B's stock. B would be disaffiliated under the provision as a result of the sale.

Special and transitional rules are also provided.

11. Earnings and profits

a. General

Present law

Under present law, distributions by corporations to shareholders are included in income by the shareholders as dividends (and taxed at ordinary income rates) only to the extent such distributions are out of current or accumulated earnings and profits. In general, a corporation's earnings and profits are intended to be a measure of the economic income of the corporation available for distribution to its shareholders. However, in many instances earnings and profits are substantially less than the corporation's economic income.

The effect on the earnings and profits of a corporation of a distribution by the corporation in redemption of shares of its own stock is determined by reference to section 312(e). That section provides that the part of a distribution that is "properly chargeable" to capital account does not reduce earnings and profits. Some cases have held, and the IRS has now ruled, that a corporation's capital account is an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus, and that this amount is reduced in proportion to the amount of the corporation's stock that is redeemed. Under this approach, earnings and profits are reduced by an amount equal to the amount of the distribution over the amount charged against capital account. See, e.g., *Jarvis* v. *Commissioner*, 43 B.T.A. 439, *aff'd*, 123 F.2d 742 (4th Cir. 1941); and Rev. Rul. 79-376, 1979-2 C.B. 133.

House bill

No provision.

Senate amendment

The Senate amendment requires that a number of changes be made in the way in which a corporation's earnings and profits are calculated.

Construction period interest, taxes, and carrying charges

For purposes of computing a corporation's earnings and profits, construction period interest, taxes, and carrying charges are required to be capitalized as a part of the asset to which they relate and written off as is the asset itself. This rule applies to all corporations. Further, it applies with respect to both residential and nonresidential real property, and to personal property.

Construction period interest and taxes include property taxes (real and personal), interest paid or accrued on debt incurred or continued to acquire, construct, or carry property, and other carrying charges, but only to the extent such taxes, interest, and other carrying charges are attributable to the construction period for such property.

This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after date of enactment.

Intangible drilling costs and mine development costs

Intangible drilling costs allowable as a deduction under section 263(c), and mineral exploration and development costs allowable as a deduction under sections 616(a) or 617, are required to be capitalized for purposes of computing earnings and profits, but only if the expenditures give rise to the creation of an asset having an anticipated economic life of more than one year. Intangible drilling costs capitalized under the provision are to be amortized on a straight-line basis over 5 years. The amortization period for mineral exploration and development expenses is 10 years. No amortization is to occur, however, prior to the date the asset is placed in service.

Unamortized intangible drilling expenses incurred in connection with the drilling of a well (or a group of related wells) are to be deducted in computing earnings and profits when it has been determined that the well (or a group of related wells) is dry. For this purpose, a group of wells is to be considered related if they are drilled from a common drilling rig. Unamortized mineral exploration and development expenses incurred in connection with a mineral property are to be deducted in computing earnings and profits when the property is abandoned.

This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after the date of enactment.

Certain trademark, trade name, and other expenditures

Amounts amortized under sections 173 (relating to circulation expenditures), 177 (relating to trademark and trade name expenditures), and 248 (relating to organizational expenditures) are to be capitalized and treated as part of the basis of the asset to which they relate. Expenditures made in connection with property having a reasonably determinable useful life are to be recovered for earnings and profits purposes over such useful life. Under the Senate amendment, there is no amortization for expenditures made in connection with property which does not have a reasonably determinable limited useful life.

This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after the date of enactment.

Certain distributions of appreciated property

In the case of a distribution of appreciated property by a corporation to a shareholder with respect to stock, earnings and profits of the distributing corporation are to be increased by the amount of gain on the distributed property that is realized by the distributing corporation on the distribution whether or not such gain is recognized. The provision does not apply to certain distributions.

With certain exceptions, the provision is applicable to the effect on earnings and profits of distributions after the date of enactment.

Changes in LIFO reserves

A corporation's earnings and profits are to be increased by the amount of any increase in the corporation's LIFO reserve for a taxable year. In addition, earnings and profits are to be decreased by the amount of any decrease in the corporation's LIFO reserve for a taxable year. However, decreases in reserve amounts below the LIFO reserve as of the beginning of the taxable year beginning after the date of enactment will not, except as provided by regulations, reduce earnings and profits. For purposes of this provision, the term "LIFO reserve" has the same meaning as that given to the term "LIFO recapture amount" under section 336.

The provision is applicable to the effect on earnings and profits of changes in reserve amounts in taxable years beginning after the date of enactment.

Deferred gain from installment sales

A corporation's earnings and profits for a year in which the corporation sells property on the installment basis are to be increased by the amount of any deferred gain on the installment sale. This is accomplished by treating all principal payments as having been received in the year of the sale.

The provision is applicable to the effect on earnings and profits of sales occurring after March 15, 1984, other than sales pursuant to binding contracts entered into on or prior to such date.

Completed contract method of accounting

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the Senate amendment, a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis.

This provision is applicable to the effect on earnings and profits of contracts entered into after March 15, 1984, other than contracts entered into pursuant to binding contracts entered into on or prior to such date.

ACRS deductions for real property

The amount by which a corporation's earnings and profits are reduced for ACRS deductions with respect to 15-year and 20-year real property is the amount of the deduction that would be allowable if the straight-line method of depreciation had been used and the property had a 40 year recovery period.

This provision is applicable to the effect on earnings and profits of property placed in service in taxable years beginning after the date of enactment.

Redemptions

In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

This provision is applicable with respect to the effect on earnings and profits of distributions in taxable years beginning after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment with several modifications.

Construction period carrying charges

The conference agreement is generally the same as the Senate amendment, with several technical clarifications.

The provision is effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

Intangible drilling costs and mineral exploration and development costs

The conference agreement clarifies the Senate amendment by providing that for purposes of computing a corporation's earnings and profits intangible drilling costs are capitalized and allowed as a deduction ratably over a 60-month period beginning with the month in which the production from the well begins. Also, the conference agreement makes it clear that for this purpose mineral exploration and development costs are capitalized and deducted ratably over a 120-month period beginning with the later of (1) the month in which the production from the deposit begins, or (2) the month in which the amount is paid or accrued.

The provision is generally effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

Certain trademark, trade name, and other expenditures

The conference agreement generally follows the Senate amendment.

The provision is effective for amounts paid or incurred in taxable years beginning after September 30, 1984.

Certain distributions of appreciated property

The conference agreement generally follows the Senate amendment. Certain exceptions to the rule are provided.

The provision is generally effective for distributions after September 30, 1984.

LIFO inventory adjustments

The conference agreement generally follows the Senate amendment with certain technical and clarifying modifications.

In general, earnings and profits shall be increased or decreased by the amount of any increase or decrease in the LIFO recapture amount. The conferees wish to clarify that this provision is designed to eliminate the impact of LIFO on earnings and profits. Thus, under present law, if a corporation's LIFO reserve increases by $10, taxable income and earnings and profits are lower than they would have been had LIFO not been used. Under the new rules, $10 would be added back to earnings and profits.

An exception is to be provided, under regulations, for decreases below the amount of the reserve as of the close of the taxable year of the taxpayer preceding the first taxable year to which the provision applies. Since the cumulative effect of the LIFO reserve has been to keep earnings and profits lower than they otherwise would have been, it is contemplated that the regulations will provide that in the event of a reduction in the LIFO reserve below its level as of the close of such taxable year (the pre-enactment reserve), earnings and profits will be increased as under present law without any offsetting reduction under the new rules. However, because a reduction in the reserve below the pre-enactment reserve results in an increase in taxable income and earnings and profits, any subsequent restoration of the reserve up to the level of the pre-enactment reserve should result in an adjustment under the new rules.

The following example is illustrative.

Assume that a calendar year taxpayer has a LIFO reserve of $100 at the end of 1984. Assume further that the reserve decreases to $95 at the end of 1985 and increases to $105 at the end of 1986. Finally, assume that the reserve decreases to $90 at the end of 1987. The change in the reserve for 1985 results in an increase in taxable income and earnings and profits under present law, with no offsetting adjustment under the new rules. Under present law, the increase in the reserve in 1986 would reduce taxable income and earnings and profits. This reduction is offset by a $10 adjustment to earnings and profits under the new rules.

The $15 reduction in the reserve for 1987 increases taxable income and related earnings and profits by $15. This increase is offset, in part, by a $10 reduction in earnings and profits under the new rules.

The adjustment for 1987 is $10 and not $15 because the provision does not require an adjustment to offset the inclusion in earnings and profits of reserve amounts not previously included in earnings and profits. By the end of 1986, $10 (not $15) of the $100 pre-enactment reserve had been taken into account in determining earnings and profits.

The provision applies to taxable years beginning after September 30, 1984.

Installment sales

The conference agreement generally follows the Senate amendment. The conference agreement makes it clear that a corporation's earnings and profits are computed as if the corporation did not use the installment method to account for the installment sale. Thus, for purposes of computing a corporation's earnings and profits, all principal payments, as determined under general Code principles, are treated as received in the year of the sale. This provision applies to all installment sales, including installment sales of inventory.

The provision applies to sales after September 30, 1984.

Completed contract method of accounting

The conference agreement is generally the same as the Senate amendment except that it applies to contracts entered into after September 30, 1984.

ACRS deductions for real property

The conference agreement is generally the same as the Senate amendment except that the provision applies to property

placed in service in taxable years beginning after September 30, 1984.

Redemptions

The conference agreement is generally the same as the Senate amendment.

The conferees wish to clarify that when a corporation has more than one class of stock, its earnings and profits generally should be allocated among the different classes in determining the amount by which a redemption of all or a part of one class of stock reduces the earnings and profits account. However, no earnings and profits generally should be allocable to preferred stock which is not convertible or participating to any significant extent in corporate growth. Therefore, a redemption of such preferred stock should result in a reduction of the capital account only, unless the distribution includes dividend arrearages, which will reduce earnings and profits.

Similarly, priorities legally required as between different classes of stock may be taken into account in allocating earnings and profits between classes. For example, assume that corporation X has 1,000 shares of class A common stock and 1,000 shares of class B common stock. Both classes are $10 par value stock and were issued at the same time at a price of $20. The class A common has a preference as to dividend and liquidating distributions in a 2:1 ratio to the class B common, and only the class B common has voting rights. Assume further that Corporation X holds net assets worth $210,000 and has current and accumulated earnings and profits of $120,000. If X distributes $140,000 in cash in redemption of all of the class A common, earnings and profits should be reduced by $80,000 and the capital account by $60,000.

Special rule for foreign corporations

The amendments made by the conference agreement may affect the earnings and profits of foreign corporations as well as domestic corporations. Application of these amendments to foreign corporations could have an impact on U.S. persons in at least three situations.

First, under section 951, a U.S. person owning 10 percent or more of the stock of a controlled foreign corporation must include in gross income a pro rata share of the corporation's subpart F income for the shareholder's year in which or with which the corporation's taxable year ends. Subpart F income is limited to the earnings and profits, computed according to U.S. tax concepts, of the controlled foreign corporation. Thus, to the extent the conference agreement may require that the earnings and profits of a controlled foreign corporation be computed, for example, by capitalizing and amortizing rather than deducting an item, it could result in an increase in a U.S. shareholder's income.

Second, under section 902, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends is deemed to have paid a proportionate share of any income taxes paid or deemed paid by such corporation to any foreign country or to any possession of the United States on the "accumulated profits" of such foreign corporation from which the dividends were paid. The so-called "deemed paid" credit to which a qualifying U.S. shareholder is entitled equals the foreign taxes paid by the foreign corporation multiplied by the ratio of the dividends to the foreign corporation's accumulated profits. For this purpose, accumulated profits are essentially equivalent to earnings and profits. Because the conference agreement could have the effect of changing the ratio of dividends to accumulated profits, it could change the section 902 deemed paid credit of the corporation's U.S. shareholders.

Third, section 1248 generally treats certain domestic corporations as recognizing dividend income on the sale or exchange, or other disposition, of the stock of certain foreign corporations. That dividend income is measured by certain earnings and profits of the foreign corporation.

Although the conference agreement extends the changes in the earnings and profits provisions to foreign corporations, as well as domestic corporations, the application of the amendments pertaining to LIFO inventory adjustments, installment sales, and the use of the completed contract method of accounting is delayed for certain foreign corporations until taxable years beginning after December 31, 1985. This special effective date applies to foreign corporations deriving less than 20 percent of their gross income from sources within the United States. It is anticipated that this delayed effective date will provide both the Treasury and affected foreign corporations and their shareholders opportunity to consider how those provisions should apply to such foreign corporations.

Distributions to 20-percent corporate shareholders

Under the proposed new earnings and profits rules, a corporation's earnings and profits can exceed its taxable income if its income is deferred for purposes of determining gross income but not for purposes of computing earnings and profits. The conferees are concerned that, without a special rule, if a corporation with earnings and profits in excess of taxable income makes a distribution to a corporate shareholder and the distribution is treated as a dividend qualifying for a dividends received deduction, it may be possible for earnings to be distributed to the corporate shareholder without ever being subject to tax in the hands of the corporate shareholder.

For example, assume that P Corporation owns 100 percent of the stock of X Corporation, that P's basis in such stock is $200, that P and X file separate income tax returns, and that X has no current or accumulated earnings and profits. Assume further that X sells an asset for a $1,000 installment note, realizing an $800 gain. Finally, assume that X borrows $500 secured by the installment note and distributes the $500 to P. In such event, under the provision, absent a special rule, P would include the $500 distribution in income but would likely qualify for a 100-percent dividends received deduction. If P later sells its X stock for $200 (the value of that stock if it is assumed that X will ultimately have a $300 tax liability, in present value terms, on account of the installment sale), it would not recognize gain or loss on the sale. As a result, P would have realized an overall profit of $500.

Under the conference agreement, except as regulations may otherwise provide, the taxable income of a corporate shareholder with a 20-percent or greater interest in the distributing corporation, and such shareholder's basis in the stock of the distributing corporation, are determined as if section 312(n) (as added by the bill) did not apply to the distributing corporation. As a result, in the above example, $200 of the distribution by X to P would be a return of capital, and $300 would be taxed to P under section 301(c)(3). P's basis in the X stock would be reduced to zero, and P would recognize a $200 gain on the sale of the stock. This special rule does not affect the computation of resulting earnings and profits of either the distributing corporation or the corporate shareholder. Thus, for purposes of computing earnings and profits of X and P, $500 of earnings and profits would be treated as having been transferred from X to P. Furthermore, the special rule applies only if the corporate shareholder would, but for the special 20-percent corporate shareholder rule, be entitled to a dividends received deduction with respect to the distribution involved.

Under the rule, a 20-percent corporate shareholder is any corporation owning, directly or indirectly, stock possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote or at least 20 percent of the total value of all classes of stock (excluding certain preferred stock) of the distributing corporation. Attribution rules apply for purposes of determining stock ownership.

This rule applies to distributions after the date of enactment.

b. Distributions by a corporation of discount obligations

Present law

A corporation may distribute as a dividend its own discount obligations to its shareholders. Only the fair market value of the obligations is includible in the gross income of such shareholders. However, some taxpayers have taken the position that the corporation's earnings and profits are reduced by the entire principal amount of such obligations (sec. 312(a)(2)).

It is unclear whether the original issue discount rules apply to such a discount obligation upon its distribution.

House bill

In the case of a dividend distribution by a corporation of its own discount obligation, the corporation's earnings and profits are reduced only by the issue price of the obligation at the time of the distribution. The issue price is to be determined under the original issue discount rules. Furthermore, the original issue discount rules apply to the holder and the issuer of the obligation upon its distribution.

The provision is effective for distributions after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill except that it applies to distributions declared after March 15, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

12. Net operating loss, etc. carryover rules

Present law

The Tax Reform Act of 1976 substantially revised sections 382 and 383, which relate to the carryover of corporate net operating losses and other corporate tax attributes following acquisitions, including reorganizations. The 1976 Act revisions relating to acquisitions other than reorganizations are generally effective with respect to taxable years beginning after June 30, 1984. Those relating to reorganizations are effective with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1984. The 1976 Act revisions are not explicitly made applicable to "G" reorganizations (relating to reorganizations of corporations in a title 11 or similar case).

House bill

The 1976 Act revisions relating to acquisitions other than reorganizations are generally effective for taxable years beginning after October 31, 1984. Those relating to reorganizations are effective only with respect to a reorganization pursuant to a plan adopted on or after November 1, 1984.

Senate amendment

The 1976 amendments relating to acquisitions other than reorganizations are generally effective for taxable years beginning after December 31, 1985. Those relating to reorganizations are effective only with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1986.

Conference agreement

The conference agreement generally follows the Senate amendment. Thus, for example, the revisions of the 1976 Act are not applicable to any reorganization pursuant to a plan of reorganization not adopted on or after January 1, 1986. In addition, the 1976 Act revisions, insofar as they relate to reorganizations, are amended to clarify that, when they become effective, they will apply to "G" reorganizations. This latter amendment is effective as if included in the amendments made by section 4 of the Bankruptcy Tax Act of 1980.

13. Distribution requirement in the case of a "C" reorganization

Present law

A "C" reorganization, as defined by section 368(a)(1)(C), is an acquisition by one corporation (the "acquiring corporation") of substantially all of the properties of another corporation (the "transferor corporation") in exchange solely for voting stock of the acquiring corporation or its parent corporation, or in exchange for such voting stock and a limited amount of money or other property. In determining whether an exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the transferor corporation, or the fact that the property acquired is subject to a liability, generally is disregarded.

A transaction can qualify as a C reorganization even if the transferor corporation does not distribute to its shareholders the consideration received from the acquiring corporation or assets not transferred by it to the acquiring corporation. Furthermore, the Service has ruled that a transaction can qualify as a C reorganization where the transferor corporation distributes a 25-percent stock interest in the acquiring corporation but retains liquid assets which it intends to use to engage in an active trade or business. (Rev. Rul. 73-552, 1973-2 C.B. 116.)

Under present law, the acquiring corporation in a C reorganization succeeds to, and takes into account, the tax attributes of the transferor corporation described in section 381, subject to limitations contained in that section and section 382. For example, the acquiring corporation generally succeeds to the earnings and profits of the transferor corporation.

Any distribution pursuant to the plan of reorganization by the transferor corporation to its shareholders in exchange for their stock in the transferor corporation is subject to section 354 (or so much of section 356 as it relates to section 354). Thus, no gain or loss is recognized to the shareholders of the transferor corporation on the receipt of qualifying consideration. Gain may be recognized under section 356, however, on the receipt of other property, but not in an amount in excess of the sum of any money and the fair market value of any other property received. If the receipt of such property has the effect of a distribution of a dividend to a shareholder, the shareholder is treated as receiving dividend income in an amount equal to the amount of the gain realized on the exchange but not in excess of the shareholder's ratable share of undistributed earnings and profits of the corporation. The principles of section 302 are applicable in testing for dividend equivalency under section 356. Any gain recognized which is not treated as dividend income is treated as gain from the sale or exchange of property.

For purposes of determining the extent to which a shareholder is to be treated as having received a dividend, the relevant earnings and profits are the accumulated earnings and profits of the transferor corporation. For this purpose, the exchange is generally deemed to occur prior to the time the transferor corporation's earnings and profits are inherited by the acquiring corporation under section 381. Furthermore, the earnings and profits of the transferor corporation inherited by the acquiring corporation under section 381 are reduced by amounts treated as a dividend under section 356.

House bill

No provision.

Senate amendment

Under the Senate amendment, a transaction can qualify as a C reorganization only if the transferor corporation distributes all of its assets (less those retained to meet claims), including consideration received from the acquiring corporation and any retained assets, within 12 months of the acquisition. Authority is provided for the Secretary to prescribe regulations providing exceptions to the distribution requirement.

The Secretary is also directed to prescribe regulations under section 312 providing for the allocation of earnings and profits between the acquiring corporation and the transferor corporation in situations in which, prior to the transaction, 80 percent or more of the stock of the transferor corporation was held by one corporate shareholder and in any other situation described in regulations.

The provision is applicable to transactions pursuant to a plan adopted after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment. However, under the conference agreement, the required distribution must be pursuant to the plan of reorganization rather than within a 12-month period beginning on the date of the acquisition. In addition, the conference agreement makes technical modifications to the Senate amendment.

The provision contained in the Senate amendment that provides that the Secretary may be regulations waive the application of the distribution requirement, subject to any conditions imposed in the regulations, is also retained under the conference agreement. The report of the Senate committee, which the conferees endorse, states that the Senate anticipated that waivers may be granted if a distribution would result in substantial hardship. The conferees also wish to make it clear that as a general rule a waiver is to be granted only on the condition that the transferor corporation and its shareholders be treated as if the retained assests are distributed and then contributed to the capital of a new corporation.

The conference agreement expands a provision contained in the Senate amendment by providing the Secretary with authority to issue regulations allocating the earnings and profits of the transferor corporation between or among such corporation, any corporation in control of the transferor corporation immediately before the reorganization, and the acquiring corporation in the case of a C reorganization. Such authority is extended to D reorganizations as well. The conferees anticipate that under those regulations, generally the consequences of an "A" reorganization (e.g., a merger) preceded by a distribution, on the one hand, and a C (or non-divisive D) reorganization followed by a distribution, on the other hand, will be consistent. In this regard, the Treasury might reconsider its regulations relating to allocations of earnings and profits in transactions under section 355.

The conferees wish to clarify that the provision applies to transactions pursuant to a plan adopted after the date of enactment by any corporation which would be a party to the reorganization if the transaction qualifies as a reorganization.

14. Control requirement in a "D" reorganization

Present law

"D" reorganizations

Under section 368(a)(1)(D), a transfer by a corporation of all or a part of its assets to a corporation controlled immediately after the transfer by the transferor or one or more of its shareholders is generally treated as a "D" reorganization if, among other things, stock or securities of the controlled corporation are distributed in a transaction qualifying under sections 354, 355, or 356. For the transaction to qualify under section 354 (or so much of section 356 as relates to section 354), the acquiring corporation must acquire substantially all the assets of the transferor corporation (a non-divisive D reorganization). For purposes of determining whether a transaction qualifies as a D reorganization, the term "control" is defined in section 368(c) as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. No attribution rules are explicitly made applicable.

Liquidation and contribution to a related corporation

In general, under section 331, amounts distributed to a shareholder in complete liquidation of a corporation are treated as in full payment in exchange for the shareholder's stock. If the stock is a capital asset in the hands of the shareholder, a complete liquidation will result in capital gain or loss. The shareholder's basis in the property received in a taxable liquidation is the fair market value of the property at the time of the distribution. With several exceptions, no gain or loss is recognized to the distributing corporation on a distribution in complete liquidation of such corporation or a liquidating sale by the corporation.

Under section 351, generally no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and, immediately after the exchange, such person or persons are in control of the corporation. As a general rule, a transferor takes a substitute basis in stock or securities received in the exchange. The corporation's basis in property received from the transferor is generally determined with reference to the basis of such property in the transferor's hands.

House bill

No provision.

Senate amendment

Under the Senate amendment, for purposes of determining whether a non-divisive transaction qualifies as a D reorganization, "control" is defined as ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the total number of shares of all other classes of stock of the corporation. Further, the constructive ownership of stock rules

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contained in section 318(a), as modified, are applicable for purposes of determining whether the transferor corporation or its shareholders are in control of the acquiring corporation. The provision is applicable to transactions pursuant to a plan adopted after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment in that under the conference agreement the general definition of "control" contained in section 368(c) does not apply for purposes of determining whether a non-divisive transaction qualifies as a D reorganization. However, the definition substituted for the section 368(c) definition by the Senate amendment is modified under the conference agreement.

Under the conference agreement, control means the ownership, directly or indirectly, of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all shares of all classes of stock. The conferees believe that by taking value into account this definition increases the utility to the Internal Revenue Service of the D reorganization provisions as a means of preventing taxpayers from bailing out earnings and profits at capital gains rates in liquidation-reincorporation transactions.

In addition, the conferees wish to clarify that they do not intend that recharacterization as a D reorganization under this provision be the exclusive means for the Service to challenge liquidation-reincorporation and similar transactions. For example, it is not intended that this provision supercede or otherwise replace the various doctrines that have been developed by the Service and the courts to deal with such transactions. See, e.g., Rev. Rul. 61-156, 1961-2 C.B. 62; *Telephone Answering Service Co.* v. *Commissioner*, 62 T.C. 423 (1974), *aff'd.*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977); and *J.E. Smothers* v. *U.S.*, 642 F.2d 894 (5th Cir. 1981).

The conferees wish to clarify that the provision applies to transactions pursuant to a plan adopted after the date of enactment by any corporation which would be a party to the reorganization if the transaction qualifies as a reorganization.

15. Collapsible corporations

Present law

The collapsible corporation rules are designed to prevent the use of a corporation to convert what would be ordinary income in the hands of a shareholder to capital gain. A shareholder's gain on the sale or exchange of stock in a collapsible corporation is generally required to be reported as ordinary income. However, the collapsible corporation rules are inapplicable if the collapsible corporation realizes a "substantial part" of the income to be derived from its collapsible assets. In *Commissioner* v. *Kelley*, 293 F.2d 904 (5th Cir. 1961), the court held that the "substantial part" test is satisfied if the corporation has realized one-third of the income to be derived from its collapsible assets.

Under a second exception, the collapsible corporation rules are inapplicable if 70 percent or less of a shareholder's gain on the disposition of his stock in the corporation is attributable to the collapsible assets (the "70/30" rule).

House bill

The House bill provides that the "substantial part" test requires the realization of at least two-thirds of the income from collapsible assets. In addition, the Secretary is authorized to promulgate regulations to make conforming changes to the 70/30 rule, treating all property described in section 1221(a) as one item of property.

The provision is effective for sales and exchanges made after the date of enactment.

Senate amendment

The Senate amendment is generally the same as the House bill except that the provision is applicable to sales and exchanges made after December 31, 1984. Under a transition rule, the provisions of the bill are inapplicable if, prior to January 1, 1985, a corporation realized a "substantial part" of the income to be derived from any property.

Conference agreement

The conference agreement follows the House bill.

16. Phaseout of graduated rates for large corporations

Present law

Present law provides graduated corporate rates on the first $100,000 of taxable income. These rates provide a maximum tax reduction of $20,250 in tax below the tax which would be imposed if the tax rate on that income were 46 percent.

House bill

No provision.

Senate amendment

The Senate amendment phases out the benefits of the graduated rates on corporations with taxable income in excess of $1 million, by imposing an additional 5 percent tax on the first $400,000 of taxable income over $1 million. This recaptures $20,000 of the graduated rate benefits for corporations with taxable income in excess of $1.4 million.

The provision applies to taxable years beginning after December 31, 1983. (Under Code section 21, the provision will apply on a pro-rata basis to 1983-1984 fiscal years.)

Conference agreement

The conference agreement generally follows the Senate amendment. However, the full $20,250 of tax benefit from the graduated rates is recaptured. Also, the conference agreement provides that this provision will not apply to any 1983-1984 fiscal years. Thus, the provision applies only to taxable years beginning after December 31, 1984.

17. Golden parachute contracts

Present law

A corporation is allowed a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Reasonable allowances for salaries or other compensation for personal services actually rendered generally qualify as ordinary and necessary trade or business expenses.

House bill

No provision.

Senate amendment

Under the Senate amendment, all payments under a "golden parachute" contract are presumed to be excessive. The presumption is rebuttable, but only by a showing that the payments are a reasonable allowance for salaries or other compensation for personal services actually rendered. It may not be rebutted by a showing that the payments otherwise qualify as an ordinary and necessary trade or business expense.

If any payments under a golden parachute contract are excessive, none of the payments under that contract are deductible, and a nondeductible excise tax of 20 percent is imposed on the recipient with respect to all of the payments.

A golden parachute contract generally is any contract entered into by a corporation with any officer, shareholder, or highly-compensated individual (including any independent contractor) providing, at the time of execution, for contingent payments of cash (or property) which are to be made in the event of a change (or threatened change) in ownership or control of the corporation (or of a significant portion of its assets). Furthermore, the present value of the payments (determined as of the time the contingency occurs) must exceed 200 percent of the highest compensation income of the individual from the corporation includible in his gross income during any of the five taxable years ending with the taxable year preceding the taxable year in which the contract is executed. Present value is determined under section 1274, as added by the bill.

Payments under golden parachute contracts, like any termination pay, are subject to FICA taxes when paid.

To the extent provided by regulations, any contract which the Securities and Exchange Commission classifies as unreasonable in situations involving a threatened takeover will also constitute a golden parachute contract.

The provision is applicable to payments under contracts entered into after March 15, 1984.

Conference agreement

General rule

Under the conference agreement, no deduction is allowed for "excess parachute payments" paid or accrued. Furthermore, a nondeductible 20 percent excise tax is imposed on the recipient of any excess parachute payments.

Parachute payment

A "parachute payment" is any payment in the nature of compensation to (or for the benefit of) a "disqualified individual" if such payment is contingent on a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of its assets, if the aggregate present value of all such payments made or to be made to (or for the benefit of) the disqualified individual equals or exceeds three times the "base amount". The "base amount" is the average annualized compensation income (including, for example, ordinary income with respect to stock options) from the corporation includible in the disqualified individual's gross income over the five-taxable-year period (or if the individual did not perform services throughout such five-taxable year period for such corporation, the portion of such period during which the individual did perform services for the corporation) preceding the taxable year in which the change of ownership or control occurs.

A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly-compensated individual of such corporation. Personal service corporations and similar entities are treated as individuals for this purpose. Thus, for example, if an individual performs services for a corporation through a personal service corporation, parachute payments to the personal service corporation are treated as made to the individual. Similarly, any office held by the individual is treated as held by his personal service corporation.

To be a parachute payment, the payment must be contingent on a change in ownership or effective control. In general a payment is to be treated as contingent on a change of ownership or control under the provision if such payment would not in fact have been made to the disqualified individ-

ual had no change in ownership or control occurred. Furthermore, a payment is to be treated as contingent on a change of ownership or control if the change determines the time such payment in fact is to be made. Finally, a payment may be a parachute payment even if the employment of the individual involved is not voluntarily or involuntarily terminated.

The following examples illustrate the "contingent on a change in ownership or control" concept.

Example (1).—Assume that a contract provides for payments to a disqualified individual if control of the corporate employer changes. Assume that control does change and payments under the contract are made. The payments are contingent on the change in control, even if the individual continues in the employ of the corporation.

Example (2).—Assume that a contract provides for payments to a disqualified individual contingent upon termination of his employment. A change of control occurs, and thereafter, as a result of the change, the employment of the individual is terminated. Payments under the contract are to be treated as contingent on the change in control.

Example (3).—Assume that a contract provides for the acceleration of vesting or a payment of any deferred incentive compensation, for the acceleration of the time for the exercise of stock options, or for payments in cancellation of stock options, contingent on a change in control. Payments resulting from such a contract are treated as contingent on a change in control.

Parachute payment presumption

Under the conference agreement, payments under a contract entered into (or amended in significant relevant respect) within one year before a change in ownership or control are presumed contingent on such a change, even if such payments are not contingent on a change in ownership or control, unless the contrary is established by clear and convincing evidence.

Property transfers

Under the conference agreement, transfers of property (e.g., stock options) are treated as payments for purposes of the provision. Any such property is taken into account at its fair market value, and all such property is to be valued for purposes of the provisions. Under the conference agreement, present values are determined in accordance with the principles of section 1274(b)(2), as added by the bill.

Change in ownership or control

Whether a particular transaction involves a change in the ownership or effective control of a corporation or in the ownership of a substantial portion of its assets is to be determined under all the facts and circumstances.

Excess parachute payments

"Excess parachute payments" are any parachute payments in excess of the base amount which are not reasonable compensation for personal services actually rendered by the disqualified individual. Under the conference agreement, it is presumed that no parachute payment is reasonable compensation for personal services actually rendered. Such presumption may be rebutted, but only by clear and convincing evidence. To the extent that the presumption is rebutted, the provision does not apply. To the extent the taxpayer establishes the amount that is reasonable compensation for services actually rendered, it is first applied against the base amount. The conferees do not intend that services adequately compensated for by payments that are not parachute payments be taken into account in determining whether parachute payments are payments of reasonable compensation.

For example, assume that the disqualified individual's base amount is $100,000. Assume further that a payment totalling $400,000, which is contingent on a change in control, is made on the date of the change. Under the provision, parachute payments total $400,000, and the provision applies because $400,000 exceeds $300,000 (three times the base amount). Excess parachute payments total as much as $300,000 ($400,000 less $100,000, the base amount). Assume that the taxpayer establishes by clear and convincing evidence that reasonable compensation for services compensated for by the parachute payments totals $150,000. Under the conference agreement, excess parachute payments equal $250,000 ($300,000 less ($150,000 less $100,000)).

If, in the above example, parachute payments totalled only $290,000, the provision would not apply. In that case, the parachute payments would not equal or exceed three times the base amount.

Reasonable compensation

The conferees believe that in most large corporations, executives are not under-compensated. As a result, the conferees contemplate that only in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that the executive was under-compensated in earlier years. On the other hand, payments of compensation previously earned which are in fact made by reason of a change in ownership or control are generally to be treated as reasonable compensation under the provision. For example, payments under the following agreements are generally to be treated as reasonable compensation under the provision if such payments would have been made in the future in any event, even though the timing of such payments is in fact be triggered by a change in control: (1) payments in cancellation of a normal stock option, or normal stock appreciation right, granted more than one year before the change; (2) exercises after termination of stock options or stock appreciation rights issued as part of a normal compensation package granted more than one year before the change; (3) compensation previously earned and deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the employee; and (4) amounts paid under a retirement plan that supplements a tax-qualified plan to the extent such amounts are designed to compensate a newly-hired key employee for the loss of retirement benefits attributable to services performed for a prior employer.

Violation of securities laws or regulations

Under the conference agreement, the term "parachute payment" also includes any payments under a contract similar to a contract providing for parachute payments which violates securities law or regulations. However, the rules relating to reasonable compensation are not applicable in determining how much of such parachute payments are excessive.

Withholding

Rules regarding withholding taxes and FICA taxes are also provided.

Application

The provision is to be applied on a pro rata basis with respect to each excess parachute payment paid or accrued by the corporation or received by the disqualified individual in excess of the portion of the base amount allocated to such payment. The conferees intend that any reasonable compensation in excess of the base amount be allocated to the first parachute payments made.

Other

The conference agreement authorizes the Treasury to prescribe regulations necessary to carry out the purposes of the provision (including regulations for the application of the provision in the case of related corporations and personal service corporations). Those regulations are to prescribe rules for the case in which the disqualified individual commences working for the corporation in the year the change in ownership or control occurs.

No inference is intended as to the deductibility under present law of amounts paid or accrued under so-called golden parachute agreements. Nor is any inference intended as to the deductibility of any parachute payments which are not excess parachute payments under the provision.

Effective date

The conference agreement is effective for payments made under contracts entered into or renewed after June 14, 1984. For this purpose, a contract cancellable at will by either party is to be treated as a new contract entered into on the date any such cancellation, if made, would be effective. Payments under agreements in effect on June 14, 1984, are not affected by the provision unless the terms of such agreements are amended in significant relevant respect after that date. The conferees intend that an agreement will be treated as so amended if it is amended (or supplemented) either to add or modify a change in ownership or control trigger (or similar trigger), to increase amounts payable (or, where payment is under a formula, to modify the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger. Where a golden parachute agreement in effect on June 14, 1984, is so amended or supplemented after that date, all amounts payable under the contract (and any supplement) are subject to the provision.

18. Increase in reduction of certain corporate tax preference items from 15 percent to 20 percent

Present law

TEFRA reduced certain corporate tax preferences by 15 percent. These preferences include real estate, capital gains, percentage depletion for coal and iron ore, bad debt reserves and interest to carry tax-exempt obligations of financial institutions, amortization of pollution control facilities, DISC, intangible drilling expenses of integrated oil companies, and mining exploration and development costs.

The corporate minimum tax was adjusted to prevent a double impact of the two provisions.

House bill

No provision.

Senate amendment

The Senate amendment generally increases the preference cutback from 15 to 20 percent, including a similar adjustment to the new Foreign Sales Corporation provision. The Senate amendment makes a corresponding adjustment to the corporate minimum tax. The cutback in the depletion allowance for coal and iron ore remains unchanged.

The provision applies to taxable years beginning after, and transactions after, December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

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E. Partnership Provisions

1. Shifting of income, gain, loss, and deduction when partnership interests change

Present law

Contributions

Under present law (sec. 704(c)), when property is contributed to a partnership, depreciation, depletion, or gain or loss with respect to the contributed property may be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (i.e., the built-in gain or loss on the property). If the partnership does not make allocations on this basis, the allocations are made as if the property had been purchased by the partnership. It generally is thought that a portion of the built-in gain or loss that would have been realized by the contributing partner if he had sold the property may be shifted to the other partners.

Retroactive allocations

The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from taking into account partnership items incurred prior to his entry into the partnership ("retroactive allocations" of partnership losses). The 1976 Act provided that when partners' interests change during the taxable year, each partner's share of various items of partnership income gain, loss, deduction, and credit is to be determined by taking into account each partner's varying interest in the partnership during the taxable year.

Some taxpayers argue that the 1976 Act rule may be avoided in the case of tiered partnership arrangements on the theory that losses sustained by the lower-tier partnership are allocable to the day in the upper-tier partnership's taxable year on which the lower-tier partnership's taxable year closes. Similarly, partnerships using the cash receipts and disbursements method of accounting have avoided the retroactive allocation rules by deferring actual payment of accrued deductions until near the end of the partnership's taxable year.

House bill

Contributions

Under the House bill, depreciation, depletion, and gain or loss with respect to contributed property are to be shared among the partners, pursuant to Treasury regulations, so as to take account of the difference between the partnership's basis for the property and the fair market value of the property at the time of contribution. The report of the House committee anticipates that the regulations under this provision generally will provide for the same result that is achieved under present law when a partnership elects to provide for sharing of depreciation, depletion, and gain or loss among the partners so as to take into account fully the difference between the basis and fair market value of the property contributed to the partnership (at the time of the contribution). Thus, it will not be possible to shift built-in gain or loss from the contributing partner to the other partners.

The provision is effective with respect to property contributed to a partnership after March 31, 1984.

Retroactive allocations

The House bill provides that if any partner's interest in a partnership changes at any time during the partnership's taxable year, each partner's share of each item of partnership income, gain, loss, deduction, and credit is to be determined by using any method prescribed by Treasury regulations which takes into account the varying interests of the partners in the partnership during the taxable year. Unless these regulations provide otherwise, the House bill requires, in the case of cash-method partnerships, that interest, taxes, payments for services or use of property, and any other item specified in regulations be assigned to each day in the period to which it is attributable (i.e., to the day or days in such period to which such item would accrue if such partnership were on the accrual method) and allocated among the partners in proportion to their interests in the partnership at the close of each day.

In the case of tiered partnerships, the bill provides that the upper-tier partnership's share of any item of income, gain, loss, deduction, or credit of the lower-tier partnership will, except as otherwise provided in regulations, be prorated equally over the portion of the taxable year during which the upper-tier partnership had an interest in the subsidiary.

The provision applies to items attributable to periods after, or amounts paid or accrued after, March 31, 1984.

Senate amendment

Contributions

The Senate amendment is the same as the House bill with respect to the partner's share of depreciation, depletion, and gain or loss on property contributed to a partnership.

Retroactive allocations

The Senate amendment generally is the same as the House bill with respect to retroactive allocations of partnership items, except that the amendment explicitly provides that when there is a disposition of less than an entire interest in a partnership by a partner (including entry of a new partner), the partnership may elect (on an annual basis) to determine the varying interests of the partners by using a monthly convention that treats any changes in any partner's interest as occurring on the first day of the month.

Conference agreement

The conference agreement follows the House bill and the Senate amendment with modifications to eliminate gaps in the provisions identified by the conference committee.

Contributions

Under the conference agreement, the Secretary is provided with authority to require items of income, gain, loss, and deduction with respect to contributed property to be shared among the partners to take account of the variation between the basis and fair market value of such property at the time of contribution. By making reference to items of income and deduction, the conferees do not intend for the Treasury to require such variations to be eliminated by allocations of operating income and loss attributable to the contributed property (other than depreciation, depletion, and similar items). Rather, the conference agreement intends to address situations in which a partner on the cash receipts and disbursements method of accounting contributes accounts receivable, accounts payable, or other accrued but unpaid items to a partnership that uses the same method of accounting. Thus, for example, if a cash-method taxpayer contributes accounts payable to a cash-method partnership, the deductions attributable to those items generally will be allocated to the contributing partner if possible, and if not, capitalized (see the discussion of retroactive allocations below). The committee intends that, similar to the amendments recently made to section 357(c) (and contrary to Rev. Rul. 60-345, 1960-2 C.B. 211), these accrued but unpaid items should not be treated as partnership liabilities for purposes of section 752. The conferees expect that the Treasury will provide regulations to cover situations in which the partnership is on the accrual method of accounting. These changes, and the changes contained in new section 724, are not intended to override the anticipatory assignment of income doctrine in those situations in which such doctrine would apply to a cash-method partner's contribution of accrued but unpaid items to a partnership. *See*, e.g., Rev. Rul. 80-198, 1980-2 C.B. 113 and Rev. Rul. 80-199, 1982-2 C.B. 122, and the cases cited therein. These changes compliment, and are consistent with, the modifications to the retroactive allocation provisions adopted by the conferees which prevent a cash-method partnership from shifting its accrued deductions to partners who are admitted to the partnership after such deductions are accrued.

The conferees are concerned with complexities that may arise in applying this new rule to allocations of depreciation and depletion. In this regard, the conferees note that the report of the Senate committee suggests ways in which the Treasury might provide for flexibility in applying the new rule (for example, in the case of small operating partnerships) when no tax avoidance potential exists. The conferees intend that this language be read as illustrative of, rather than as a limitation on, the Secretary's authority to provide reasonable rules as long as no abuse potential is present. For example, the conferees recognize that the Secretary may decide to require taxpayers to allocate only the built-in gain or loss on contributed property under new section 704(c) and permit allocations of depreciation, depletion, or similar items with respect to such property, to be governed by section 704(b), provided this flexibility is not likely to result in the contributing partner avoiding the effect of the allocation of built-in gain or loss (such as when the property is expected to be held by the partnership until it has little, if any fair market value). Although partnerships may continue to rely on the regulations issued under present section 704(c)(2) until new regulations are proposed, the conference agreement provides authority for the Secretary to significantly modify or expand those rules. Those modified regulations may take into account situations not addressed by the current rules, including those involving contributions of (1) more than one item of property with built-in gain or loss by a single partner, (2) property with built-in gain or loss by more than one partner, (3) property with built-in gain that would constitute ordinary income under the various recapture provisions, (4) property which is disposed of by the partnership for "substituted basis" transaction as defined in new section 7701(a)(42), (5) property when there are disproportionate profit and loss sharing arrangements contained in the partnership agreement, and (6) property which is not disposed of prior to the contributing partner's disposition of his partnership interest.

Finally, the conferees wish to clarify the intended effect of this new rule on the allowance for depletion. Under present law, a partnership allocates the adjusted basis of an oil or gas property among those who are partners as of the time the property is acquired and also allocates the amount realized from the taxable disposition of such property among the partners. Each partner uses these items to separately compute his depletion deductions and gain or loss with respect to the property. Thus, the partnership does not actually allocate depletion or

gain or loss with respect to such property depletion to its partners. The conferees intend that the Treasury regulations will provide for allocations of adjusted basis and amount realized to account for any built-in gain or loss on the contributed oil and gas properties, but may permit flexibility in allocating adjusted basis in non-abusive cases consistent with the discussion above.

Retroactive allocations

The conference agreement follows the House bill and the Senate amendment, except that (1) the treatment of items attributable to more than one year is modified, (2) the monthly convention rule of the Senate bill is not included, and (3) the treatment of tiered partnerships is clarified.

Under the conference agreement, a technical defect of the House bill and Senate amendment which would have permitted taxpayers to avoid the retroactive allocation rules by delaying payment of deductible cash-method items until the first day of the year following the year of a change in partnership interests is modified. Thus, if any portion of such an item is properly attributable to periods before the beginning of the taxable year, the agreement requires that such portion be allocated to the persons who were partners on the days to which such portion is attributable in proportion to their varying interests in the partnership on those days (determined in a manner consistent with section 704). This determination will require allocation of such items in the manner in which the partners would have borne the corresponding economic cost, even though the cost is actually borne by another partner (typically, a later-admitted partner) in connection with a change in the partners' interests in the partnership (other than a change governed by section 761 rather than section 706). If the persons to whom all or part of such items are allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is taken into account, then their portion must be capitalized by the partnership and allocated to the basis of partnership assets in the manner required by section 755.

With respect to the monthly convention, the conferees understand that the Secretary will provide for a monthly convention by regulation; thus, the statutory provision adopted by the Senate is unnecessary. Under this convention, partners entering after the 15th day of a month will be treated as entering on the first day of the following month and partners entering during the first 15 days of a month will be treated as entering on the first day of the month. Further, the conferees note that the Secretary may provide for other conventions and may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that use of a convention could result in significant tax avoidance.

With respect to the treatment of tiered partnerships, the conference agreement provides that when there is a change in the interests of the partners of the upper-tier partnership, items of the subsidiary are (except as otherwise provided by regulations) to be allocated among the partners of the upper-tier partnership (1) by assigning the appropriate portion of each item to the appropriate day in the upper-tier partnership's taxable year on which the upper-tier partnership is a partner in the lower-tier partnership, and (2) by allocating the portion assigned to a day among the partners in proportion to their interests in the upper-tier partnership as of the close of the day (determined in a manner consistent with section 704). For this purpose, items allocable to periods before or after the upper-tier partnership's taxable year will be assigned to the first or last day of that year, respectively. If the persons to whom items are properly allocated are no longer partners in the upper-tier partnership on the firstday of the upper-tier partnership taxable year in which the item is taken into account, then that such persons' portion of such items are capitalized and allocated to the basis of partnership assets in the manner required by section 755.

Effective dates:

The provisions of the conference agreement relating to contributions apply to contributions made after March 31, 1984. In the case of allocations with respect to items other than depreciation, depletion, and gain or loss, the conferees expect that the regulations requiring allocation and describing the method of allocation will take effect no earlier than the date those regulations are proposed.

The provisions of the conference agreement relating to retroactive allocations of partnership items apply to amounts attributable to periods before or after March 31, 1984, and in the case of tiered partnerships, amounts paid or accrued by the lower tier partnership after March 31, 1984.

2. Uses of partnerships to change the character and timing of income, gain, loss, or deduction

a. Payments to partners for property or certain services

Present law

The contribution of property to a partnership in return for a partnership interest is generally a tax-free transaction (sec. 721). If, instead of contributing property to a partnership, the taxpayer sells property to the partnership, the taxpayer recognizes gain or loss on the sale and the partnership is generally required to capitalize the amount of the purchase price, which may be deductible over the useful life of the property (or any applicable recovery period). When services are provided to a partnership, the partnership may be permitted to deduct amounts paid or incurred for such services (subject to the rules generally applicable to other taxpayers), and the party providing services must include an equivalent amount in income. However, a partnership, like any taxpayer, is generally required to capitalize (rather than currently deduct) expenditures which relate to the improvement of property or which create an asset the useful life of which extends substantially beyond the end of the taxable year. Present law (sec. 709) also provides specifically that a partnership may not currently deduct amounts paid or incurred to organize the partnership. Instead, the partnership may elect to deduct these amounts ratably over a 5-year period, or, alternatively, may capitalize these expenses. In addition, neither the partnership nor any partner may even deduct syndication fees. These rules are equally applicable to services provided by third parties and services provided by a partner acting in a capacity other than that of a member of the partnership.

When a partnership allocates income from partnership operations among its partners, the partners generally include these amounts in income for the taxable year of the partner in which the partnership taxable year ends. This is distinct from a distribution of partnership assets, which generally is tax-free to the extent that the amount distributed does not exceed the recipient-partner's basis for his partnership interest. This tax-free treatment is based, in part, on the theory that a partner is entitled to withdraw the adjusted basis of his investment in a partnership (including the constructive investment retained by the partnership that corresponds to the partnership income on which the partner has paid tax) before recognizing gain on the investment.

Although amounts allocated to a partner are not deductible by the partnership, an allocation of taxable income to one partner may have the effect of a deduction for the remaining partners by reducing the amount of taxable income allocated to them.

Under case law, partnerships have been used to circumvent the requirement to capitalize certain expenses and other rules and restrictions concerning various expenses by making allocations of income and corresponding distributions in place of direct payments for property or services. Similarly, taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related distribution of partnership property (including money). Although Treasury regulations provide that the substance of the transaction should govern in these latter cases, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property by the partner to a partnership or to another partner.

House bill

Recharacterization of payments for capital expenses

Under the House bill, if a partner performs services for, or transfers property to, a partnership and receives a related allocation (direct or indirect) of partnership income or gain, the transaction will be treated as a transaction between the partnership and a person who is not a partner. This rule applies only if a direct payment for the property or services would have been a capital expenditure by the partnership. Thus, the amount paid to the partner in consideration for the property or services will be treated as a fee for services or purchase price of property provided to the partnership (as the case may be) and the partnership will be required to capitalize these amounts. The partnership will disregard the purported allocation to the partner performing services or transferring property to the partnership in determining the partners' shares taxable income or loss.

This provision applies to services performed, or property transferred, after March 1, 1984.

Disguised sales

The House bill provides that, when a partner transfers money or other property to a partnership and there is a related direct or indirect transfer of money or other property to that partner or other partner, the transaction is to be treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnerships. The selling partner will be required to recognize gain (or loss) on all or part of the amount received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership thereby deferring or avoiding tax on the transaction.

This provision applies to property transferred after March 1, 1984.

Definition of partner

For purposes of the preceding rules, the House bill treats partners joining at the end of a series of transactions as partners for the entire series.

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Senate amendment

Payments for services or property

The Senate amendment generally is consistent with the House bill with three modifications. First, clarifying amendments explicitly limit the application of the rule to cases in which the performance of services or transfer of property and a related allocation or distribution to a partner are, when viewed together, properly characterized as occurring between the partnership and a partner acting in his nonpartner capacity. Second, the rule is not limited to transactions in which direct partnership payments would have to be capitalized. Third, the provision applies to services performed or property transferred after February 29, 1984.

Disguised sales

The Senate amendment generally is consistent with the House bill with two modifications. First, clarifying amendments explicitly limit the provision to cases in which a transfer of money or property to a partnership and a related transfer of money or property by the partnership are, when viewed together, properly characterized as a sale of property. Second, the provision applies to property transferred after March 31, 1984, except for property transferred before December 31, 1984, if (1) there was a written private placement offering memorandum in existence on February 29, 1984, (2) the partner had expended $250,000 in connection with the offering of February 29, 1984, (3) the partner contributing encumbered property is the sole general partner, and (4) all of the encumbrances incurred in anticipation of the contribution are without recourse.

Definition of partner

The Senate amendment contains no provision relating to the definition is a partner, since Treasury's general regulatory authority will permit it to prescribe rules to prevent abuses.

Conference agreement

The conference agreement follows the Senate amendment.

The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner.

Effective dates.—The provision of the conference agreement relating to disguised payments for services or property apply to services performed or property transferred after February 29, 1984. The provision relating to disguised sales of property apply to property transferred after March 31, 1984, with two exceptions. First, the conference agreement includes the transitional rule of the Senate amendment for certain transfers for which there was a written private placement offering in existence on February 29, 1984. Second, the agreement provides a transitional rule, for any transfer of property pursuant to a contract which was a binding contract on March 31, 1984, and at all times thereafter.

b. Character of gain or loss on contributed property

Present law

The character of income or loss from the disposition of property by a partnership is generally determined at the partnership level. Under present law, a contribution of property to a partnership by a partner, followed by a sale of the property, may result in a character of gain or loss different from that which would have resulted from a direct sale by the partner. Thus, taxpayers have contended that ordinary income may be converted into capital gain when dealer status exists at the partner but not at the partnership level and that capital loss may be converted into ordinary loss when dealer status exists at the partnership but not the partner level.

This result can be contrasted with the treatment of certain ordinary income property distributed by a partnership and subsequently sold by the recipient. The character of gain or loss on property in such a case generally is determined by the character of the property in the hands of the distributee with two exceptions. First, in the case of certain inventory items, the ordinary income character of an asset in the hands of the partnership carries over to the partner for a 5-year period. Second, the ordinary income character of certain unrealized trade or business receivables also carries over to the partner on an indefinite basis (sec. 735).

House bill

Under the House bill, if a partnership disposes of property which was inventory property in the hands of a partner immediately before its contribution, then any gain or loss recognized by the partnership on the disposition of the property during a period of 5 years after the date of the contribution will be treated as ordinary income or loss. Gain or loss on a disposition of unrealized receivables contributed by a partner will be treated as ordinary income or loss regardless of the date of disposition. The House bill also provides that built-in losses on capital assets will retain their character as capital losses for a period of 5 years after the date of contribution, but only to the extent of pre-contribution unrealized losses.

The bill further provides that, for purposes of the rules regarding contributed and distributed property (i.e., the new rules and section 735 of present law but not section 751), certain trade or business property which would qualify as a capital asset under section 1231 if held for one year or more by the partner or partnership prior to contribution or distribution (as the case may be) will not be treated as ordinary income property. Also, if property subject to section 724 or section 735 is disposed of in a nonrecognition transaction, the treatment of the transferred property will carry over to any substituted basis property resulting from the transaction (other than stock of a Subchapter C corporation received in a section 351 transfer).

The provisions apply to property contributed (or distributed in the case of section 735) after March 31, 1984.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

c. Transfers of partnership interests by corporations

Present law

The gain or loss on the sale or exchange of a partnership interest is generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (sec. 751). For purposes of this provision, ordinary income items include the recapture of depreciation deductions previously taken on partnership property.

Also under present law, when a corporation distributes property (or sells property in the course of certain complete liquidations), income attributable to recapture property (and certain installment obligations) is taxed to the corporation, while other gain attributable to appreciation in value of the transferred property generally goes unrecognized.

Some taxpayers have taken the position that the present law recapture provisions can be avoided by the distribution or liquidating sale by a corporation of an interest in a partnership that holds recapture property. The United States Claims Court rejected this position in *Holiday Village* v. *United States*, No. 87-82T (June 6, 1984).

Basis adjustment.—Under present law (secs. 743 and 754), on a sale or exchange of interests in the partnership (or a transfer by reason of death) a partnership may elect to adjust the basis of partnership assets to reflect differences between the basis of partner's interest in the partnership and the partner's share of the basis of the partnership property. The election must apply to all sales or exchanges of partnership interests and may be revoked only for sufficient reason (Treas. Reg. sec. 1.754-1(c)).

House bill

For purposes of determining the amount of gain recognized by a corporation on any distribution, the House bill treats the distribution of a partnership interest as a distribution of the corporation's proportionate share of the recognition property of the partnership. Recognition property is defined as any property with respect to which the corporation would recognize gain if it distributed the property in a distribution (sec. 311 or 336) or sold the property in a liquidation sale (sec. 337).

Basis adjustments.—Under the House bill, when a partnership has an appropriate election in effect, the basis of partnership property may be adjusted following the distribution of an interest in a partnership to reflect differences between the basis of the distributee partner's interest in the partnership and the distributee partner's share of the basis of the partnership property (secs. 743 and 754).

These provisions apply to distributions, sales, and exchanges made after March 1, 1984, in taxable years ending after that date.

Senate amendment

The Senate amendment generally is the same as the House bill, except that the provision applies to distributions, sales, or exchanges made after March 31, 1984, in taxable years ending after that date.

Conference agreement

The conference agreement follows the Senate amendment with technical changes affecting the placement of the new provision within the Internal Revenue Code and providing that for purposes of section 708, section 743, or any other provision of subchapter K specified in regulations (not just section 743 as in the House bill and Senate amendment) a distribution of a partnership interest by a partnership or corporation will be treated as a sale or exchange of the interest. The conference agreement also replaces a specific technical amendment to section

751 in the Senate amendment with a general provision under which, in determining the amount of gain or loss with respect to property, for income tax purposes, fair market value with respect to property shall not be treated as less than the amount of any nonrecourse liability to which the property is subject. Of course, this provision would, have no application to transactions covered by section 751(c). The conferees stress that no inference is intended as to whether or not the results obtained by the provisions of this section differ from those obtained under current law.

These provisions apply to distributions, sales, and exchanges made after March 31, 1984.

d. Use of tiered partnerships to alter character of income on exchanges of partnership interest

Present law

Under present law, some taxpayers have argued that ordinary income treatment of unrealized receivables and substantially appreciated inventory may be avoided when the assets are held in a lower-tier partnership. Thus, if all of the assets held in a lower-tier partnership are section 751 assets, it is not entirely clear whether the ordinary income rules of section 751 should be applied by regarding an exchange of interests in the upper-tier partnership as an exchange of a capital asset (the interest in the lower-tier partnership) or of ordinary income assets (the section 751 assets held by the lower-tier partnership).

House bill

Under the House bill, it is made clear that the ordinary income rules of section 751 require fragmentation of the partnership's section 751 items from the partnership interest. Under this approach, a partner will be treated as disposing of such items independently of the rest of his partnership interest. The rule will apply regardless of how many tiers of partnerships exist between the transferor partner and the ordinary income assets.

The bill also provides that this approach regarding the fragmentation of section 751 items is to apply to interests in trusts in the manner provided for in regulations.

The provision is effective for distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

3. Exchanges of like-kind property

Present law

An exchange, like a sale of property, is generally a taxable transaction. However, present law provides that no gain or loss is to be recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment. This provision (sec. 1031) specifically does not apply to exchanges of stock in trade or other property held primarily for sale, or to stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.

Present law does not require specifically that a like-kind exchange be completed within a specified period in order to qualify for tax-free treatment. In *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979) the United States Court of Appeals for the Ninth Circuit held that an exchange qualified for like-kind treatment even though the property to be exchanged could be designated by the transferor for up to 5 years after the transaction and even though the transferor could have ultimately received cash rather than like-kind property.

Present law does not state specifically whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property.

House bill

The House bill provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days after the date on which the taxpayer relinquishes property (or after the due date of the taxpayer's tax return) is not to be treated as like-kind property.

Also, the like-kind exchange rules will not apply to any exchange of interests in different partnerships.

The provision relating to deferred like-kind exchanges is effective for transfers after the date of enactment. For transfers on or before date of enactment, any property received after December 31, 1986, will not be treated as like-kind property. The provision relating to partnership exchanges is effective for transfers of property after March 31, 1984, other than exchanges made pursuant to binding contracts entered into on or before March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill, with two modifications. First, property which was not identified as the property to be received by the taxpayer on the date the transferred property was relinquished will not qualify as like-kind property. Second, the provisions apply to transfers after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment except that transferors are permitted 45 days after the transfer to designate the property to be received and that a modified form of the effective date provisions of the House bill are adopted. The conferees note that the designation requirement in the conference agreement may be met by designating the property to be received in the contract between the parties. It is anticipated that the designation requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer property 1 to A if zoning changes are approved and property 2 if they are not, the exchange would qualify for like-kind treatment. As under present law, these new rules would not permit a taxpayer who receives cash and later purchases the designated property to claim like-kind exchange treatment.

Effective dates.—The provision relating to deferred like-kind exchanges is effective for transfers after the date of enactment. For transfers on or before date of enactment, any property received after December 31, 1986, will not be treated as like-kind property, except if the property to be received was designated in a written binding contract entered into before June 14, 1984, then the property must be received on or before December 31, 1988. The provision relating to partnership exchanges is effective for transfers of property after the date of enactment other than exchanges made pursuant to binding contracts entered into on or before March 1, 1984. In the case of any transfer on or before the date of enactment which the taxpayer treated as part of a like-kind exchange and which is liable as a result of this provision, the period for assessing any deficiency of tax shall not expire prior to January 1, 1988.

The conference agreement also provides that the prohibition on like-kind exchange treatment for transfers of partnership interests is not to apply when general partnerships interests are exchanged pursuant to a plan of reorganization of ownership interests which took effect on March 29, 1984, provided that all of the exchanges contemplated by the reorganization plan are completed on or before December 31, 1984.

4. Use of tiered partnership to achieve step-up in basis of partnership assets

Present law

Under present law, a distribution of property by a partnership to a partner may result in an increase or decrease to the adjusted basis of such property in the hands of the distributee partner. In such cases, present law permits (but does not require) the partnership to adjust the basis of remaining partnership assets to take account of the change in the basis of the distributed property. In addition, when a partnership interest is sold or exchanged, present law permits (but does not require) the basis of partnership assets to be adjusted to reflect the difference between the transferee's adjusted basis in his interest and his share of the basis of all partnership assets. These basis adjustments are permitted only if the partnership makes a valid election which, once made, may be revoked only upon a showing of sufficient reason and applies to al distributions by a partnership and to all transfers of interests in the partnership.

Under present law, it may be possible in a tiered partnership arrangement to manipulate the basis adjustment provisions to inflate artificially the adjusted basis of property held by the partnership, as illustrated by the example contained in the report of the House committee.

House bill

The House bill prohibits an upper-tier partnership from adjusting the basis of its property following a distribution of an interest in a lower-tier partnership if the lower-tier partnership does not have a section 754 election in effect. This provision will prevent taxpayers from achieving a step-up in the basis of assets by means of inconsistent elections under section 754.

This provision is effective for distributions after March 1, 1983, in taxable years ending after that date.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

5. Allocation of liabilities to partners

Present law

A partner may deduct his allocable share of partnership losses to the extent of the adjusted basis of his partnership interest. A partner's basis includes both the amount of any partnership debt for which the partner assumes liability and the amount of the partner's share of partnership liabilities. In the case of partnership debt for which neither the partnership nor any partner has any personal liability (i.e. nonrecourse debt), all partners (including limited partners) increase their basis by a share of the nonrecourse debt (determined in accordance

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with their respective interests in partnership profits).

In *Raphan* v. *United States* (United States Claims Court, No. 452-78, September 26, 1983) the court held that a general partner who guaranteed repayment of what was otherwise a nonrecourse debt of the partnership was not to be treated as personally liable for such debt. Thus, the debt retained its nonrecourse status, and the limited partners were entitled to take into account a portion of such debt in computing the basis of their partnership interests.

House bill

The House bill directs the Treasury to prescribe regulations concerning the inclusion of partnership liabilities in the basis of the partners' partnership interests, and to take into account, where possible, the manner in which the partners share the economic risk of loss with respect to the borrowed amounts. The report of the House committee anticipates that these regulations will, among other things, reflect the position taken in Rev. Rul. 83-151, 1983-43 I.R.B. 6, and will reject the holding in *Raphan* v. *United States*. Thus, the regulations will specify that a partnership debt for which a partner is primarily or secondarily personally liable, whether in his capacity as a partner or otherwise, is not a nonrecourse debt, and thus generally does not provide limited partners with additional basis for their partnership interests. Similarly, when a limited partner guarantees what is otherwise a nonrecourse debt of the partnership, the regulations will not shift the basis attributable to that debt away from the limited partner as a result of the guarantee.

This grant of regulatory authority will take effect upon enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill in substance with certain modifications. Under the agreement, the decision in the *Raphan* case is not to be followed for purposes of applying section 752 or the regulations thereunder. In addition, the Treasury is to revise and update its regulations under section 752 (as soon as practicable) to take account of current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc. The conferees intend that the new regulations will reject the holding of the *Raphan* decision effective March 1, 1984, and that other changes in the regulations will apply prospectively from the date new regulations are proposed or some later date specified by the Treasury. The conferees do not intend that any inference should be drawn regarding the validity of the *Raphan* decision for transactions prior to March 1, 1984, and the conferees do to intend to affect in any way the rights of the various parties to that case. Finally, the conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt, as defined by such regulations). With respect to bona fide nonrecourse debt, the conferees do not expect that such regulations will make major changes to the manner in which the partners' shares are determined, but may attempt to provide more certainty than presently exists.

F. Trust Provisions

1. Trust distributions

Present law

Under present law, beneficiaries are taxed on amounts distributed from a trust or estate to the extent of the trust's or estate's distributable net income. The trust or estate is allowed a deduction for amounts taxed to its beneficiaries. Present Treasury regulations provide that distributions of property are deemed to carry out distributable net income to the extent of the property's value at the time of distribution. In such a case, there is no gain or loss realized by the trust or estate, and the basis of the property in the hands of the beneficiary generally is its value to the extent it carries out distributable net income. (Treas. Reg. sec. 1.66-1(a)-2(f)).

House bill

Under the House bill, the distribution of property by a trust or estate results in the recognition of gain or loss on the distribution as if the property had been sold to the beneficiary. Alternatively, the bill allows the trustee or executor to elect to treat distributions of property as carrying out distributable net income only to the extent of the lesser of the property's basis or its fair market value at the time of distribution. If the election is made, the basis of the property in the hands of the beneficiary will be the same as the trust's or estate's basis.

The provision does is effective with respect to distributions made after March 1, 1984, in taxable years ending after that date.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment with a technical modification providing that distributions of appreciated property result in gain to the trust only if the trustee elects. If no election is made, such a distribution is treated as carrying out distributable net income only to the extent of the lesser of the property's basis or its fair market value at the time of the distribution. In such a case, the basis of the property in the hands of the beneficiary will be the same as the trust's or estate's basis.

The conference agreement clarifies that this provision does not affect the uniform basis rules of the Code (such as the rule providing a basis adjustment for property received in satisfaction of a pecuniary bequest).

Additionally, the conferees do not intend that this provision will change the present law tax effects of charitable contributions. For example, if a trust beneficiary makes a gift to a charitable organization property received in an in-kind distribution, that transfer is not to be considered a taxable disposition within the meaning of the Code. The present law rules governing gifts of appreciated property will continue to apply to such gifts.

Finally, the conference agreement provides that the provision applies to trust distributions after June 1, 1984, in taxable years ending after that date.

2. Taxation of multiple trusts

Present law

Treasury regulations promulgated following the Tax Reform Act of 1969 provided that multiple trusts are treated as one trust if the trusts had (1) the same grantor and substantially the same beneficiaries, (2) no substantially independent purposes, and (3) as their principal purpose, the avoidance or mitigation of progressive rates of tax or of the alternative minimum tax.

In *Edward L. Stephenson Trust* v. *Commissioner*, 81 T.C. 283 (1983), the Tax Court held that the Treasury regulations were invalid because the regulations were inconsistent with the intent of Congress regarding the tax treatment of multiple trusts.

House bill

The House bill provides that, under Treasury regulations, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax.

This provision is effective for taxable years beginning after March 1, 1984.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

G. Accounting Changes

1. Premature accruals

Present law

Under the accrual method of accounting, an expense is generally deductible in the taxable year in which (1) all the events have occurred that determine the fact of the liability and (2) the amount of the liability can be determined with reasonable accuracy (the so-called "all events test"). Whether an expense involving a future obligation can satisfy the all events test in a year significantly earlier than the year in which the taxpayer must fulfill the obligation has been the subject of controversy under present law. Neither the Internal Revenue Code nor case law requires a taxpayer to account for future expenses on a present value basis.

The Code allows a deduction for contested liabilities if (1) the taxpayer contests the asserted liability, (2) the taxpayer transfers money to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the liability is contested, a deduction would be allowed for the taxable year of transfer or for an earlier taxable year (sec. 461(f)).

House bill

In general, the House bill provides that in determining whether an accrual method taxpayer has incurred an amount during the taxable year, all the events which establish the taxpayer's liability for such amount will not be deemed to have occurred any earlier than the time when economic performance occurs. If economic performance has occurred, the amount will be treated as incurred for all purposes of the Code. Amounts incurred are deductible currently only if they are not properly chargeable to a capital account and are not subject to any other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs.

Economic performance

The House bill provides principles for determining when economic performance occurs in the case of two categories of liabilities: (1) liabilities arising from another person's providing of goods or services or the use of property to the taxpayer; and (2) liabilities of the taxpayer to provide property or services. Economic performance occurs with respect to the first category as the property or services are provided to the taxpayer. Economic performance occurs with respect to the second category as the taxpayer provides the property or services.

A special rule is also provided for tort liabilities, liabilities arising under a worker's

compensation act, and or employee benefit liabilities. In these situations, economic performance occurs as payments are made in satisfaction of the liability.

In the case of any type of liability not specifically described by the bill, economic performance will occur at the time determined under Treasury regulations.

Exceptions.—The economic performance standard will not apply to a liability of the taxpayer to provide benefits to employees of the taxpayer through a qualified pension, profit-sharing, or stock bonus plan described in section 404 or 404A; to contributions to a funded welfare benefit plan to which section 419 (as added by the bill) applies; or to items the time for deduction of which is determined under other sections of the Code, including additions to a bad debt reserve (sec. 166), vacation pay (sec. 463), qualified discount coupons (sec. 466), and additions to reserves by insurance companies subject to tax under subchapter L.

Net operating loss carrybacks

The House bill provides a 10-year carryback for net operating losses attributable to certain liabilities deferred under these provisions. The bill also provides a special carryback rule for losses incurred in connection with the decommissioning of a nuclear power plants. Such losses may be carried back to each of the taxable years during the period beginning with the taxable year in which the plant was placed in service. No loss, however, may be carried back to a taxable year beginning before January 1, 1984, unless it may be carried back without regard to these rules.

The provisions of the bill apply generally to expenses incurred (without regard to the economic performance requirement) after the date of enactment.

Senate amendment

The Senate amendment is generally the same as the House bill with the following exceptions.

First, if a taxpayer has a liability to provide benefits to employees (other than through a plan to which section 404 or 404A applies), and if payments with respect to such liabilities are made within 2½ months after the end of the taxable year, economic performance is treated as occurring in such taxable year. For contributions to certain trusts, including funded welfare benefit plans, economic performance occurs as payments are made to the plan.

Second, the Senate amendment clarifies that the economic performance standard must be satisfied before a deduction is allowable under section 461(f) (relating to contested liabilities).

The Senate amendment also includes provisions relating to current deductions for certain nuclear power plant decommissioning expenses and mine reclamation and similar costs (see items 2 and 3, infra). A special NOL carryback rule, under which carrybacks would not be limited to taxable years beginning on or after January 1, 1984, is also provided.

The amendment applies to expenses incurred under current law after the date of enactment and to expenses incurred under current law prior to the date of enactment with respect to which economic performance occurs after the date of enactment. The rules of section 481 would apply to require any adjustments necessary to prevent double deductions.

Conference agreement

The conference agreement generally follows the House bill, with modifications. However, the agreement adopts the Senate amendment's provisions relating to nuclear power plant decommissioning costs and to costs associated with the reclamation and closing of mine and solid waste disposal sites, with certain modifications (see Items 2 and 3, infra).

Exception from economic performance requirement for certain recurring items

In many ordinary business transactions, economic performance may not be met until the year following the year in which the all events test is otherwise satisfied. To avoid disrupting normal business and accounting practices and imposing undue burdens on taxpayers, the conference agreement provides an exception under which certain expenses may be treated as incurred in the taxable year in which the all events test is otherwise met even though economic performance has not occurred. This exception applies if four conditions are met: (1) the all events test, without regard to economic performance, is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8½ months) after the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently treats items of that type as incurred in the taxable year in which the all events test is met; and (4) either (a) the item is not material or (b) the accrual of the item in the year in which the all events test is met results in a better matching of the item with the income to which it relates than would result from accruing the item in the year in which economic performance occurs.

This exception does not apply to workers' compensation liabilities, tort liabilities, or deferred compensation that is subject to the rules of section 404 as amended by the conference agreement.

Recurrency and consistency.—In determining whether an item is recurring in nature and is consistently reported by the taxpayer, consideration should be given to the frequency with which the item and similar items are incurred (or expected to be incurred) and the manner in which these items have been reported for Federal income tax purposes. The conferees intend for this exception to be available to taxpayers starting up a trade or business as well as to taxpayers already in a trade or business. In addition, a new type of expense or expense that does not recur every year should not necessarily be excluded from this exception.

Materiality.—The factors taken into account in determining the materiality of an item will include the size of the item, both in absolute terms and in relation to the taxpayer's income and other expenses, and the treatment of the item on the taxpayer's financial statements. If an item is considered material for financial statement purposes, it will also be considered material for tax purposes.

For example, assume that a calendar-year taxpayer enters into a one-year maintenance contract on July 1, 1985. If the amount of the expense is prorated between 1985 and 1986 for financial statement purposes, it also should be prorated for tax purposes. If, however, the full amount is deducted in 1985 for financial statement purposes because it is not material under generally accepted accounting principles, it may (or may not) be considered an immaterial item for purposes of this exception.

In some circumstances, items that are not material for financial accounting purposes will be treated as material items under this provision. For example, an item of expense which is immaterial for purposes of consolidated financial statements that combine a corporate taxpayer's financial data with those of affiliated companies may be material if the taxpayer is viewed separately. The conferees intend that where the item is directly related to an activity, the materiality of the item will be separately determined with respect to that activity. The materiality of overhead expenses that relate to several activities of the taxpayer will be measured against those collective activities.

In the case of any partnership or other pass-through entity, the conferees intend that in appropriate circumstances and to the extent provided in regulations, an item will be considered immaterial only if it is not material when analyzed at both the entity and at the partner (or, in the case of a trust or estate, beneficiary) level. Thus, an item that may not be material at the partnership level may be material at the partner level. Application of this rule may be appropriate, for example, when a partner invests in an accrual method partnership that makes a special allocation to the partner of an item that is not material to the partnership but is material to the partner. The conferees intend this rule to be applied in such a manner that no significant additional reporting requirements be imposed on partnerships and other flow-through entities in nonabusive situations.

Finally, the conferees intend that the above standards for determining whether an item is a material item apply only for purposes of the recurring item exception to the economic performance test. No inference is implied with respect to whether an item is material for purposes of any other Code provision. For example, an item that may not be considered material for purposes of the economic performance test may nevertheless be material for purposes of the fraud and false statement provisions of the Code (sec. 7206(1)). Likewise, an item that is not material under the economic performance exception may be material under the provisions relating to changes in methods of accounting (see Treas. reg. sec. 1.446-1(e)(2)(ii)(a)).

Matching.—In determining whether the accrual of an item in a particular year results in a better matching of the item with the income to which it relates, generally accepted accounting principles will be an important factor, although not necessarily dispositive. Costs directly associated with the revenue of a period are properly allocable to that period.[1] For example, a sales commission agreement may require certain collection activities to be performed in a year subsequent to the year in which sales income is reported. In such a case, economic performance with respect to some portion of the liability to pay the commission may not occur until the following year. Nevertheless, deducting the commission expense in the year in which the sales income is reported results in a better matching of the commission expense with the sales income. Likewise, if income from the sale of goods is recognized in one year, but the goods are not shipped until the following year, the shipping costs are more properly matched to income in the year the goods are sold rather than in the year the goods are shipped.

Expenses such as insurance or rent generally can be allocated to a period. Thus, a calendar year taxpayer with a twelve-month insurance contract entered into on July 1, 1984, generally should allocate one-half the expense to 1984 and one-half to 1985. In appropriate circumstances, however, the expense may be an immaterial item and accruable in its entirety in 1984. Expenses such as advertising costs that cannot practi-

[1] "Basic Features and Basic Elements of Financial Accounting," *AICPA Professional Standards*, AC sec. 1025.19.

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cally be associated with income of a particular period may under generally accepted accounting principles be assigned to the period in which the costs are incurred. The conferees intend that, in general, the matching requirement will be satisfied with respect to advertising expenses if the period to which the expenses are assigned for tax and financial reporting purposes is the same.

Modifications and clarifications with respect to economic performance standard

Interest.—In the case of interest, economic performance occurs with the passage of time (that is, as the borrower uses, and the lender foregoes use of, the lender's money) rather than as payments are made. Interest incurred by accrual method taxpayers with respect to debts incurred in transactions occurring after June 8, 1984, the date of conference action, will be deductible only on a constant interest basis. (See sec. 44 of the conference agreement relating to the effective date of the OID and unstated interest rules). Interest on obligations issued on or prior to that date are not subject to the statutory prohibition against noneconomic accruals of interest. However, the conferees intend no inference regarding the propriety of interest accruals with respect such obligations that are inconsistent with the principles stated in Rev. Rul. 83-84.

Payments for nuclear waste disposal.—The conferees anticipate that the Treasury Department will issue regulations providing that economic performance with respect to amounts paid under the Nuclear Waste Disposal Act of 1982 occurs as payments are made to the Federal government.

Natural gas refunds.—Regulated natural gas utilities may receive refunds from their suppliers for amounts they have been overcharged. Generally, these refunds are made to the utilities pursuant to regulatory commission orders and must be passed through to customers, usually within 8 to 12 months after receipt. Rev. Rul. 63-182, 1963-2 C.B. 194, which interpreted the all events test under existing law, permits a utility to deduct the amount refunded to customers in the year the refunds are received by the utility rather than in the year the refunds are passed through to customers.

The conferees intend that the Treasury Department have authority under the conference agreement to provide that, in the case of natural gas supplier refunds, a utility may deduct such refunds in the year the refund is included in the income of the utility, provided that the refunds are passed through to consumers within a reasonable period of time in the following taxable year and that adequate interest is paid over to and includible in the income of the consumers.

Reliance on other existing rulings and regulations.—The conferees expect that the Treasury Department will review existing regulations and rulings to determine whether they are consistent with the policies and principles set forth herein. Until new regulations are issued under these provisions or the existing rulings are revoked or clarified, taxpayers may continue to rely on these rulings to the extent they are not inconsistent with the general principles of economic performance or the generic exception for recurring items. Likewise, the conferees expect that taxpayers may rely on present law with respect to agreements entered into with the Internal Revenue Service (for example, under section 446 or 7121 of the Code or Rev. Proc. 80-51, 1980-2 C.B. 818), until new regulations are issued.

Contested liabilities.—The conference agreement adopts the Senate amendment's provision requiring economic performance before an amount transferred to a section 461(f) trust may be deducted. In the case of workers' compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant and does not discharge the taxpayer's liability to the claimant, such payment does not satisfy the economic performance test.

Proof of compliance with economic performance standard.—The conferees intend that enforcement of compliance with the economic performance standard be carried out in a manner that does not impose substantial additional recordkeeping burdens on taxpayers. In the absence of unusual circumstances, the existence of a valid contract requiring another person to provide property or services to the taxpayer prior to the end of the taxable year (or 8½ months thereafter in the case of recurring items) would be sufficient to establish compliance with the economic performance standard with respect to the taxpayer's liability for an expense reflected in such contract.

More lenient standards may be warranted where an item is incurred by a foreign corporation.[8] The conferees recognize that information regarding economic performance, which in some cases must be obtained from third parties, may be especially difficult to obtain in this situation, particularly if the U.S. taxpayer owns only a minority interest in the foreign corporation. The conferees expect that regulations to be prescribed by the Treasury Department will provide that economic performance will be treated as having occurred by a particular date if the best available evidence indicates that it has so occurred.

Compensation for services.—The conference agreement provides that economic performance with respect to a liability to an employee generally occurs as the employee renders his or her services. However, an employer's deduction for compensation or other benefits paid to an an employee in a year subsequent to economic performance is subject to the rules in the Code (as amended elsewhere in the conference agreement) governing deferred compensation, deferred benefits, and funded welfare benefit plans.

Carrybacks of net operating losses

The conference agreement adopts the provision of the House bill that no net operating loss carrybacks resulting from nuclear decommissioning may be carried back to a taxable year before January 1, 1984, unless such loss may be carried back to such year without regard to these rules.

Effective date

The conference agreement follows the House bill with the following modification: Taxpayers may elect (with respect to each type of deductible item) the provisions of the bill to apply (1) to expenses incurred under current law after the date of enactment (as in the House bill), or (2) to expenses incurred under current law prior to after the date of enactment as to which economic performance occurs after the date of enactment (as in the Senate amendment) with the spread of any section 481 adjustment limited to 3 years.

[8] Even if a corporation is not subject to U.S. tax jurisdiction, its taxable income may be relevant in determining the taxable income of a U.S. shareholder. Taxable income, and thus earnings and profits, of a foreign corporation must be determined according to U.S. tax principles, including the all events and economic performance tests.

2. Nuclear power plant decommissioning expenses

Present law

An accrual-basis taxpayer may deduct an anticipated expense no sooner than the tax year in which (1) all events necessary for determining the existence of the liability have occurred, and (2) the amount of the liability can be determined with reasonable accuracy.

Generally, under Federal and State laws, utilities that operate nuclear power plants are obligated to decommission the plants at the end of their useful lives.

It is unclear under present law when decommissioning expenses are properly accrued.

House bill

The House bill does not except nuclear decommissioning costs from the general rule, adopted in the bill, of allowing accrual basis taxpayers to deduct future liabilities only when economic performance occurs.

Senate amendment

A taxpayer responsible for nuclear power plant decommissioning (the "taxpayer") may elect to deduct contributions to a qualified decommissioning fund, subject to certain limitations.

A qualified nuclear decommissioning fund (a "fund") is a segregated reserve dedicated exclusively for the payment of nuclear decommissioning costs, taxes on fund income, and management costs of the fund. A fund is a separate taxable entity and is taxed at the maximum corporate income tax rate (46 percent). A fund is also subject to rules which (1) limit its investments to the same assets which may be purchased by a Black Lung Disability Trust Fund, (2) prohibit the purchase of a related party's assets, and (3) prohibit self-dealing.

The taxpayer must obtain a ruling from the Secretary to establish the maximum annual deduction that may be claimed for contributions to the fund. The ruling has two purposes: (1) to prevent accumulation of funds in excess of those required to pay future decommissioning costs (attributable to remaining plant life at the date the fund is established), and (2) to ensure that contributions to the fund are not accelerated (i.e., more rapid than level funding). For example, if two-thirds of a plant's useful life remains when a fund is established, then the taxpayer's deduction would be limited to contributions necessary to pay two-thirds of the estimated future decommissioning cost, on a level funding basis. The Secretary shall review this limit at least once during plant life, or more frequently by petition of the taxpayer.

Contributions to a qualified decommissioning fund are deductible, in the year made, but only to the extent these amounts are added to the cost of service charged to customers and included in the taxpayer's taxable income. Withdrawals from a decommissioning fund, for whatever purpose, except payment of taxes imposed on the fund and fund management costs, are included in the taxpayer's taxable income, in the year withdrawn. Amounts paid for decommissioning expenses are deductible from the taxpayer's gross income, as permitted by the Code, in the year paid.

If a decommissioning fund fails to comply with the qualification requirements, it may be disqualified by determination of the Secretary. In the event of disqualification, the Secretary may require that some or all of the fund balance (i.e., principal plus accumulated interest) be included in the taxpayer's taxable income. No deduction is allowed for contributions to a disqualified fund. In the year that plant decommissioning is sub-

stantially completed, the balance of the fund must be included in the taxpayer's taxable income. The Secretary will provide rules for determining when decommissioning is substantially complete.

The Senate amendment also provides that all customer charges for decommissioning expense, whether or not contributed to a qualified fund, must be included in the taxpayer's taxable income in that year.

These provisions are effective for decommissioning fund contributions made after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment with several clarifications.

The conferees intend that where responsibility for decommissioning a nuclear power plant is divided between taxpayers, each taxpayer may establish a fund for their share of the liability.

In the event that a nuclear power plant, or interest therein, is sold or otherwise disposed of prior to completion of decommissioning, the seller's decommissioning fund will be treated as disqualified. A buyer may at the discretion of the Secretary make a one-time deductible deposit, in excess of the annual ruling amount, into a new decommissioning fund. However, the buyer's start-up deposit is limited to the balance of the seller's qualified decommissioning fund.

The conferees recognize the importance of ensuring that utilities comply with nuclear power plant decommissioning requirements. In view of this concern, the conferees believe that it may be appropriate for the tax-writing committees to study further the tax treatment of decommissioning costs, and the merits of providing tax incentives for establishing decommissioning funds.

3. Mine reclamation and similar costs

Present law

An accrual-basis taxpayer may deduct an anticipated expense no sooner than the tax year in which (1) all events necessary for determining the existence of the liability have occurred, and (2) the amount of the liability can be determined with reasonable accuracy.

Federal and State laws (and certain municipal permits and ordinances) require reclamation of surface mines and waste disposal sites. The Internal Revenue Service takes the position that reclamation expenses cannot be accrued until reclamation occurs. Notwithstanding the Service position, the Tax Court in *Ohio River Collieries v. Commissioner* held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed.

House bill

The House bill does not except mine reclamation and similar costs from the general rule, adopted in the bill, of allowing accrual basis taxpayers to deduct future liabilities only when economic performance occurs.

Senate amendment

Taxpayers may elect to deduct mine and waste disposal site reclamation and closing costs, required by certain Federal and State statutes, prior to economic performance under a uniform method. Hazardous waste disposal sites, to which the Comprehensive Environmental Compensation and Liability Act of 1980 applies, are excluded from this provision.

Site reclamation costs

Electing taxpayers may deduct certain estimated reclamation costs, in current dollars, for land that is disturbed during the tax year, discounted at a compound rate of 2 percent per annum.

Site closing costs

Electing taxpayers may deduct certain estimated site closing costs, in current dollars, attributable to minerals mined (waste deposited) during the tax year, based on the units of production (capacity) method, discounted at a compound rate of 2 percent per annum.

Sinking funds

All amounts deducted for the cost of reclaiming a parcel of land are deemed deposited in a parcel-specific, tax-exempt sinking fund that is deemed to earn interest at 50 percent of the short-term rate provided in Code section 1274 (i.e., 110 percent of the short-term Federal rate). All amounts deducted for site closing costs are deemed deposited in a tax-exempt sinking fund, on a site by site basis, which earns interest at 50 percent of the long-term section 1274 rate. The balance of each sinking fund includes all deemed deposits and associated interest.

Amounts expended for qualified reclamation and site closing activities, allocable to land disturbed or units of production (capacity) subsequent to the date of election, are deductible in the year paid. Such amounts are deemed withdrawn from the applicable sinking fund, to the extent of its remaining balance, and the withdrawal is included in taxable income in that year.

The balance of each reclamation sinking fund is recaptured (i.e., included in taxable income) when reclamation of the parcel (with respect to which deductions were claimed) is substantially completed, but no later than the end of the third taxable year subsequent to creation of the sinking fund. Similarly, the balance of the site closing sinking fund is recaptured when site closing is substantially completed.

Effective date

The Senate amendment is effective after the date of enactment subject to two transition rules: (1) with respect to fixed price mineral supply contracts, entered into prior to March 1, 1984, taxpayers may continue existing accounting practices provided that deductions are taken on a current dollar cost basis, and (2) the Service may not challenge a taxpayer's entitlement to deductions, taken prior to March 1, 1984, for land disturbed or units produced prior to March 1, 1984, on the basis that the liability has not been incurred, if the deductions were based on current dollar cost estimates. (However, the deductions could be challenged on the basis that costs were not estimated with reasonable accuracy.)

Conference agreement

The conference agreement generally follows the Senate amendment with several clarifications and modifications.

In the case of mining, a site is defined as a "property" within the meaning of Code section 614. The conferees intend that the election to deduct reclamation and closing costs under this provision must be made for a site in its entirety. Where an election is made and responsibility for site reclamation and closing is divided between taxpayers with an interest in the site, each taxpayer may claim deductions (subject to the recapture rules) for their share of the liability. For each site, the election may be revoked by the taxpayer; however, the balance of the site reclamation and closing funds must be included in income in that tax year, and the election may not be reinstated.

Hazardous waste site reclamation and closing costs, incurred pursuant to the requirements of certain Federal and State statutes, are included in the conference agreement, except for sites listed in the National Contingency Plan (established under section 105 of the Comprehensive Environmental Compensation and Liability Act of 1980). Waste disposal site reclamation and closing expenses that arise from compliance with a municipal permit or ordinance, rather than a Federal or State statute, are included in the conference agreement.

The conference agreement simplifies the Senate amendment in several respects. The requirement to discount (at 2 percent per annum) deductions for future reclamation and site closing costs is eliminated. The requirement to account for reclamation sinking fund deductions on a parcel by parcel basis is eliminated. A single reclamation sinking fund is required with respect to each site. The requirement to recapture the balance of a reclamation sinking fund no later than three years after the end of the tax year in which the fund was created is also eliminated.

Amounts expended for qualified reclamation and site closing activities, allocable to land disturbed or units of production (capacity) subsequent to the date of election are deemed withdrawn from the applicable sinking fund in the year paid. Unlike the Senate bill, such withdrawals are not included in taxable income. However, only the excess of the amount paid for reclamation and closing activities over the year-end sinking fund balance (after deemed deposits and interest) is deductible in the year paid.

The deemed interest rate on the site reclamation and closing sinking funds is determined according to the following schedule: 70 percent of the short-term rate provided in Code section 1274 (compounded semiannually) in tax years ending in 1984 and 1985, 85 percent in 1986, and 100 percent in tax years ending on or after January 1, 1987.

The conferees agreed that the balance of the site reclamation and closing sinking funds should be subject to a reasonable limitation in order to prevent abuse of this provision. Amounts in the site reclamation and closing sinking funds in excess of these limits, at the end of each tax year (after deemed deposits, interest, and other withdrawals) are deemed withdrawn and are included in that year's taxable income.

The balance of the site reclamation sinking fund, at the end of each tax year, is limited to the current cost of reclaiming land that has been disturbed, subsequent to the date of election, but not previously reclaimed. For example, if at the end of the first tax year after site opening 20 acres have been disturbed and the per acre cost of reclamation is $10, then $200 (10 x $10) may be deducted in that year and the sinking fund balance is limited to the same amount. If at the end of the second tax year 20 additional acres are disturbed, the per acre cost of reclamation has risen to $11, and no reclamation work has been paid for, then $220 (20 x $11) may be deducted in that year and the sinking fund balance is limited to $440 (40 x $11).

The balance of the site closing sinking fund, at the end of each tax year, is limited to the current cost of closing the portion of the site which has been utilized (based on a units of production or capacity method), subsequent to the date of election. For example, suppose that site capacity is 500 units, 100 units are produced (or utilized) at the end of the first year, and the current cost of closing the entire site is $1,000. In this case, $200 ($1,000 x 100/500) may be deducted in that year and the sinking fund balance is limited to the same amount. If at the end of the second tax year an additional 100 units are produced and the current cost of site closing has risen to $1,100, then $225 may be deducted (i.e., the unrecovered cost of current site closing ($1,100-$200) times the proportion of remaining units produced

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during the tax year 100/(500–100)) and the fund balance is limited to $440 ($1,100 x 200/500).

In the event that a mine or waste disposal site is sold or otherwise disposed of prior to completion of site reclamation and closing, the conferees intend that the seller will recognize the outstanding balance of site reclamation and closing sinking funds in income. If any portion of the site is disposed of, then this portion of the site's reclamation and closing funds are subject to recapture. Recapture of sinking fund balances is also required at the end of the tax year in which a waste disposal site is listed on the National Contingency Plan.

The conference agreement clarifies that reclamation activities, for purposes of this provision, are limited to those activities performed prior to site closing and in connection with reclaiming land disturbed on the mine (or waste disposal) site.

Effective date

Minerals are considered sold subject to a fixed price agreement if their price is determined strictly in accordance with a formula which was fixed as of March 1, 1984 and does not permit, either directly or indirectly, adjustment for changes in tax liability.

The conference agreement clarifies that the fixed price mineral supply contract transition rule applies on a pro rata basis according to units of production. For example, if site production is 100 tons in a tax year, of which 40 tons is sold pursuant to a fixed price supply contract, then only 40 percent of the site reclamation and closing costs allocable to that year (based on current dollar cost estimates) are deductible in that year. If an election were made, then 60 percent of site reclamation and closing costs would be deductible, under the general rules of this provision.

If deductions are claimed pursuant to the fixed price supply contract transition rule, in connection with a site where the taxpayer has made an election, then amounts expended for qualified site reclamation and closing activities, allocable to land disturbed or units produced subsequent to the date of election, are deemed withdrawn from the applicable sinking fund on a cumulative units of production basis. For example, suppose that as of the end of tax year 1990, 500 tons have been produced from a site subsequent to the date of election, of which 300 tons were sold pursuant to fixed price supply contracts, and deductions were claimed in accordance with the transition rule. If the taxpayer paid $1,000 for site reclamation in 1990, then only $400 (200/500 x $1000) would be deemed withdrawn from the site reclamation sinking fund. Similarly, the limitation applicable to the site reclamation (closing) fund would be equal to 40 percent of the current cost of reclaiming (closing) the site attributable to land disturbed (units produced) subsequent to the date of election.

4. Prepaid expenses

Present law

Except with respect to prepaid interest and prepayments by farm syndicates, the Internal Revenue Code contains no provisions expressly prescribing the proper timing of deductions for prepaid items in the case of cash-method taxpayers. Under the weight of judicial authority and Internal Revenue Service rulings, a prepaid expense is deductible when paid only if (1) the expenditure is a payment and not merely a deposit, (2) there is a business purpose for the prepayment, and (3) deduction of the expense in the year of prepayment does not result in a material distortion of the taxpayer's income.

In the case of interest, deductions are allowed only for the year to which the interest relates. Deductions of certain farm syndicates are also limited to certain periods to which the expenses relate.

Expenditures that result in the creation of an asset having a useful life extending substantially beyond the close of the taxable year may not be deducted in full currently, but must be capitalized.

House bill

A tax shelter computing taxable income under the cash receipts and disbursements method will not be allowed a deduction with respect to any amount earlier than the time at which such amount is treated as incurred (i.e., properly deductible under the accrual method of accounting). An amount will not be treated as incurred at any time earlier than the time at which economic performance occurs. Thus, a cash basis tax shelter may not deduct an amount until both economic performance has occurred and the amount has been paid.

Under the House bill, a tax shelter means (1) a partnership or other enterprise (other than a corporation which is not an S corporation) in which interests have been offered for sale, at any time, in any offering required to be registered with a Federal or State agency; (2) a partnership or other enterprise if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise); or (3) any partnership, entity, plan, or arrangement which is a tax shelter within the meaning of section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax.)

Senate amendment

Certain taxpayers engaged in the trade or business of farming who compute taxable income under the cash receipts and disbursements method are not allowed a deduction with respect to any amount paid for feed, seed, fertilizer, and other similar farm supplies earlier than the time when the feed, seed, fertilizer, or other supplies are actually used or consumed.

This provision generally applies to any person engaged in the trade or business of farming if more than 50 percent of such person's farming expenses paid during the taxable year are prepaid expenses.

The Senate amendment provides two exceptions to the 50-percent test. If either of these two exceptions are met, prepaid expenses continue to be deductible as allowed by present law, even though those prepaid expenses are greater than 50 percent of farming expenses for that year. The first exception applies if an eligible farmer fails to satisfy the 50-percent test due to a change in business operations directly attributable to extraordinary circumstances. The second exception applies if over the preceding 3-year period an eligible farmer satisfies the 50-percent test on the basis of the three preceding taxable years. The term "eligible farmer" will include (1) any person whose principal residence is on a farm, (2) any person with a principal occupation of farming, and (3) any family member of persons describe in (1) or (2). The exception applies only to an eligible person's farming activities attributable to the farm on which the residence is located, or to farms included in the "principal occupation" of farming activities.

Conference agreement

The conference agreement generally follows the House bill, precluding a tax shelter computing income using the cash receipts and disbursements method from deducting prepaid expenses any earlier than when economic performance occurs. For this purpose, the recurring item exception to the economic performance requirement (see Item 1, supra) will not apply.

Certain exceptions are provided under which prepaid expenses of a tax shelter will be deductible if economic performance occurs within 90 days after the end of the taxable year in which the prepayment is made. However, the maximum deduction that is allowable for any prepaid expenses under this exception is limited to the cash investment by the taxpayer in the tax shelter. For this purpose, the cash investment in a tax shelter which is a partnership is the taxpayer's basis in the partnership determined without regard to any liabilities of the partnership (with or without recourse) and without regard to any borrowings of the partner that are arranged by the tax shelter. In the case of tax shelters that are not partnerships, similar rules will apply. Thus, in the case of individual tax shelters, cash investment would not include any amounts borrowed by the individual which are arranged by the organizer or promoter or are secured by the investment.

For the purposes of this exception only, in the case of oil and gas activities, economic performance is deemed to occur with respect to all intangible drilling expenses of a well when the well is "spudded." For example, if a taxpayer contributed cash (not out of borrowings arranged by the tax shelter) to an oil drilling tax shelter in late December of a taxable year and the spudding of the well commenced within 90 days after the close of the taxable year, the entire amount of the prepaid intangible drilling expense would be deductible, subject to the limitations of present law requiring that the prepayment not be a deposit, that it be made for a business purpose, and that it not result in a material distortion of income.

To the extent that oil and gas prepayments do not meet the requirements of the 90-day exception, they are subject to the general principle provided in new section 461(h); thus, economic performance will occur as the drilling services are provided to the taxpayer. If drilling is commenced in the year of prepayment, only that portion of the intangible drilling costs attributable to drilling prior to the end of the year will be deductible in that year. Such portion of the costs will be deductible without regard to cash investment limitation.

With respect to expenses incurred in the trade or business of farming, the conference agreement clarifies that section 464 will be applied before the prepaid expense provisions, and that accrual method tax shelters will be subject to the timing rules of section 464. The change with respect to accrual method tax shelters is intended to equalize the treatment of cash and accrual farming tax shelters.

The prepaid expense provisions will apply to individual taxpayers engaged in farming activities with the principal purpose of tax avoidance. The conferees intend that marketed arrangements in which individuals carry on farming activities utilizing the assistance of a common managerial or administrative service may be presumed under certain circumstances to have the principal purpose of tax avoidance. If under such arrangements, taxpayers prepay a substantial portion of their farming expenses with borrowed funds, they should generally be presumed to have a principal purpose of tax avoidance. This presumption may also be appropriate outside the context of farming.

Neither the general rule requiring economic performance to occur before a deduction is allowable nor the 90-day exception

overrides any limitations of present law on the deductibility of prepaid expenses, including the requirement of a payment rather than a deposit, a business purpose for the prepayment, and no material distortion of income.

Effective date.—The conference agreement is effective with respect to prepayments made after March 15, 1984.

5. Deferred payment transactions

Present law

Time for inclusion or deduction of deferred interest

Original issue discount ("OID", or interest not paid currently) on a debt obligation issued for property generally is not taken into income by a cash method lender or deducted by a cash method borrower until received or paid, unless the debt instrument is publicly traded or the property for which it is issued is publicly traded stock or securities. If the lender is not an individual and the instrument is publicly traded or the property is publicly traded stock or securities, the OID provisions of the Code require the lender to recognize a portion of the deferred interest as income annually during the loan period and allow the borrower to deduct a corresponding amount, irrespective of whether the parties report income on the cash method or on the accrual method. The OID provisions also apply to debt instruments issued for cash.

For evidences of indebtedness issued after July 1, 1982, the amount of interest annually includible and deductible uner the OID provisions is determined on a constant interest basis, reflecting the compounding of accrued interest over the term of the instrument.

The OID rules do not apply to (1) obligations issued by individuals; (2) obligations having a maturity of one year or less; (3) as to holders, obligations not held as a capital asset; or (4) obligations the interest on which is exempt from tax under section 103 or any other provision of law.

Measurement of interest and prineipal

If the parties to a sale or exchange providing for deferred payment fail to state interest at least at a safe-harbor simple interest rate fixed by regulation, interest is imputed at a higher compound rate (sec. 483). Interest imputed under this provision ("the unstated interest rules") is allocated among deferred payments in proportion to the amount of the payments. Exceptions to these rules are provided for transactions in which all payments are due no more than one year after the sale, transactions in which the sales price does not exceed $3,000, certain annuity payments, certain sales of patents, and (as to the seller) sales of ordinary income property. The maximum imputed interest rate applicable to real estate transactions between related parties involving $500,000 or less is 7 percent.

House bill

The House bill extends the OID rules to obligations issued for nontraded property, deferred payments for services and use of property (whether or not evidenced by a formal debt obligation), obligations issued by individuals, and obligations not held as capital assets. The bill incorporates requirements similar to section 483 relating to the adequacy of the stated interest element of a deferred payment transaction involving the sale of nontraded property, the use of property, or the performance of services. The interest element in such transactions is compared to a compound safe-harbor rate that approximates a market rate. If inadequate interest is stated in the obligation, or if adequate interest is stated but is not unconditionally payable on a current basis, interest will be imputed annually at a higher rate (or at the stated rate, if higher than the imputed rate).

Exceptions to these rules are provided for sales of principal residences, certain sales of farms, sales involving total payments of $250,000 or less, certain annuity transactions, and certain sales of patents.

Section 483 will continue to apply only in the case of deferred payment transactions involving sales or exchanges of property that are within one of the exceptions to the OID rules. Where section 483 applies, unstated interest income or expense computed on an economic accrual basis (in accordance with the principles set forth in new section 1272 and Rev. Rul. 83-84, 1983-1 C.B. 97) will be reported and deducted as under present law—when payment is made in the case of a cash method taxpayer, when payment is due in the case of an accrual method taxpayer. The bill retains the exceptions of present law except the exception relating to sellers of ordinary income property. The bill also continues the 7 percent maximum imputed interest rate for certain real estate transactions between related parties.

These provisions generally apply to transactions entered into after December 31, 1984. The provisions relating to the current inclusions of OID income do not apply to obligations of individuals issued before March 2, 1984. The provisions relating to debt-for-nontraded property exchanges do not apply to sales or exchanges occurring after December 31, 1984, if made pursuant to a written contract (including an option contract) on March 1, 1984. Certain limitations relating to the manner in which interest may properly be accrued and the principal amount of debt instruments issued for nontraded property are effective for transactions occurring after March 1, 1984, and before January 1, 1985.

Senate amendment

The Senate amendment generally is the same as the House bill, except that it exempts from the OID and unstated interest rules cash method borrowers who issue discount obligations in connection with the purchase of property substantially all of the use of which will be for purposes other than business or investment. In addition, the Senate amendment exempts from the OID rules loans of $10,000 or less between members of the same family, unless tax avoidance is one of the principal purposes of the loan.

The interest element of deferred payment obligations involving services or use of property is dealt with in a separate Code provision (see new sec. 467, as added by this bill). The special transitional rules relating to the accrual of interest and the principal amount of debt obligations issued for nontraded property apply to transactions occurring after February 28, 1984, and before January 1, 1985.

Conference agreement

The conference agreement follows the Senate amendment, with several modifications, technical amendments, and clarifications.

Exceptions to the OID and unstated interest rules

The exception from the OID rules for loans of $10,000 or less is expanded to include loans between any individuals (not just family members) where the lender is not engaged in the trade or business of lending money. An additional exception is provided in the case of debt-for-nontraded property transactions where all payments under the obligation are due no more than six months after the date of sale.

The periodic deduction rule of section 163(e) will not apply to issuers of short-term obligations reporting income on the cash method.

Under the conference agreement, the OID and unstated interest rules do not apply to any amount which constitutes an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. It is not intended that this exception apply if the possibility that the life contingency will determine the amount of the payments is remote; that is, the contingency must be real and significant. In addition, the OID rules do not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company subject to tax under subchapter L provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting these requirements is involved, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

The general exception for transactions to which section 267 applies is deleted. Thus, the interest element of a deferred payment sale between related parties will be subject to the OID rules.

The conference agreement clarifies that the exceptions to the OID rules for sales of principal residences, certain sales of farms and sales involving total payments of $250,000 or less apply to both the lender and the borrower in such transactions, not just to the lender.

Other modifications

The agreement modifies both bills to provide that if the stated interest rate in an obligation is 110 percent or more of the applicable Federal rate, but is not paid currently at that rate, interest will be imputed at the stated rate rather than at 120 percent of the applicable Federal rate.

As a corollary to the fair market value rule applicable in potentially abusive situations, the conference agreement makes it clear that the Internal Revenue Service retains the right to challenge a transaction in which the principal amount of an obligation is *less* than the fair market value of the property received in exchange for the obligation. Thus, taxpayers may not intentionally overstate original issue discount in deferred payment sales transactions. Taxpayers might be inclined to overstate the interest element of a transaction where, for example, the property involved in the sale is nondepreciable or the seller-lender is not subject to U.S. tax on its discount interest income.

Finally, the requirement in the effective date provisions that interest must be accrued on a constant interest basis applies to transactions occurring after June 8, 1984, the date of conference action. The conferees intend no inference regarding the propriety of interest accruals with respect to transactions occurring prior to that date that do not comply with the concepts stated in Rev. Rul. 83-84.

Clarifications of intent

The conferees agreed to certain clarifications as to the scope and application of the OID provisions.

First, the conferees do not intend that taxpayers be able to circumvent the 110 percent imputed rate contained in the OID provisions simply by coupling a low-interest loan with a sale of property. Thus, if Seller agrees to lend money to Buyer at an interest rate equal to 100 percent of the applicable Federal rate (thereby complying with the low-interest loan provisions of the bill), and Buyer uses the proceeds of the loan to

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purchase nontraded property from Seller, the loan will be treated as a purchase money loan subject to the 110 percent test and 120 percent imputed interest rate of the OID rules rather than the 100 percent rate applicable to low-interest loans.

Second, no OID will be deemed to exist in situations where a debt instrument issued for nontraded property bears interest, unconditionally payable at least annually, at a variable rate, provided the stated rate is a floating rate, adjusted at no more than six-month intervals, at least equal to 110 percent of the Federal short-term rate (or other appropriate indices provided under regulations).

Finally, the conferees anticipate that the Commissioner will issue regulations, similar to the regulations under existing section 483, dealing with the tax consequences of debt obligations which are assumed or taken subject to, that is, the transfer of obligations to make or rights to receive deferred payments subject to the OID rules. The conferees intend that such rules apply not only to the assumption of deferred payment obligations, but also to assumptions of obligations to third-party lenders. These rules will apply to sales and exchanges after December 31, 1984, and therefore will apply to debt obligations that are assumed or taken subject to after that date even though such obligations were first issued prior to that date.

6. Deferred payments for use of property and services

Present law

A cash method lessor includes rent in income only when payment is received, while an accrual method lessee deducts a portion of the rent in each year of the lease, irrespective of when rent is paid. Thus, a mismatching of income and deductions may occur in the case of a deferred payment lease involving a cash method lessor and an accrual method lessee.

Where a lease provides for current payments of rents, but at disproportionately higher levels in the later years of the lease term (i.e., the rents are "backloaded" or "stepped"), portions of the true rent allocable to the earlier years are in substance being deferred until later years, when the deferred amounts are repaid with interest. The result is deferral of income by the lessor.

It is unclear under present law under what circumstances uneven rent payments will be treated as resulting in deferral or prepayment of rent. The Internal Revenue Service has issued a revenue procedure stating that the payment of uneven rents in a so-called "leveraged lease" will not be regarded as involving a deferral or prepayment of rent provided the rent payable for any year does not exceed 110 percent of the average annual rent payable over the term of the lease and is not less than 90 percent of this average. Rev. Proc. 75-21, 1975-1 C.B. 715.[3]

House bill

The House bill contains no provision relating to the "principal" element of deferred payment transactions involving the use of property or services. It does, however, provide for annual inclusion and deduction of interest with respect to such transactions in certain circumstances (see item 5, supra).

Senate amendment

The Senate amendment requires that both the rent element and the interest element of a deferred rent transaction be included in the income of the lessor and deducted by the lessee annually, unless rent is paid before the end of the year following the calendar year in which the property is used. A transaction involving stepped rents is treated as a deferred rent transaction if any periodic increase is not commercially reasonable. In general, whether an increase is commercially reasonable is determined on the basis of all the facts and circumstances.

In the case of a sale-leaseback transaction involving payment of stepped rents, an annual increase will be considered as not commercially reasonable if it exceeds the greatest of (1) the percentage increase in the Consumer Price Index (or other index specified by regulations) during the immediately preceding lease period, (2) the Federal short-term rate in effect at the time the lease is entered into, or (3) the increase in specified costs with respect to the property payable by the lessor to unrelated parties during the period between the payments. Leases providing for even "steps" of up to 5 years, with cumulation and compounding of the permissible increases during the period, will qualify as commercially reasonable.

Similar rules are to be provided by regulations for the interest element in deferred payment transactions involving services and for "front-loaded" payment transactions.

The provisions are generally applicable to agreements entered into after March 15, 1984, other than agreements entered into pursuant to a written binding commitment if effect on March 15, 1984. Under a transitional rule, in the case of leases where there was written evidence of a firm plan on March 15, 1984, to lease property which had not been placed in service before that date, the parties will not be subject to the permanent rules; however, such persons will be required to report rental income and deductions in amounts at least as great as those in a specified schedule, regardless of the actual payments made under the agreement. In addition, an exception is provided for a particular lease that was being negotiated on March 15, 1984.

Conference agreement

The conference agreement adopts the House bill and the Senate amendment with modifications.

Overview

The conference committee believes that the deferred rent provision of the Senate amendment is deficient in two respects. First, commercial reasonableness is too vague a standard by which to determine the tax consequences of a lease agreement. The conferees feel that this standard is unworkable and injects an unacceptable degree of uncertainty into legitimate business transactions. Second, the Federal rate safe harbor provided in the Senate amendment would permit rent increases over the term of a lease that would, in general, significantly exceed the increases that could be justified as an economic matter.

Accordingly, the conference agreement adopts a tax avoidance purpose test, makes this test applicable to a narrower range of lease agreements, and eliminates the safe harbor based on the Federal rate. (As under the Senate amendment, only leases involving total payments in excess of $250,000 and either deferred payments or stepped rents are affected by the conference agreement.) The tax avoidance purpose test will be applied only in the case of certain leasebacks and long-term leases. If this test is satisfied, the rents payable under the lease will be "leveled" for purposes of the tax treatment of the parties to the lease, that is, the parties will take into account annually the constant rental amount and interest on unpaid rental amounts from prior years. The conference agreement provides certain safe harbors under which leases will not be deemed to be motivated by tax avoidance.

In cases not involving leasebacks or long-term leases or in which it has been established that there is no tax avoidance purpose for the backloading, the rents specified in the lease agreement will be recognized for tax purposes. However, the parties will be required to report the rent allocable to the period (and interest on unpaid rents) on an accrual basis, regardless of their method of accounting. Thus, the general rule will be "matching" on an accrual basis by both lessors and lessees.

Finally, lessors who, by virtue of having demonstrated no tax avoidance purpose, are not subject to rent leveling during the term of the lease will be subject to a recapture provision on disposition of the leased property. Under this provision, any gain realized on such a disposition will be treated as ordinary to the extent of the excess of the accruals that would have been taken into account had the lessor been subject to the rent leveling provision over the actual accruals of rents up to the date of transfer. The conferees believe that even in situations where the parties can demonstrate that tax avoidance is not a principal purpose of the stepping of rents, and rents are reported on a consistent basis, there is an opportunity to convert ordinary income into capital gain by selling property subject to an agreement providing for increasing rents. The recapture provision prevents such a conversion.

The conferees emphasize that no inference is intended as to the ability of the Internal Revenue Service to challenge the form of an agreement involving deferred or stepped rents under general accrual or clear reflection of income principles, on the basis that a purported lease constitutes a mere financing transaction, or on other grounds.

Matching requirement in case of "section 467 rental agreements"

The conference agreement affects only those leases that would have been subject to the provision contained in the Senate amendment, that is, leases involving total payments in excess of $250,000 and either (1) increasing (or decreasing) rents, or (2) rents payable beyond the close of the calendar year following the year in which the associated use occurs. Such leases are referred to as section 467 rental agreements.

The parties to a section 467 rental agreement not involving a leaseback or a lease of property for a term in excess of 75 percent of the property's ACRS life will not be subject to the tax avoidance purpose test or the rent leveling provision. Both the lessor and the lessee under such agreements, however, will be required to accrue annually the rent allocable to the taxable year where actual payment of the rent is deferred.[4] The rent

[3] The revenue procedure also provides an alternative test based on rents payable over the first two-thirds of the lease term.

[4] The conferees intend that any rent or interest accrued by the lessor under this provision as well as under the rent leveling provision will be treated in the same manner as a receivable or other debt owed to an accrual basis taxpayer. Thus, if the lessee due to bankruptcy or other circumstance ultimately fails to pay rent or interest imputed under this provision when due, the lessor will be able to claim a bad debt deduction, at the time and to the extent a bad debt deduction is permitted under present law to accrual basis taxpayers. Similarly, a lessee under a section 467 rental agreement will have income under discharge of indebtedness or tax benefit principles to the extent a rental or interest amount previously accrued pursuant to this provision is forgiven or otherwise goes unpaid.

allocable to a taxable year will be determined from the terms of the lease. If the lease specifies amounts that are allocable to particular periods but these amounts are not paid until more than one year after the year to which they relate, the amount of rent to be accrued for each period will be an amount determined in accordance with Treasury regulations based on present value concepts. It is anticipated that these regulations could provide different methods for determining the appropriate amount, depending upon the particular type of lease involved. Present values will be determined, and interest will accrue on any accrued but unpaid rent (and any unpaid interest on such interest), at a rate of 110 percent of the applicable Federal rate, compounded semiannually.

Constant rental accrual in certain situations

Rents will be deemed to accrue on a level present value basis in two situations. First, level rents will be imputed if a section 467 rental agreement is silent as to the allocation of rents over the lease period. Second, level rents will be imputed if (1) a section 467 rental agreement provides for increasing rents, (2) one of the principal purposes of providing for increasing rents is the avoidance of taxes, and (3) the lease is either part of a leaseback transaction or for a term in excess of 75 percent of the "statutory recovery period" for the property subject to the lease. A leaseback transaction for this purpose is one that involves a lease of property to any person who had any interest in such property within the two-year period such lease goes into effect (or to a person related person to such person). The conferees do not intend that a de minimis ownership interest be deemed an interest for this purpose.

The statutory recovery period for purposes of the 75 percent test is essentially the period provided under the ACRS provisions of the Code. Property that is not recovery property will be treated as if it were recovery property for purposes of this test.

Regulatory safe harbors.—The Treasury Department is directed to prescribe regulations setting forth circumstances under which rents will not be treated as being stepped for tax avoidance purposes. Among the circumstances for which safe harbors are to be provided are (1) increases in amounts determined by reference to price indices such as the Consumer Price Index, (2) rents based on a percentage of the lessee's receipts or similar amounts, (3) reasonable periods during which rents are forgiven or abated, and (4) changes in amounts paid to unrelated third parties.

Thus, the conferees intend that the regulations will provide that a lease calling for rents that increase at a variable rate equal to the rate of the increase in the CPI (or other appropriate price index) during the lease period does not have tax avoidance as a principal purpose. Such a lease may limit the increase to a specified maximum percentage and still come within the CPI safe harbor, and increases based on such a formula may be aggregated and made in intervals of five years or less.

Similarly, increases that are based on a fixed percentage of the lessee's gross receipts or similar amounts, or that reflect the lessee's obligation under the lease to bear specified costs (such as real estate taxes, insurance, maintenance, and similar costs) of the lessor will not be considered to be motivated by tax avoidance. Because the amount of increases in the CPI or in third party costs generally is not subject to manipulation by the parties, and it is a common commercial practice to pass such increases on to lessees, such increases should not generally be considered in determining whether rents are stepped to avoid taxes.[5]

In addition, the conferees intend that the regulations will provide a safe harbor for leases under which no rent is payable (or is payable at a reduced rate) for a reasonable period of time after the inception of the lease. Whether the length of a "rent holiday" is reasonable will be determined by commercial practice in the locality where the use of the property will occur at the time the lease is entered into. The conferees expect that, in general, this rent holiday will not exceed twelve months, and in no event shall exceed twenty-four months.

The conferees anticipate that the Treasury Department will issue regulations adopting standards under which leases providing for fluctuations in rents paid by no more than a reasonable percentage above or below the average rent payable over the term of the lease will be deemed not motivated by tax avoidance. The conferees understand that the Internal Revenue Service has taken the position that a 10 percent fluctuation above or below the average rent is permissible in the case of leases involving personal property. Rev. Proc. 75-21, 1975-1 C.B. 715, sec. 5. The conferees note that the standards of Rev. Proc. 75-21 may not be appropriate for real estate leases, and that it may be appropriate in the regulations to provide less restrictive standards for such leases.

Tax avoidance standard.—A section 467 rental agreement involving a leaseback or a term in excess of 75 percent of the property's statutory recovery period will be subject to the rent leveling provision only if a principal purpose of the stepping of rents is tax avoidance. The determination of the existence of a tax avoidance purpose will be made on the basis of all the relevant facts and circumstances. A major factor in this determination will be whether and to what extent the tax brackets of the lessor and the lessee differ at the time the lease is entered into, and the parties' reasonable expectations as to their relative tax brackets over the term of the lease. Where their tax brackets are roughly equal, a natural tension will normally exist between the lessor and lessee since the lessor will defer recognition of income at the cost to the lessee of a deduction to which it would otherwise be entitled.

On the other hand, where a lessor is in a higher marginal tax bracket than a lessee (e.g., where the lessee is a tax-exempt entity or has substantial NOLs or is otherwise in a low marginal bracket), the motives of the parties in stepping the rents will be closely scrutinized, and taxpayers should be held to a higher standard of proof. They should be required to show that market conditions or other substantial business reasons justify the specified increases. In particular, the conferees believe that so-called "sandwich" lease transactions, whereby a tax-exempt entity is interposed between two taxable parties as a lessee-sublessor to achieve deferral of income for the ultimate lessor without sacrificing the deductions of the sublessee, should generally be suspect.[6] The conferees emphasize that they intend no inference as to the ability of the Internal Revenue Service to challenge these sandwich lease transactions under existing law.

The involvement of tax-exempt organizations or taxpayers in an NOL position or low marginal tax bracket will not, however, create a conclusive presumption of a tax avoidance purpose, even where such person serves as a sublessor. Rather, all the facts and circumstances must be considered in determining the purpose of the transaction. If those facts and circumstances suggest substantial nontax reasons for a particular rent structure, the terms of the lease should be respected for tax purposes, even if a tax-exempt or NOL taxpayer is simultaneously a lessor and lessee.

For example, if a tax-exempt trade association negotiated a long-term lease for office space in excess of its current needs in order to assure the availability of additional space in the future, and temporarily sublets a portion of the space to a taxable third party, the transaction need not be viewed as per se motivated by tax avoidance. Increases in rents under the primary lease and sublease would be respected if it could be demonstrated that tax avoidance was not a principal purpose of the increases. The absence of such a purpose might be shown by the existence of leases containing similar terms between the primary lessor and taxable third parties. The burden of proving the absence of a tax avoidance purpose would, however, be on the taxpayer.

Another factor in determining whether a tax avoidance purpose exists is whether under the lease the lessee has an option to renew at a rental amount significantly less than rental amounts payable during the later years of the lease, particularly where the option rental amount is roughly equal to what the constant rental amount would have been for the primary term of the lease had the rent leveling provision been in effect.

The Treasury Department in regulations may prescribe other factors that are indicative of a tax avoidance purpose.

Recapture on disposition of leased property in certain situations

If property subject to a leaseback or a long-term lease is not subject to the rent leveling provision, any gain realized by the lessor on disposition of the property during the term of the agreement will be treated as ordinary income to the extent of the "recapture amount." For this purpose, the gain realized is reduced by the amount of gain treated as ordinary income under other provisions of the Code (e.g., sec. 1245 or 1250).

The recapture amount is the excess of the amount which would have been taken into account by the lessor if the rents had been reported on a constant rental basis over the amount actually taken into income by the lessor under the general matching provision. Only amounts that are fixed and determinable will be taken into account in making this computation. The Treasury Department is to provide regulations under which exceptions similar to the exceptions provided under sections 1245 and 1250 shall apply for purposes of the rent recapture provision, and under which the ordinary income taint on the property will be preserved in cases where the property is transferred and the transferor's basis in the property carries over to the transferee.

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[5] The conferees intend no inference as to the effect of a lease clause requiring the lessee to assume the burden of any increases in the lessor's debt service on the property, however, including the effect of such a clause on the status of the lease as a true lease.

[6] A variation of the sandwich lease is an arrangement whereby a cash basis taxpayer simultaneously serves as lessee and sublessor under a master lease with an accrual basis lessor and a sublease with an accrual basis sublessee. Although the sublease calls for stepped rental payments, the sublessee may take the position it is entitled to accrue annually a level amount of rent that reflects the average rent payable over the term of the lease. The lessor will accrue annually only the amount of rent actually paid on the ground that it is entitled only to that amount.

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Other regulations

The conference agreement provides that the Treasury Department is to issue regulations requiring reporting of the interest elements only of deferred payment transactions involving services, in a manner consistent with the treatment of interst in deferred payment rental transactions. Regulations will also deal with the treatment of front-loaded (i.e., prepaid) agreements. The conferees intend that the provisions relating to deferred payment services agreements and front-loaded agreements and the regulations thereunder be applied prospectively from the date of issuance of regulations.

Effective date and transitional rules

These provisions are effective for agreements entered into after June 8 1984, subject to the transitional rules provided in the Senate amendment.

7. Capitalization of construction period interest and taxes

Present law

In general, no immediate deduction is allowed for real property construction period interest and taxes (Code sec. 189).

This rule does not apply to (1) low-income housing, (2) residential real property (other than low-income housing) acquired, constructed, or carried by a corporation (excluding certain corporations) or (3) real property if the property is not, and cannot reasonably be expected to be, held generally in a trade or business, or in an activity conducted for profit.

The capitalized interest and taxes are amortized generally over a 10-year period.

House bill

No provision.

Senate amendment

The rules under section 189 are extended under the Senate amendment to require corporations (other than corporations currently subject to sec. 189) to capitalize construction period interest and taxes for residential real property (other than low income housing). The definition of construction period is the same as under present law.

This provision will apply to interest or taxes paid or incurred in taxable years beginning after December 31, 1984, for the construction of residential real property begun after March 15, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

8. Start-up expenses

Present law

Generally, expenses incurred prior to the establishment of business are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity. However, some expenses such as interest or taxes are allowed as deductions for nonbusiness purposes, and the Supreme Court held in *Snow* v. *Commissioner*, 416 U.S. 500 (1974) that research and experimental expenses are deductible under section 174 notwithstanding the trade or business requirement.

A taxpayer may elect to treat start-up expenses as deferred expenses that may be deducted ratably over a period of not less than 60 months (sec. 195).

Present law is unclear whether, in the absence of an election under section 195, a specific item should be capitalized or expensed.

House bill

No provision.

Senate amendment

Under the Senate amendment, taxpayers will be required to treat start-up expenditures as deferred expenses. Taxpayers will be allowed to amortize such expenditures over a period of not less than 60 months as may be selected by the taxpayer. The definition of start-up expenditures is intended to be generally the same as under present law but also covers certain pre-opening costs.

The Senate amendment applies to taxable years beginning after June 30, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment with the following modification. Under the conference agreement, start-up expenditures that are allowed as deductions under sections 163, 164, and 174 shall not be treated as deferred expenses.

The conference agreement also clarifies that the definition in the Senate amendment of start-up expenditures covers certain pre-opening costs, but only for periods after the effective date of the provision.

9. LIFO conformity

Present law

The "Last-In-First-Out" (LIFO) method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, and for credit purposes. An exception to the conformity requirement is provided for certain differences, including differences that arise because the taxpayer adopts the LIFO method for financial statement purposes beginning with an accounting period other than the taxable year for which the taxpayer first used the LIFO method for tax purposes. (Treas. Reg. sec. 1.472-(2)(1)(viii)(A).) Furthermore, the Internal Revenue Service has issued several rulings which provide limited exceptions to the LIFO conformity rule in other factual situations.

In *Insilco Corp.* v. *Commissioner*, 73 T.C. 589 (1980), *aff'd. in an unreported decision* (2nd Cir. 1980), the Tax Court held that the LIFO conformity rules were met by a subsidiary using the LIFO method to compute its income in its financial reports issued to its parent company, even though the parent company converted the subsidiary's earnings to a non-LIFO basis in the parent's consolidated financial statements.

House bill

The House bill treats all members of the same group of financially related corporations as a single taxpayer for purposes of the LIFO conformity requirement. The term "group of financially related corporations" means (1) any affiliated group as defined in section 1504 determined without regard to the exceptions in sec. 1504(b) and by substituting a 50-percent stock ownership test for an 80-percent stock ownership test, and (2) any other group of corporations which issue consolidated financial statements or reports generally to shareholders and others.

The House bill does not affect the exceptions to the conformity requirements already provided under current law, or Treasury's authority to provide other such exceptions in the future.

The House bill applies to taxable years beginning after the date of enactment.

Senate amendment

The Senate amendment generally is the same as the House bill, except the provision also applies to a group of corporations that issue financial statements on a combined basis.

Conference agreement

The conference agreement follows the Senate amendment with certain clarifications and modifications.

First, the conference agreement clarifies that the conformity requirement applies to the financial statements of a corporation that include under the equity method of accounting the results of operations of a corporation that uses the LIFO method of accounting for tax purposes, but only if that corporation is a member of the affiliated group by applying the 50-percent stock ownership test (described under the House bill).

Second, the conference agreement clarifies the transition rules for taxpayers who accounted for inventories on methods similar to those involved in the *Insilco* decision. The conference agreement provides that a taxpayer who relied on *Insilco* (or a similar interpretation of the law) in prior years may elect to remain on the LIFO method for tax purposes and conform its financial statements to the LIFO method. In such a case, the LIFO cost for financial statement purposes may be different than the LIFO cost for tax purposes because the LIFO method is first used for financial reporting purposes in a different year than it was first used for tax purposes. The conference agreement clarifies that such differences in the LIFO cost are not a violation of the conformity requirement (i.e., Treas. Reg. sec. 1.472-2(e)(1)(viii)(A) would apply).

Under the conference agreement, no inference is implied with respect to the taxpayer's compliance with the conformity requirement under present law. Thus, even a taxpayer who complies with the provisions of this bill may nevertheless be subject to challenge by the Internal Revenue Service for violation of the conformity requirement in prior years. However, in order to prevent unwarranted exposure to subsequent decisions contrary to *Insilco*, the conference agreement provides that for this purpose only the IRS may provide a special procedure for taxpayers who want to continue to use the LIFO method to make a protective LIFO election (consistent in all respects with their existing LIFO election) so that taxable years beginning after the date of enactment are protected. No inference is created as to whether a conditional LIFO election may be valid in other contexts.

Taxpayers who elect to change to the LIFO method for tax purposes will be allowed a spread of any adjustment required under section 481 not to exceed 4 years. (The LIFO method as used prior to the effective date would not be treated as a category A method under Rev. Proc. 80-51, 1980-1 C.B. 816).

Effective date.—The provision applies to taxable years beginning after the date of enactment.

H. Tax straddles

Present Law

Exemption of stock and stock options from straddle rules

Losses incurred in positions in actively traded personal property are deferred to the extent that the taxpayer has unrecognized gain on offsetting positions in a straddle. Positions are offsetting generally if there is a substantial diminution in the risk of loss from holding one position by reason of holding the other position. In addition, interest and carrying costs allocable to personal property which is part of a straddle are required to be capitalized, and present law provides authority for regulations to impose rules as to straddles that are comparable to present law wash sale and short sale rules. Present law excludes from the straddle rules stock and stock options that are traded on domestic exchanges.

Mark-to-market rules

Gains and losses from regulated futures contracts (RFCs) are determined by marking such contracts to market and, if they

are capital assets, by treating all resulting gain or loss as 60 percent long-term and 40 percent short-term capital gain or loss (60/40 treatment). This formula results in a maximum tax rate of 32 percent for noncorporate taxpayers. This treatment applies to contracts traded on a domestic board of trade or exchange designated as a contract market by the Commodity Futures Trading Commission (CFTC) and to certain foreign currency contracts.

Hedging exemption

Neither the straddle rules nor the mark-to-market and 60/40 treatment apply to gains and losses from properly identified hedging transactions entered into in the normal course of the taxpayer's trade or business and resulting in ordinary income or loss. The hedging exemption is not applicable to certain syndicates with limited partners or limited entrepreneurs.

Treatment of options

Historically, options market makers on securities exchanges have reported ordinary income or loss from their options transactions as well as from transactions in the property subject to the option. Commodity traders derive capital gain or loss from their RFC transactions and are subject to mark-to-market and 60/40 treatment.

Gain or loss from the sale, exchange or lapse of an option held by an investor is capital gain or loss generally, long-term or short-term depending on the period the option is held by the investor, and short-term in any case to an option grantor. If an option is exercised, the premium paid by the holder or received by the grantor results in additional gain or loss with respect to, or an adjustment to the basis of, the underlying property. Questions have been raised about the applicability of these rules to certain cash settlement options and options on RFCs (commodity options).

Mixed straddles

Mixed straddles are straddles composed in part of RFCs subject to a 32 percent maximum tax rate and in part of other positions subject to a maximum 50 percent tax rate. Taxpayers may elect, if the straddle is properly identified, to exclude the RFC portion of a mixed straddle from the mark-to-market and 60/40 rules. Treasury may prescribe regulations similar to the short sales rules with respect to straddle positions. Present regulatory authority to prescribe rules for mixed straddles may be inadequate to insure effective rules.

Wash sale rule

Under the wash sale rule of present law, losses from the disposition of stock and securities are deferred if substantially identical property is acquired within 30 days before or after such disposition. The wash sale rule does not apply to certain short sales against the box which provide taxpayers with an opportunity to defer income. For taxpayers other than corporations, the wash sale rule does not apply if the loss is in connection with the taxpayer's trade or business, while it is inapplicable to corporate taxpayers only if the loss is incurred in the ordinary course of the corporation's business as a securities dealer.

Identification requirement

The hedging exemption, the mixed straddle election, the present law election of securities dealers to identify securities as held for investment, and the identified straddle rule (which limits the applicability of the loss deferral rule), all require identification by the close of the day during which a position is established. Substantial price movements may occur within the course of a day which give taxpayers an opportunity for unwarranted tax benefits through the use of these provisions.

House bill

Overview

The House bill repeals the blanket exceptions from the straddle rules for stock and exchange-traded stock options. More limited exceptions are provided. In addition, the mark-to-market rule and the 32-percent maximum rate of tax are extended to certain exchange-traded options held by investors and to all listed options held by options market makers. Commodity options are also made subject to the mark-to-market rule and accorded the 32-percent maximum rate of tax.

Repeal of exception for certain stock and stock options

Stock

The House bill repeals the exception from the tax straddle rules for direct positions in stock. A more limited exception is provided for a straddle all of the positions of which consist of the holding of stock or the short sale of stock. However, the exception for positions in stock is inapplicable to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Exchange-traded stock options

In general, the straddle rules, including the loss-deferral rule, are extended to straddles involving exchange-traded stock options. An exception is provided for qualified covered call writing transactions.

Qualified covered call options

A covered call option is one that is written with respect to stock that is held by the taxpayer (or acquired by the taxpayer in connection with the granting of the option). The granting of a covered call option substantially reduces a taxpayer's risk of loss with respect to the underlying stock to the extent that the option is deep-in-the-money. The House bill contemplates that taxpayers can continue to write at-the-money and non-deep-in-the-money covered calls (i.e. qualified covered calls), without running afoul of the straddle rules.

In general, a qualified covered call option is an exchange-traded option (1) the gain or loss with respect to which is not ordinary income or loss, (2) the term of which is more than 30 days, and (3) which is not deep-in-the-money. The term "deep-in-the-money option" is defined as an option that has a strike price lower than the lowest qualified benchmark." Generally, the "lowest qualified benchmark" is the highest available strike price that is less than the "applicable stock price" (defined below). In the case of an option with a term of more than 90 days and a strike price exceeding $50, the lowest qualified benchmark is the second highest available strike price that is less than the applicable stock price. However, in any case, the lowest qualified benchmark will not be treated as being less than 85 percent of the applicable stock price.

Exchange rules currently provide for strike prices on options at five-dollar intervals (or "benchmarks") for options on stock trading at prices under $100. For stock trading at prices over $100, there are $10 benchmarks. The lowest strike price currently authorized is $10. Thus, for example, with respect to stock trading at $50, an exchange-traded call option with a strike price of $45 or more and a term exceeding 30 days would qualify for the exception.

The term "applicable stock price" is generally defined as the closing price of the optioned stock on the most recent date on which such stock was traded before the date on which the option was granted. However, if the opening price of the optioned stock on the day the option is granted is greater than 110 percent of the closing price on the last previous trading date, then the opening price of the stock is treated as the applicable stock price.

In general, a qualified covered call option must be written on a national securities exchange registered with the Securities and Exchange Commission (SEC). The Secretary may designate other exchanges as qualifying for this treatment if the exchange has rules adequate to carry out the purposes of the exception to the straddle rules for qualified covered calls. The House bill contemplates that, as a condition of designating an exchange, the Secretary could require that trades on the exchange be subject to information reporting under section 6045 (relating to reports by brokers).

The Secretary is granted broad regulatory authority to modify the provisions of the bill (e.g., to take account of changes in the practices of options exchanges or to prevent tax avoidance). The bill contemplates that the Secretary will prescribe rules for the determination of the applicable strike price if the options exchanges modify their benchmarks.

Treatment of gain or loss where the taxpayer is the grantor of a call option

The House bill provides that, if at any time a taxpayer holds stock and is the grantor of an outstanding option to buy such stock, which option has a strike price that is less than the applicable stock price, then any amount that would otherwise be treated as a long-term capital gain with respect to the stock is treated as a short-term capital gain to the extent of any short-term capital loss recognized on the option. This short-term capital gain character would be preserved where the stock is transferred in a nonrecognition transaction (including a gift).

Extension of mark-to-market rule

The House bill extends the mark-to-market rule (including the 60/40 treatment that results in a 32-percent maximum tax rate) to nonequity listed options and dealers' equity options. Rules are provided to prevent limited partners (or entrepreneurs) of an options dealer from recognizing gain or loss from equity options as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Definition of listed option contract

The House bill defines a listed option as any option (other than a right to acquire stock from the issuer) that is traded on (or subject to the rules of) a qualified board of trade or exchange. A qualified board of exchange is a national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange or board of trade that the Secretary determines has rules adequate to carry out the purposes of the relevant statutory provisions. The bill contemplates that, as a condition of designating an exchange or board of trade, the Secretary may require information reporting consistent with the rules of section 6045 (relating to returns of brokers).

Equity listed options

An equity option is defined to mean any option to buy or sell stock, and any other option the value of which is determined by reference to an index of stocks of the type that is ineligible to be traded on a commodity futures exchange (e.g., an option contract on a sub-index based on the price of nine hotel-casino stocks). The definition of equity option excludes options on broad-

based stock indexes (such as the Standard & Poor's 500 index) and options on stock index futures; thus, these options fall within the definition of nonequity options (discussed below). Holders of equity options (other than dealers) remain subject to the general rules for the taxation of options, including the loss-deferral rule.

Nonequity listed options

A nonequity option is defined as any listed option that is not an equity option. Under the bill, any holder of a nonequity option (whether an options dealer or an investor) is treated as if the option were disposed of at year-end for a price equal to its fair market value, and any gain or loss is taxed as if it were 60-percent long-term and 40-percent short-term (just as the holders of RFCs are treated). All options on RFCs are, by definition, nonequity options under the bill.

Treatment of dealer options

The House bill changes the claimed present-law treatment of options market makers and codifies present law with respect to professional commodity traders by providing that both categories of traders are treated as buying and selling capital assets, except to the extent that an option or future is acquired to hedge property that would generate ordinary income or loss. An options dealer is defined as any person who is registered with the SEC and an appropriate national securities exchange as a market maker or specialist in listed options. Under the bill, an options dealer would not recognize ordinary income or loss with respect to his stock and securities transactions, unless the taxpayer is a dealer in stock and securities under general Federal income tax rules (determined without regard to whether options in such property produce ordinary income or loss).

In addition to nonequity options, which are marked-to-market in the hands of all holders, equity options held by options dealers are also subject to the mark-to-market rule and 60/40 treatment. To prevent dealers from passing through 60/40 treatment of equity options to limited investors, the bill provides that 60/40 treatment does not apply to gain or loss on dealer equity options that is allocable to limited partners or limited entrepreneurs (regardless of the percentage of such gain or loss that is so allocated).

Hedging exemption

In general, the hedging exemption under present law remains available. However, the House bill limits the ability of certain taxpayers to deduct losses from hedging transactions where the hedging exemption is claimed.

Under the House bill, an options dealer who is a dealer in the underlying property is treated the same as a commodity trader who is a dealer in the cash commodity. Thus neither the loss-deferral rule nor the mark-to-market rule applies to an option or an RFC that is identified as a hedging transaction where gain or loss on both the option or the RFC and the underlying property would be ordinary income or loss (as determined under the bill).

For certain taxpayers, the House bill limits the deductibility of any loss on a hedging transaction to the taxable income (determined without regard to such loss) derived from the conduct of the trade or business to which the hedging transaction relates. This provision is intended to prevent the passthrough of ordinary losses to limited investors from transactions engaged in by traders who qualify as dealers in the underlying property.

The limitations on the deductibility of hedging losses apply to the following taxpayers: (1) any taxpayer who enters into a hedging transaction relating to stock or securities, (2) any individual, and (3) any corporation if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned by five or fewer individuals. The term "hedging loss" is generally defined as the excess of (1) the allowable deductions for the taxable year attributable to hedging transactions (determined without regard to the rule limiting hedging losses), over (2) income received or accrued by the taxpayer during such taxable year from such transactions. However, an exception to the limitations on losses is provided for economic losses. The bill provides that the limitations do not apply to a hedging loss to the extent that such loss exceeds the aggregate unrecognized gains from hedging transactions (including gains from hedged property) as of the close of the taxable year. The "aggregate unrecognized gain" is defined as that term is used for purposes of the straddle rules: (1) the amount of gain that would be taken into account with respect to property if such property were sold on the last business day of such taxable year at fair market value, plus (2) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

Cash-settlement options

For cash-settlement options that are not subject to the mark-to-market rule (e.g., narrow-based options on stock indices), the House bill amends section 1234 to clarify that gain or loss on the sale, exchange, lapse, or exercise of the option is capital gain or loss with respect to grantors or holders. For purposes of the bill, a cash-settlement option is defined as any option which on exercise settles in (or could be settled in) cash or property other than the underlying property. As under present law, the receipt of cash on exercise of a cash-settlement option is a taxable event.

Regulatory authority relating to mixed straddles

The House bill broadens the scope of Treasury's regulatory authority to prescribe rules for mixed straddles. The bill requires the Secretary to prescribe such regulations with respect to gain or loss on straddle positions as may be necessary to carry out the purposes of the loss-deferral rule, within six months from the date of enactment. To the extent consistent with this purpose, the regulations should include rules applying the principles of the wash sale rule and the short-sale rule.

Effective dates

General rules

In general, the provision repealing the exemption from the straddle rules for stock options and stock applies to positions established after October 31, 1983. However, the application of the straddle rules to offsetting position stock is effective for positions established on or after May 23, 1983.

The special rule for the treatment of gain where the taxpayer is the grantor of an option to buy stock applies to positions established after March 1, 1984.

The provisions extending the mark-to-market rule to nonequity options and dealer equity options generally apply to positions established after the date of enactment. However, with respect to commodity options, the amendments made by the bill apply to positions established after October 31, 1983.

The provision clarifying the treatment of cash-settlement options applies to options purchased or acquired after October 31, 1983. The amendments to the hedging exemption apply to taxable years beginning after December 31, 1984.

Elections

The mark-to-market rules may be applied to nonequity options and dealer equity options on or before the general effective dates under either of two elections provided by the bill.

Positions held on the date of enactment.—Taxpayers can elect to apply the mark-to-market rule to nonequity listed options or dealer options that they held on the date of enactment. The election must cover all such positions held by the taxpayer on the date of enactment.

Positions held before the date of enactment.—In lieu of the election described above, taxpayers can elect to apply the mark-to-market rule to all positions held by the taxpayer during the taxable year that includes the date of enactment (the "transition year"). If the taxpayer makes this full-year election, all nonequity listed options and dealer options held at any time during the transition year must be marked-to-market.

With respect to stock options, any tax liability for the transition year which is attributable to appreciation in such options can be paid in two to five equal annual installments. Interest is charged on any unpaid installments of tax that are still outstanding after the due date for the first installment.

Senate amendment

Repeal of exception for certain stock and stock options

Under the Senate amendment, an interest in stock is included within the straddle rules only if (1) it is offset by an option to buy or sell actively traded stock, or (2) it is stock in a corporation formed or availed of to take positions in personal property offsetting positions held by any shareholder. The hedging exemption is applicable, under the Senate amendment, to such offsetting position stock held by a member of the same affiliated group (as defined in sec. 1504(a)) as the taxpayer.

Under the Senate amendment, the two benchmark standard applicable to certain qualified covered calls applies where the strike price is exactly $50 (as distinguished from over $50 in the House bill). The Senate amendment also eliminates the limitation of a qualified covered call to one with a strike price not less than 85 percent of the applicable stock price. The Senate amendment reduces the amount of costs of carrying a position that is part of a straddle that is required to be capitalized by dividends on stock included in a straddle, with respect to positions established after the date of enactment.

The repeal of the exception from the straddle rules for stock (other than offsetting position stock) and exchange traded stock options applies to positions established on or after January 1, 1984, under the Senate amendment. The Senate amendment also defers the application of the identification requirement for hedging transactions applicable to stock and stock options until 60 days after the date of enactment.

Extension of the mark-to-market rule

The Senate amendment defines equity options more broadly than the House bill, to include all options on stock indexes. Thus, investors in options on stock index RFCs do not receive mark-to-market and 60/40 treatment under the Senate amendment.

The Senate amendment extends the election to pay in 2 to 5 annual installments the additional tax for the taxable year including the date of enactment derived from prior

year appreciation in stock options. Under the Senate amendment, tax attributable to appreciation in stock offset by a stock option and which under present law would result in ordinary income is subject to the election. Under the Senate amendment, regulations as applied to a position in a mixed straddle are not to be effective with respect to a position established before January 1, 1984.

Limitation on hedging losses

Under the Senate amendment, the limitation of net hedging losses to income from the trade or business in which the hedge was entered into applies only to limited partners or limited entrepreneurs.

Exercise of options on regulated futures contracts

Under the Senate amendment, it is explicitly provided that gain or loss is recognized on the exercise of an option on an RFC. This rule is applicable with respect to options purchased or granted after October 31, 1983.

Short sale against the box

The Senate amendment provides that rules similar to those requiring the deferral of losses from disposing of stock in wash sales (sec. 1091) will apply to require the deferral of losses incurred on closing short sale transactions where the taxpayer sells the stock or enters into a second short sale within the period beginning 30 days before and ending 30 days after the closing of the short sale.

Regulatory authority with respect to identification requirement

The Treasury is authorized under the Senate amendment to impose earlier identification deadlines under certain provisions requiring identification of a position by the close of the day on which the position is acquired. This requirement would be imposed by regulation and would apply to the hedging exemption, the mixed straddle election, identified straddles, and, in the case of securities dealers, the identification of securities held by investment. The Treasury could also provide by regulation for a method of identification other than on the taxpayer's records. It is contemplated that any additional identification requirements for the hedging exemption that may be imposed under the regulations will be consistent with the intended application of the identification rule for the hedging exemption expressed in the report of the Senate Finance Committee in 1981 as follows:

Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items. S. Rep. No. 97-144, 97th Cong., 1st Sess. 151 (1981).

Treasury would have the authority to require earlier identification only for particular classes of taxpayers, like tax shelters, or to exempt particular classes of taxpayers, like bona fide government securities dealers.

Conference agreement

The conference agreement follows the House bill with several modifications.

1. Repeal of exception for certain stock and stock options

The conference agreement modifies the definition of a qualified covered call option with respect to the restriction that limits the lowest qualified benchmark to 85 percent of the applicable stock price by making it applicable only to stock with an applicable stock price of $25 or less. With respect to stock with an applicable stock price of $150 or less, the conference agreement adopts an overall limitation restricting the lowest qualified benchmark otherwise determined to the amount which is $10 below the applicable stock price. For purposes of the loss-deferral rule, but not for purposes of the limitations on interest and carrying costs (sec. 263(g)) and the short sale and wash sale rules in section 1092, under the conference agreement a covered call option will not be treated as qualified, if gain from the disposition of the stock to be purchased under such option is included in gross income in a taxable year subsequent to the year in which the option is closed and the stock is not held for more than 30 days following the date on which the option is closed. In determining whether this holding period requirement is satisfied, rules similar to those applicable in determining whether a taxpayer is eligible for the dividend received deduction under section 246(c)(3) and (4) will apply (without regard to the exception to those rules for a qualified covered call option).

The conference agreement modifies the House bill and Senate amendment by excluding options written by options dealers in the ordinary course of their activity of writing options from the definition of a qualified covered call option. The conference agreement also makes a technical amendment pursuant to which a qualified covered call option constitutes a position within the meaning of sec. 1092(d)(2) but a straddle consisting only of stock and a qualified covered call is not treated as a straddle for purposes of sec. 1092 and sec. 263(g).

Offsetting positions, one of which is actively traded stock or an interest in such stock and one of which is a position in substantially similar or related property (other than stock) as determined under regulations, constitute a straddle subject to the loss deferral rule and other straddle rules, under the conference agreement. This rule is in lieu of the House bill's more expansive application of the straddle rules to stock and is in addition to the Senate bill's rule that eliminates the exemption only for a straddle consisting of stock and an option. Application of the straddle rules to actively traded stock and exchange traded stock options applies, as under the Senate amendment, to positions established after December 31, 1983. However, the conferees intend that the regulations defining positions that are substantially similar or related to stock held by the taxpayer will apply to straddles described in the following paragraph only for positions established on or after March 1, 1984, and for positions not described in the following paragraph only on a prospective basis.

A straddle consisting of stock and substantially similar or related property includes offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related. It also includes a short position in a stock index RFC (or alternatively an option on such an RFC or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively a portfolio of stocks whose performance mimics the performance of the stocks included in the index). Identical results will be applicable under the provision reducing the holding period of stock held by a corporation for purposes of the dividend received deduction where the taxpayer has diminished its risk of loss by holding another position in substantially similar or related property. However, stock offset by another position (other than an option) in substantially similar or related stock, which may result in a reduction in a corporate taxpayer's holding period for purposes of the dividend received deduction, does not constitute a straddle.

The conference agreement adopts the Senate amendment's extension of the hedging exemption to offsetting position stock of a member of the same affiliated group (as defined in section 1504(a)) as the taxpayer.

Under the conference agreement, any loss realized from a qualified covered call option granted by the taxpayer which has a strike price below the applicable stock price will be long-term capital loss if gain from a sale or exchange of the stock at the time such loss is realized would be long-term. In addition, the holding period for the stock subject to such option shall not include any period during which the taxpayer is the grantor of the option. It is anticipated that stock option losses and the holding period of stock will also be subject under regulations to sec. 1233(b) and (d) principles as applied to straddles consisting of stock and stock options. However, straddles consisting of stock and qualified covered call options to which the straddle rules are inapplicable will be affected only by the statutory rules under discussion. These rules are in lieu of the provision in the House bill and Senate amendment which would convert long-term gain from the sale or exchange of stock to short-term, to the extent of short-term losses realized on such options. The conferees believe that these rules reduce record-keeping requirements for taxpayers relative to a provision recharacterizing gain on sale of the stock. These rules are applicable to positions established after June 30, 1984.

The conference agreement extends the identified straddle rules of sec. 1092(a)(2) to straddles consisting entirely of section 1256 contracts. Thus, such a straddle which satisfies the definition of an identified straddle under section 1092 as amended by the bill will not cause sec. 263(g) or sec. 1092(a) to apply to any position by treatment of part or all of such straddle as also including positions not part of the identified straddle.

The identification requirement applicable to the hedging exemption, as under the Senate amendment, will not apply to transactions in stock or stock options until 60 days after the date of enactment.

2. Mark-to-market and 60/40

The conference agreement clarifies the provision disqualifying from capital gain or loss status options and RFCs of options dealers and commodity traders held to hedge ordinary income or loss property, by limiting disqualification to cases where a loss from the property would be an ordinary loss to the taxpayer. Thus, for example, ordinary income resulting solely from application of the new market discount rules added by the bill, will not affect the capital gain or loss status of an offsetting option.

The conference agreement eliminates the reference to registration with the SEC in the definition of "options dealer" as contained in the House bill and Senate amendment since there is no such registration requirement for options dealers. Further, the conferees intend that the capital gain or loss status of options traded in the normal course of an options dealer's activity in trading options is to be determined without regard to the identification requirement of sec. 1236.

The conferees wish to clarify that the hedging exception to the capital asset status of section 1256 contracts in sec. 1256(f)(4)(B), as added by the bill, is not intended to limit the scope of the hedging ex-

emption of present law, so that, a section 1256 contract may hedge property to be acquired or obligations to be incurred to the extent those results are obtained under section 1256(e).

Several stock index options are currently traded for which there has been no designation by the CFTC for futures trading in the same index. These options held by investors are not subject to mark-to-market and 60/40 treatment until the Secretary of the Treasury determines that they meet the requirements of law for such a CFTC designation. The conferees expect such designations will have prospective effect only. Thus, the conferees urge the Treasury Department to take prompt action to determine the status of these options. The conference agreement provides for the extension of mark-to-market and 60/40 treatment, as well as the covered call exception, to options traded on a market other than a board of trade or exchange if the Secretary of the Treasury determines that such market has rules adequate to carry out the purposes of the provisions governing the treatment of section 1256 contracts. The Secretary is also to determine whether persons trading in such market qualify as options dealers.

Under the conference agreement, the rule that makes 60/40 treatment inapplicable to gains and losses with respect to dealer equity options applicable to limited partners and limited entrepreneurs is clarified by providing that such gains and losses are treated as short-term capital gains and losses.

Clarifying and technical corrections are made to the definition of "equity option" under the conference agreement.

For stock option market makers electing mark-to-market and 60/40 treatment for all positions held during the taxable year which includes the date of enactment, the conference agreement adopts the Senate amendment's extension of the election to pay the tax resulting from prior years' appreciation in stock options in 2 to 5 annual installments to the tax resulting from unrealized appreciation in stock, and limits the election to gain from stock and options which would be ordinary income to the taxpayer if the stock and options were disposed of by the taxpayer on the last day of the taxable year preceding the taxable year which includes the date of enactment.

3. Treatment of gains and losses of options and commodities dealers as earned income and for certain subchapter S purposes

Under the conference agreement, gains and losses derived in the ordinary course of trading in section 1256 contracts and property related to such contracts (e.g., stock used to hedge options) are defined as earnings from self-employment for purposes of applying the tax on self-employment income and the rules relating to contributions to self-employment plans. This treatment is extended only to options dealers, and commodity dealers, as defined in the bill. A commodity dealer is any person registered with a domestic board of trade designated as a contract market by the CFTC who buys or sells options or RFCs subject to the rules of such board. This treatment applies to taxable years beginning after the date of enactment except that for options dealers electing 60/40 and mark-to-market rules for the taxable year which includes the date of enactment, it applies for such taxable year. The conferees intend that no inference be made as to whether options dealers and commodity dealers be viewed as engaged in a trade or business in connection with their transactions in section 1256 contracts as a result of the application of self-employment taxes to such persons.

Under present law, a tax is imposed on corporations making a subchapter S election in certain cases where net capital gain exceeds 50 percent of the corporation's taxable income. Further, when an election is made by a corporation which has subchapter C earnings and profits, it may be taxable on a portion of its passive investment income and, in certain cases, the election may be terminated. To facilitate subchapter S elections by options and commodities dealers, the conference agreement excepts gains and losses with respect to section 1256 contracts and related property derived in the normal course of an options or commodities dealer's transactions in options or commodities from net capital gain subject to tax under section 1374 and from passive investment income as defined in section 1362(d)(3).

The conference agreement provides that an election to be an S corporation made by a commodities dealer or options dealer made within 75 days after the date of enactment of the bill will be effective for the taxable year which includes the date of enactment without regard to the requirement in sec. 1362(b) requiring the election to be made by the 15th day of the third month of the year.

4. Capitalization of interest and carrying costs and other rules

Interest and carrying costs of a straddle position that are required to be capitalized are reduced, as under the Senate amendment, by dividends on stock included in a straddle. The conference agreement provides that this reduction is limited to the portion of the dividend included in income after allowance of the dividends received deduction. The conference agreement also provides for additional reductions with respect to market discount and acquisition discount included in income under secs. 1276 and 1281 as added by the bill. New sec. 263(h) added by the bill, which disallows the deduction of short sale expenses in certain cases, section 1277 added by the bill, which requires the deferral of net direct interest on indebtedness with respect to market discount bonds, and section 1282 as added by the bill, which requires the deferral of interest on indebtedness with respect to short-term obligations, are to be applied before the application of the rule requiring the capitalization of costs with respect to straddle positions. The conference agreement amends the provision of present law prescribing capital gain or loss treatment with respect to certain contract terminations to exclude from its application (effective as if such exclusion had been included as part of such provision as adopted in ERTA) the retirement of any debt instrument (whether or not through a trust or other participation arrangement, such as a mortgage pass-through certificate).

5. Mixed straddle regulations

The conference agreement extends the regulatory authority, with respect to mixed straddles, to include as a mixed straddle positions not described as such in present law section 1256(d)(4). In addition the regulatory authority is extended to provide rules governing the application of sec. 263(g).

In addition, the conference agreement prescribes that the regulations will provide rules that will apply in lieu of the application of section 1233(d) principles to mixed straddles if the taxpayer so elects. Under these rules, a taxpayer may either (i) offset gains and losses from positions which are part of mixed straddles by separately identifying each mixed straddle to which such treatment applies or (ii) establish a mixed straddle account with respect to a class of activities for which gains and losses will be recognized and offset on a periodic basis. These two new elections will be in addition to the mixed straddle election of present law. Under either of the new alternatives, 60/40 treatment will apply only to net gain or loss from the straddle transactions and only to the extent attributable to section 1256 contracts. Under the rules applicable to a mixed straddle account, not more than 50 percent of any net gain from the account may be treated as long-term capital gain and not more than 40 percent of any net loss from the account may be treated as short-term capital loss.

It is intended that, regulations adopting the principles of section 1233(d), authorized under present law for straddles, will result in recharacterizing short-term losses realized from mixed straddle positions not subject to section 1256 as 60/40 losses in the case of mixed straddles that are not either identified or subject to the account described in the preceding paragraph. Under present law, a mixed straddle may also produce 60/40 losses on the section 1256 contracts and short-term gain on the other positions included in the mixed straddle, effectively converting long-term gain realized from transactions unrelated to the straddle to short-term. Taxpayers can avoid this result under present law by making a mixed straddle election foregoing marking-to-market and 60/40 treatment for their section 1256 contracts included in a mixed straddle.

The regulations prescribed by the conference agreement will permit taxpayers to avoid the loss recharacterization rule that results from applying sec. 1233(d) principles while retaining favorable treatment for mixed straddle net gains derived from section 1256 contracts.

Straddle-by-straddle identification

It is intended that, in applying the regulations to separately identified mixed straddles, the determination by the taxpayer of what constitutes a mixed straddle generally will be accepted by the Internal Revenue Service if the taxpayer has adopted a reasonable and consistently applied method of identifying straddle positions which clearly reflects income in the absence of circumstances indicating that the taxpayer has not properly identified straddles pursuant to such method.

The present law election to exclude section 1256 contracts from 60/40 and mark-to-market treatment may be exercised only if all positions included in a mixed straddle are identified not later than the day on which the first section 1256 contract so included is acquired. It is intended that the offset for gains and losses from mixed straddles under the regulations prescribed under the conference agreement may apply in cases where the taxpayer holds either section 1256 contracts or other positions before a mixed straddle is established. In such cases it is intended that the regulations will require the pre-straddle gains and losses accrued at the time the mixed straddle is created to be recognized at such time. Such gain or loss from positions not subject to sec. 1256 will be short-term or long-term, depending on the taxpayer's holding period when the mixed straddle is created, and gain or loss from pre-existing section 1256 contracts will receive 60/40 treatment. In all such cases, appropriate basis adjustments will be made to exclude such pre-existing gains and losses from the mixed straddle offsetting rules.

If a mixed straddle is terminated without disposing of all positions, it is contemplated that the regulations will require recharacterization of gains and losses from some closed positions. For example, if the taxpay-

er closes a section 1256 contract at a loss of $10 which is offset by an unrealized gain of $10 on an offsetting position not subject to section 1256, the loss will be recharacterized as short-term and will be deferred under sec. 1092 to the extent there continues to be unrecognized gain on the offsetting position at year-end. Under the offsetting position rules, if the loss on the section 1256 contract in this example were $12, the additional $2 that is not offset by unrealized gain would receive 60/40 treatment and would be recognized, assuming it is not offset by unrecognized gain in the offsetting position at year-end. Similarly, if the taxpayer realized a $12 gain on closing a section 1256 contract offset by an unrealized $10 loss on an open offsetting position not subject to section 1256, the rule would recharacterize $10 of such gain as short-term, which would be recognized currently since section 1092 does not defer gains. The remaining gain of $2 would also be recognized and receive 60/40 treatment. The taxpayer could avoid tax on the $10 gain converted to short-term by closing out the offsetting position at a $10 loss before year-end.

If a mixed straddle is terminated by closing out positions other than the section 1256 contracts, it is contemplated that the gain or loss will be offset by the loss or gain with respect to the section 1256 contracts as of the time such positions are closed and any net gain or loss attributable to the positions other than section 1256 contracts will be short-term. Losses from closing positions other than section 1256 contracts generally will not be deferred by sec. 1092 but instead will be netted against any offsetting gain on the section 1256 contracts included in the mixed straddle to the extent of such gain at the time the loss position is terminated. Adjustments to subsequent gain or loss with respect to section 1256 contracts included in a mixed straddle and retained following its termination will be made as under sec. 1256(a)(2) to reflect the portion of such gain or loss absorbed under the offsetting position rules. For example, if the taxpayer closes a position other than a section 1256 contract at a $12 gain and, on the date of disposition, there is a $10 loss determined by marking-to-market the offsetting section 1256 contract, the taxpayer will have a $2 short-term gain. If the taxpayer retains the section 1256 contract at year-end and it is marked-to-market at the same price that resulted in the offsetting $10 loss, no further gain or loss is recognized.

The holding period of positions other than section 1256 contracts included in a mixed straddle will not commence until the mixed straddle is terminated. In this regard, all post-straddle period gain or loss, as to amount and treatment as short-term or long term, is to be determined without regard to gain and loss attributable to the straddle period.

For mixed straddles with respect to which both section 1256 contracts and offsetting positions remain open at year-end, gain and loss attributable to positions that are not section 1256 contracts are not recognized currently. However, gains on section 1256 contracts are recognized under section 1256 and, to the extent offset by unrecognized losses on positions that are not section 1256 contracts, will be recharacterized as short-term gains under the regulations. Similarly, year-end losses on open section 1256 contracts, to the extent offset by unrecognized gains on positions that are not section 1256 contracts, will be recharacterized as short-term losses and will be deferred under section 1092.

Mixed straddle account election

The mixed straddle account rules will accommodate taxpayers who, with respect to a class of trading activities, have such a large volume of transactions that identification of specific mixed straddles is impractical. The account rules will accommodate, for example, market makers in options on XYZ company stock who also have long and short non-option positions in XYZ company stock in substantial volume. If the taxpayer is also a market maker in options on ABC company stock, it is intended that a second account be established with respect to such options and the underlying stock. The conferees intend that the Treasury have considerable flexibility in determining the nature of these accounts, and in specifying the classes of activities for which separate accounts must be established.

All gains and losses on positions in the account are to be determined and offset on a periodic basis which may be a daily or less frequent basis. Those positions not closed during the period are to be marked to market as of the close of the period. In determining how frequently positions in the account are to be marked-to-market and gains and losses are to be netted, the Secretary is to take account of recordkeeping and other administrative burdens that would be imposed on taxpayers.

Gains and losses from positions that are not section 1256 contracts are to be netted for the period and gains and losses from section 1256 contracts for the period are separately netted. The gain or loss from the positions that are not section 1256 contracts are then offset against the loss or gain from the section 1256 contracts. Overall net gain or loss for the period attributable to positions not subject to section 1256 constitutes short-term gain or loss. Overall net gain or loss for the period attributable to section 1256 contracts constitutes 60/40 gain or loss. Net short-term gain and net long-term loss resulting from applying the rules to any period retain their character without regard to the results derived from applying the rules to other periods within the taxable year. If, as a result of applying these rules, over 50 percent of the aggregate net gain for the taxable year from the account is long-term, the excess over 50 percent will be converted to short-term gain. Similarly, if over 40 percent of the aggregate net loss for the taxable year from the account is short-term, the excess over 40 percent will be recharacterized as long-term loss.

Gains and losses with respect to positions entering the account that have accrued as of the date the account is established will be recognized at that time and treated as long-term or short-term depending on the taxpayer's holding period as of that date, or as 60/40 gain or loss for section 1256 contracts. Appropriate basis adjustments will be made to reflect such gains and losses. Similar rules will apply where positions are transferred to and from the account.

It is intended that, under the regulatory rules prescribed in accordance with the conference agreement, the Treasury will have broad authority to place positions held by the taxpayer in the account and to exclude positions from the account, and otherwise to prescribe standards with respect to the account to insure that income is clearly reflected, and the purpose of the mixed straddle rules is carried out.

Effective date of regulations

The conference agreement adopts with a technical modification the Senate amendment's prohibition against applying the regulations under section 1092(b) to mixed straddles established prior to January 1, 1984. Under the House bill and Senate amendment, regulations under section 1092(b) (including regulations relating to mixed straddles) are to be prescribed within 6 months after the date of enactment of the bill. The conference agreement modifies this requirement so as to apply to the initial regulations. The conferees also intend that the regulations providing for netting of identified mixed straddles and for a mixed straddle account will apply to any taxable year, if the taxpayer elects, to the extent that the amendments applicable to section 1256 contracts under the bill apply for such taxable year under the effective date provisions of section 102 (f) and (g) of the bill.

6. Limitation on losses from hedging transactions

The conference agreement adopts the Senate amendment's restriction on the application of the rule limiting net hedging losses to income from the trade or business in which the hedging transaction was entered into to losses allocable to limited partners and limited entrepreneurs. The taxable income determined without regard to hedging transactions is to be separately computed for partners and S corporation shareholders with such limited interests. The conference agreement adopts a clarifying amendment limiting unrecognized hedging gains resulting in a disallowance of hedging losses to those relating to the trade or business in which the hedging losses were incurred.

7. Options on section 1256 contracts

The conference agreement adopts the Senate amendment providing that gain or loss is recognized on the exercise of an option on a section 1256 contract. Under this provision, if an option on a section 1256 contract is excluded from mark-to-market and 60/40 treatment as a result of a mixed straddle election, the treatment of gain or loss resulting from exercise of the option will be determined under the rules of section 1234(a) and (b). In cases in which an option on a section 1256 contract is not accorded 60/40 treatment (because, for example, a mixed straddle election was made with respect to the option), gain or loss will not be accorded 60/40 treatment to either holders or grantors of the options. Thus, the conferees reject the assertion that the "character" of property underlying an option on a section 1256 contract includes the deemed holding period provided to section 1256 contracts. Similarly, the grantor's obligation under an option on a section 1256 contract will not be treated as a section 1256 contract if the option is not directly accorded section 1256 contract treatment.

8. Wash sale rules to apply to losses on certain short sales and other transactions

The conference agreement adopts the Senate amendment extending the wash sale rule to a loss realized on the closing of a short sale if, within 30 days before or after such closing, the taxpayer sells, or enters into another short sale of, substantially identical stock or securities.

Under present law, the wash sale rule does not apply, in the case of taxpayers other than corporations, if the loss is incurred in a trade or business while, in the case of a corporation, it is inapplicable only if the taxpayer is a dealer in stocks or securities and the loss is sustained in a transaction made in the ordinary course of such business. Under the conference agreement the corporate exclusion is made applicable to all taxpayers so that the wash sale rule is inapplicable only if the taxpayer is a dealer in stocks or securities and the loss is sustained in a transaction made in the ordinary course of the taxpayer's business of dealing in stocks and securities.

These amendments apply to losses sustained on short sales occurring after the date of enactment. The limitation of the ex-

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emption to dealers in stocks and securities applies to sales after December 31, 1984.

9. Time for identification by taxpayers of certain transactions

The conference agreement adopts the Senate amendment providing regulatory authority to require identification earlier than the close of the day on which an acquisition is made with respect to identified straddles, mixed straddles, the hedging exemption, and securities held for investment by a dealer. The conference agreement restores the present law requirement applicable to identified straddles that the straddle must be identified on the taxpayer's records. This provision applies to positions entered into after the date of enactment.

10. Treatment of losses from pre-1981 straddles

Present law

Prior to the adoption of rules relating to straddles and marking RFCs to market by the Economic Recovery Tax Act of 1981 (ERTA), it was unclear whether a claimed loss was allowable on the disposition of a position in a straddle where offsetting unrecognized gain on another position or positions included in the straddle was deferred. In Revenue Ruling 77-185, 1977-1 C.B. 48, the Internal Revenue Service ruled that a loss claimed on disposing of legs of a silver futures straddle where the straddle was continued was not deductible because there was no closed and completed transaction and the disposition represented no real economic change. Similar arguments were rejected by the Tax Court in *Smith* v. *Commissioner of Internal Revenue*, 78 T.C. 350 (1982) although the loss found to have been incurred in that case was disallowed because, under the facts of the case, it was not incurred in a transaction entered into for profit. The Internal Revenue Service is continuing to litigate the allowability of pre-1981 straddle losses in accordance with the position adopted in Rev. Ru. 77-185 and is challenging such losses where claimed by commodity dealers as well as by investors with isolated transactions such as those involved in the *Smith* case.

House bill

No provision.

Senate amendment

The Senate amendment requires the Secretary of the Treasury to report to the Committee on Finance and the Ways and Means Committee before October 1, 1984, with respect to progress made in reducing the backlog of cases involving the treatment, prior to ERTA, of regulated futures contracts.

Conference agreement

The conferees believe it is inappropriate to prolong the uncertainty with respect to the treatment of losses claimed with respect to straddle positions for periods prior to 1981. Accordingly, in lieu of the Senate amendment's requirement of a report with respect to pre-1981 cases, the conference agreement provides that a loss on the disposition of a position entered into before 1982 will be allowed, except to the extent nonrecognition is required under any applicable provision, if the position is part of a transaction entered into for profit. This treatment applies where the position is part of a straddle as defined in section 1092 as in effect on the day after the date of enactment of ERTA (as well as a straddle consisting entirely of RFCs), and is one to which the provisions of Title V of ERTA did not apply. The loss generally will be allowed for the taxable years in which the position is disposed of. Rules affecting the period within which the loss is recognized, and its treatment as long-term or short-term, such as sec. 1233 or sec. 1234, are to be applied without regard to the fact that the position is part of a straddle.

The provision does not apply to syndicates, as defined in sec. 1256(e)(3)(B). In determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied if there is a reasonable prospect of any profit from the transaction.

In the case of commodity dealers and persons actively engaged in investing in RFCs, the provision is to be applied by presuming that the position is held as part of a transaction entered into for profit unless the Internal Revenue Service establishes to the contrary. In determining whether a taxpayer is actively engaged in trading in RFCs with an intent to make a profit, a significant factor will be the extent of transaction costs. If they are sufficiently high relatively to the scope of the taxpayer's activities that there is no reasonable possibility of a profit, the presumption will be unavailable. RFCs for purposes of applying the presumption are regulated futures contracts as defined in section 1256(b) before its amendment by the bill.

For purposes of the provision, the term "commodities dealer" has the same meaning as such term in the amendments by the bill providing for application the self-employment income tax to such persons.

I. Foreign Provisions

1. Maintaining the source of U.S. source income

Present law

All U.S. source income of U.S. persons is subject to U.S. tax. The United States also subjects foreign source income of U.S. persons to U.S. tax, but allows a credit for foreign taxes paid on foreign source income. U.S. taxpayers can convert the source of some U.S. source income by paying interest, insurance premiums, or other amounts to a foreign corporation. When the foreign corporation distributes dividends or pays interest to its U.S. owners, generally the dividends or interest are foreign source income. The U.S. owners may pay no U.S. tax and no foreign tax on this artificially converted foreign source income. The same conversion of U.S. to foreign source income can occur when a controlled foreign corporation earns tax-haven-type income that causes an inclusion in the income of its U.S. shareholders (under subpart F).

House bill

For purposes of the foreign tax credit limitation, when 50-percent U.S.-owned corporations whose U.S. source income (including U.S. business income) is 10 percent or more of gross income over a 3-year period pay interest or dividends to a U.S. taxpayer, the portion of the payment attributable to U.S. source income will be treated as U.S. source income. The same result will apply to inclusions under subpart F. The House bill applies to income earned by paying corporations after the date of enactment, but generally does not apply to interest earned on term obligations held on March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill, but it specifies a pro rata method of calculating amounts attributable to U.S. source income. Its effective date is generally the same as the House bill. However, two transitional rules are provided. First, the amendment exempts interest earned by foreign finance subsidiaries until 1992 if the interest arises from loans whose source of funds is (1) debt outstanding on March 7, 1984 (or outstanding on March 31, 1984, pursuant to a binding commitment on March 7) or (2) its equity on March 31, 1984. Second, for corporations other than foreign finance subsidiaries, the amendment does not apply to interest earned on term obligations held on March 7, 1984.

Conference agreement

The conference agreement generally follows the House bill, with substantial technical modifications. The effective date rules follow the Senate amendment, with technical modifications.

Explanation of rules

The conference agreement expressly extends the provision to foreign personal holding company inclusions (Code sec. 551). The conferees saw no reason to allow conversion of U.S. source income to foreign source income through the use of this class of incorporated pocketbooks.

The conference agreement eliminates the 3-year base period provided in the House bill and the Senate amendment; the provision operates on a year-by-year basis under the conference agreement. The agreement makes this change because the 3-year base period could result in too little or too much U.S. source income.

The conference agreement provides separate rules for application of the provision to (1) subpart F and foreign personal holding company income inclusions, (2) interest, and (3) dividends. The conference agreement provides that subpart F inclusions (Code sec. 951(a)) and foreign personal holding company inclusions will be treated as derived from U.S. sources to the extent attributable to U.S. source income of the U.S.-owned foreign corporation with respect to which the inclusions are required.

In general, interest paid or accrued by a U.S.-owned foreign corporation during a taxable year will be treated as derived from U.S. sources to the extent properly allocable (under regulations prescribed by the Secretary) to U.S. source income of the foreign corporation for that taxable year. Interest is to be allocated for this purpose using the same method used (pursuant to Code section 954(b)(5)) to compute the amount of any subpart F or foreign personal holding company inclusion made with respect to the foreign corporation. The conference agreement applies this rule to interest paid or accrued to a (10-percent) U.S. shareholder of the foreign corporation (Code section 951(b)) or to a person related to such a shareholder (Code section 267(b)). In addition, the Secretary may prescribe regulations providing that interest paid or accrued to any person, whether or not the person is a U.S. shareholder, will be subject to the provision. Such regulations might be necessary in the case of U.S.-owned foreign corporations only some of whose U.S. owners are 10-percent U.S. shareholders.

A portion of any dividend paid or accrued by a U.S.-owned foreign corporation will be treated as derived from U.S. sources on the basis of a U.S. source ratio. The "U.S. source ratio" of a dividend equals the earnings and profits from U.S. sources for the taxable year out of whose earnings and profits the dividend was paid or accrued, divided by the total earnings and profits for that taxable year. Thus, while the conference agreement eliminates the 3-year base period, in determining whether a dividend will be treated as derived from U.S. sources the source of a prior year's earnings and profits will control to the extent that the dividend is paid out of that prior year's earnings and profits.

The provision applies for purposes of the foreign tax credit limitation only. In addition, the conference agreement makes clear that the provision applies only to subpart F and foreign personal holding company inclusions, dividends, and interest that would

otherwise be treated as derived from foreign sources.

The conference agreement modifies the exception provided in the House bill for inclusions with respect to, and payments received from, U.S.-owned foreign corporations with small amounts of U.S. source income. Under the conference agreement, the exception will apply to dividends and interest only. It will not apply to subpart F and foreign personal holding company inclusions since these provisions do not operate absent threshold amounts of tax-haven type or passive income. Under the conference agreement, the exception will apply when a U.S.-owned foreign corporation has earnings and profits and less than 10 percent of the earnings and profits are attributable to U.S. sources; under the House bill, by contrast, the exception would have applied when less than 10 percent of a U.S.-owned foreign corporation's gross income was from U.S. sources. The agreement adopts this change because of the possibility that taxpayers could defeat the purpose of the provision if it contained a gross income test by earning U.S. source gross income (such as interest) offset by few expenses and sheltering that income with foreign source gross income fully or nearly offset by expenses. In addition, under the conference agreement, the 10-percent test will be applied to earnings and profits on a year-by-year basis rather than, as under the House bill, to income in a 3-year base period. To prevent manipulation of the 10-percent exception, the conference agreement provides that, for purposes of the exception, earnings and profits will be determined without any reduction for interest paid or accrued by a U.S.-owned foreign corporation to a U.S. shareholder of the foreign corporation or to a related party, whether U.S. or foreign.

The term "U.S.-owned foreign corporation" is defined as in the Senate amendment, with minor technical modifications. The conference agreement specifies that, for purposes of the provision, the term "dividend" includes any gain treated as ordinary income under Code section 1246 or as a dividend under Code section 1248. The conference agreement provides that the provision will apply before the Code's foreign loss recapture rules.

The conference agreement requires the Secretary to prescribe such regulations as may be necessary or appropriate for application of the provision in the case of interest or dividend payments through one or more entities. For example, a U.S.-owned foreign corporation that earns gross U.S. source income but that pays interest to a related foreign party might thereby reduce the amount of income that would otherwise be resourced. The Secretary is to prescribe rules so that an inclusion in income of a U.S. taxpayer on account of the related foreign corporation *will* be subject to resourcing. Such an inclusion could occur, for example, under the rules of subpart F, on a dividend or interest payment by the related foreign corporation, or on an investment by the related foreign corporation in U.S. property. The following example provides a more detailed illustration.

Example 1

A foreign corporation wholly owned by a U.S corporation ("CFC-1") earns $100 of gross U.S. source dividends (that is foreign personal holding company income subject to subpart F) but reduces its current year earnings and profits to zero by a $100 interest payment to another foreign corporation wholly owned by the same U.S. corporation ("CFC-2"). Because of the interest payment, there is no subpart F inclusion by the U.S. parent corporation on account of CFC-1 and no dividend payable for the year by CFC-1. Thus, the U.S. parent has no current income with respect to CFC-1 that could be subjected to resourcing. Absent the special rule under discussion, the $100 of U.S. source dividends received by CFC-1 would not give rise to any resourcing of income from CFC-1 or CFC-2 that is included in the U.S. parent's gross income. To prevent this result, the regulations to be prescribed by the Secretary will, for example, subject to resourcing a subpart F inclusion on account of CFC-2 determined with respect to its current year earnings and profits regardless of whether the 10-percent exception from resourcing would otherwise apply. The regulations will treat as U.S. source income CFC-1's $100 interest payment to CFC-2. The U.S. parent's subpart F inclusion on account of CFC-2 consequently will be resourced to the extent of the $100 interest payment (and any other U.S. source subpart F income of CFC-2).

The application of the resourcing provision is illustrated generally in the following examples:

Example 2

A foreign corporation wholly-owned by a U.S. corporation earns $100 of net income and pays a $20 dividend. Ninety dollars of the net income is attributable to the insurance of U.S. risks and $10 is attributable to the insurance of foreign risks of related parties located in other foreign countries. All of the income is subpart F income to the U.S. parent corporation (under Code section 953, and Code section 954(e) as amended by the conference agreement). Since $90 of this $100 subpart F inclusion is attributable to U.S. source income of the foreign corporation (the $90 of net income attributable to the insurance of U.S. risks), $90 of the inclusion will be treated as U.S. source income of the parent corporation under the provision.

As a result of the $100 subpart F inclusion, the $20 dividend is considered to be paid from previously taxed earnings and profits and is excluded from the parent corporation's gross income under Code section 959. The provision, therefore, has no application to the tax-free $20 dividend.

Example 3

A foreign corporation, 90 percent of the total combined voting power in which is held by a U.S. corporation, earns net income of $95 from the sale of personal property in a second foreign country. The foreign corporation also earns net dividend income (after allocation of expenses) of $5 from a U.S. money market account. All of the foreign corporation's $100 of net income is foreign base company income.

Among the foreign corporation's expenses (deductions from net income) is a $20 interest payment to its U.S. parent. The foreign corporation's $95 of net sales income is from foreign sources. Its $5 of net dividend income is from U.S. sources. Assume, for purposes of this example only, that earnings and profits equal net income and that $19 of the $20 interest payment was allocated to gross foreign sales income and the remaining $1 to gross U.S. dividend income in computing the respective amounts of net income from foreign and U.S. sources.

Under subpart F, the U.S. parent corporation must include its pro rata share of the foreign corporation's $100 of foreign base company income in its gross income for the taxable year. Assume, because the U.S. parent controls 90 percent of the voting power in the foreign corporation, that its pro rata subpart F inclusion is $90.

To determine whether the 10-percent exception from resourcing may apply (i.e., whether less than 10 percent of the foreign corporation's earnings and profits for the year are attributable to U.S. sources), the foreign corporation's earnings and profits are first recomputed without any reduction for the $20 interest payment to its U.S. parent. Earnings and profits recomputed in this manner equal $120. Of this amount, $6, or five percent, is attributable to U.S. sources (the $5 of net U.S. dividend income plus the $1 of the $20 interest payment previously allocated to gross U.S. dividend income in computing the amount of net income from U.S. sources).

While less than 10 percent of the foreign corporation's recomputed earnings and profits for the year are, thus, attributable to U.S. sources, the 10-percent exception does not apply to subpart F income. The portion of the U.S. corporation's $90 subpart F inclusion attributable to U.S. source income of the foreign corporation is 5/100ths of $90, or $4.50. Therefore, $4.50 of the subpart F inclusion will be treated as U.S. source income of the U.S. parent under the provision.

The 10-percent exception does, however, apply to interest payments. Because less than 10 percent of the foreign corporation's recomputed earnings and profits are attributable to U.S. sources, the $20 interest payment made by the foreign corporation to its U.S. parent is not subject to resourcing under the provision.

Example 4

A foreign corporation wholly owned by a U.S. corporation earns $85 of gross income, consisting of $60 of gross income from manufacturing operations in its country of incorporation, $10 of gross U.S. bank interest, and $15 of gross interest on a loan to a U.S. affiliate. The foreign corporation incurs total expenses of $115, consisting of $85 of manufacturing expenses and $30 of interest payments to its U.S. parent. The foreign corporation, thus, has a net loss of $30 for the taxable year. Assuming, for simplicity, that earnings and profits equal net income, the foreign corporation also has a deficit in earnings and profits of $30 for the taxable year. The foreign corporation pays a $20 dividend out of earnings and profits for an earlier taxable year. One hundred percent of the earlier year's earnings and profits were from foreign sources and no interest was paid to U.S. affiliates in the earlier year. The foreign corporation owns assets with a total fair market value of $500, consisting of assets used in its manufacturing operations worth $300, a $100 U.S. bank deposit, and a $100 loan to a U.S. affiliate.

To determine whether the 10-percent exception applies to the $30 of interest paid to the U.S. parent, the foreign corporation's earnings and profits for the current year must first be recomputed without any reduction for this interest paid to a U.S. shareholder. Earnings and profits recomputed in this manner equal zero ($ −30 + $30). The 10-percent exception, therefore, does not apply since a requirement of the exception—that the foreign corporation have earnings and profits for the year—is not satisfied.

To determine how much of the $30 of interest payments will be treated as U.S. source income of the U.S. parent under the provision, the payments must be allocated to gross income of the foreign corporation from U.S. and foreign sources, respectively. The U.S. parent corporation uses the asset method (Treas. Reg. sec. 1.861-8(e)(2)(v)) to allocate interest under the provision. Thus, it allocates $18 of the interest paid ($30 × ($300/$500)) against the foreign corporation's $60 of gross manufacturing income, $6 ($30 × ($100/$500)) against the foreign corporation's $10 of gross U.S. bank

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interest, and $6 ($30 x ($100/$500)) against the foreign corporation's $15 of gross interest on its U.S. affiliate loan. Since all of the manufacturing income is from foreign sources and of all the interest income from U.S. sources, a total of $12 ($6 + $6) of the interest paid is properly allocable under the provision to U.S. source income of the foreign corporation. Therefore, $12 of the $30 of interest paid by the foreign corporation to its U.S. parent will be treated as U.S. source income of the U.S. parent under the provision.

Because the foreign corporation has no earnings and profits for the current year, the U.S. parent corporation has no subpart F inclusion with respect to any separately computed net U.S. interest income earned by the foreign corporation. Any such income would otherwise be subpart F income and, because wholly attributable to U.S. source income of the foreign corporation in this case, would be treated as U.S. source income of the parent under the provision.

Because the $20 dividend paid to the U.S. parent corporation is paid out earnings and profits for a year for which all earnings and profits were from foreign sources, no portion of the dividend will be treated as U.S. source income of the U.S. parent under the provision.

Effective date

General rule

Under the Senate amendment, the provision generally will take effect on the date of enactment. In the case of a taxable year of a U.S.-owned foreign corporation in which the date of enactment occurs, only income received or accrued by the U.S.-owned foreign corporation during that taxable year after the date of enactment generally will be taken into account for resourcing purposes. However, the conference agreement makes clear that *all* income received or accrued by the U.S.-owned foreign corporation during that taxable year will be taken into account for purposes of applying the exception for corporations with small amounts of U.S. source income (the 10-percent exception).

Transitional rules

The two transitional rules provided in the Senate amendment are retained in the conference agreement, with some liberalizing technical modifications.

Under the first transitional rule, certain interest received or accrued by "applicable CFCs" (controlled foreign corporations) will not be taken into account for resourcing purposes if the interest is allocable to certain CFC obligations outstanding, or certain CFC equity, as of March 31, 1984. Interest received or accrued prior to 1992 on U.S. affiliate obligations held by an applicable CFC and allocable to that CFC's capitalizations on March 31, 1984 qualifies for this treatment. For this purpose, an applicable CFC's capitalization on March 31, 1984 is equal to the sum of the CFC's obligations (issued by the CFC) and equity outstanding on March 31, 1984. Obligations outstanding on March 31, 1984 are not counted for this purpose if they were not issued before March 8, 1984, unless a binding commitment by the CFC to issue them was in effect on March 7, 1984.

Qualified interest in a given taxable year is determined by multiplying the interest received or accrued in that year on an applicable CFC's loans to its U.S. affiliates by a limiting fraction. The limiting fraction is equal to (1) the aggregate principal amount of U.S. affiliate obligations held by the CFC on March 31, 1984 (but not in excess of the CFC's March 31, 1984 capitalization), divided by (2) the average daily principal amount of U.S. affiliate obligations held by the CFC during the taxable year. In no event may the limiting fraction exceed one.

The numerator of the limiting fraction is adjusted downward to reflect (1) retirements in that taxable year of any obligations issued by the CFC that are included in its March 31, 1984 capitalization, and (2) a pro rata portion of the CFC's equity allocable to these retired obligations.

The conference agreement makes technical modifications with respect to the treatment of obligations with original issue discount (OID) under the first transitional rule. It treats the principal amount of CFC and U.S. affiliate obligations with OID as including, as of any day, the aggregate amount of all OID on such obligations previously includible in gross income as of that day. It also specifies that proper adjustments are to be made in the numerator of the limiting fraction for OID accruing after March 31, 1984 on CFC obligations and U.S. affiliate obligations. The latter rule will allow an upward adjustment in the numerator, where necessary, for OID accrued after March 31, 1984 on OID-type CFC obligations. However, to the extent that the proceeds of OID-type CFC obligations included in a CFC's March 31, 1984 capitalization were used, as of March 31, 1984, to finance non-U.S. affiliate obligations, no special adjustment in the numerator will be allowed under this rule.

The conference agreement slightly expands the definition of "applicable CFC." Under the conference agreement, an applicable CFC is any CFC in existence on March 31, 1984, the principal purposes of which on that date consisted of issuing obligations (whether short-term or long-term) and lending the proceeds to affiliates. A corporation will satisfy this principal purpose test if at least half of its liabilities on March 31, 1984, were CFC obligations and if at least half of its assets on that date were loans to affiliates.

The terms "affiliate," "U.S. affiliate," and "U.S. affiliate obligation" are defined in the same manner as under the Senate amendment. The definition of "CFC obligation" is revised under the conference agreement so that otherwise qualified interest on certain obligations issued on or before December 31, 1982 will be covered by the first transitional rule.

The first transitional rule does not apply in determining whether the 10-percent exception applies. Thus, if an applicable CFC has $100 of earnings and profits for a given year, $15 of which is attributable to qualified interest, $5 of which is attributable to other U.S. source income, and $80 of which is attributable to foreign source income, the 10-percent exception will not apply for that year: For purposes of the exception, 20 percent of the applicable CFC's earnings and profits will be attributable to U.S. sources. However, because, under the transitional rule, qualified interest is not taken into account for resourcing purposes, only 5/100ths (rather 20/100ths) of a dividend paid by the applicable CFC out of that year's earnings and profits will be subject to resourcing.

Under the second transitional rule, interest earned on term obligations held on March 7, 1984 by U.S.-owned foreign corporations that are not applicable CFCs is not taken into account for resourcing purposes. The conference agreement also extends the application of the second transitional rule to certain obligations of applicable CFCs: Interest earned on term obligations of U.S. persons other than U.S. affiliates that are held by applicable CFCs on March 7, 1984 will not be taken into account for resourcing purposes under the rule. The liberalizing of the Senate amendment definition of "applicable CFC" may also alter the applicability of the second transitional rule in certain cases.

The conference agreement provides that the foreign tax credit limitation generally will be computed separately (as it is under present law for certain interest income, for example) for income derived from a U.S.-owned foreign corporation that benefits from either of the two transitional rules, i.e., is not resourced. Thus, foreign taxes paid by the recipient of such income on other income will not be creditable against the U.S. tax on the income that benefits from either transitional rule. This rule will not apply to certain income received or accrued before January 1, 1986.

2. Maintaining the character of interest income

Present law

A U.S. taxpayer's foreign source passive interest income cannot escape both U.S. and foreign tax under the United States' separate foreign tax credit limitation. This separate limitation prevents foreign taxes on non-interest income from offsetting U.S. tax on foreign source interest income. U.S. taxpayers seek to circumvent this rule by having foreign subsidiaries or regulated investment companies (RICs) earn interest income (for example, by depositing money in foreign banks). Under regulations, when the U.S. taxpayer is taxable on the earnings of the foreign subsidiary or RIC, its income may be foreign source dividend income, not interest income. Thus, artificially recharacterized "non-interest" income may escape both U.S. and foreign tax.

House bill

For purposes of applying the separate foreign tax credit limitation on interest, the House bill treats foreign dividends as interest to the extent that the paying corporation's earnings and profits arise from passive interest. This rule applies only if 10 percent or more of the paying corporation's earnings and profits for a 3-year base period arise from passive interest. It applies only to 50-percent U.S.-owned corporations. It does not affect interest paid by subsidiaries. It applies to distributions after the date of enactment except distributions attributable to interest earned on term obligations held on March 1, 1984.

Senate amendment

The Senate amendment is generally the same as the House bill. It applies to any RIC, whether or not 50-percent U.S.-owned. It applies to distributions attributable to interest earned by distributing corporations in taxable years beginning after the date of enactment. Except for foreign finance subsidiaries grandfathered under the resourcing rule, the amendment does not apply to distributions attributable to interest earned on term obligations held on March 7, 1984. All payors get a fresh start for the 3-year base-period test so that the first year that counts under that test is the first taxable year beginning on or after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment, with substantial modifications. In general, the conference agreement subjects income of a U.S. person that is attributable to separate limitation interest income of a U.S. owned foreign corporation (sec. 904(d)(2)) or RIC to the separate foreign tax credit limitation for interest.

For purposes of the foreign tax credit limitation, the conference agreement treats dividends or interest that are paid or accrued by a designated payor corporation (and attributable to any taxable year of

such a designated payor corporation) as interest income subject to the separate foreign tax credit limitation for interest to the extent that the aggregate amount of such dividends and interest does not exceed the separate limitation interest of the designated payor corporation for the taxable year. For these purposes, a dividend includes any subpart F (sec. 951) or foreign personal holding company inclusion (sec. 551) and any gain treated as ordinary income under section 1246 or as a dividend under section 1248. The agreement defines the term "separate limitation interest" to mean, with respect to any taxable year, the aggregate amount of the interest income of the type that is subject to the separate limitation which is received or accrued by the designated payor corporation during the taxable year, reduced by the sum of any deductions properly allocable (under regulations prescribed by the Secretary) to such income.

This rule maintaining the character of interest income will not apply to any amount attributable to the taxable year of a designated payor corporation if the designated payor corporation has earnings and profits for such taxable year, and if less than 10 percent of those earnings and profits is attributable to separate limitation interest. The conference agreement eliminates the three-year base period in order to measure interest that should be subject to the separate limitation more accurately.

Interest that a designated payor corporation pays or accrues to any of its U.S. shareholders (a U.S. person who owns or who is considered to own 10 percent or more of its voting power) or to a person related to any of its U.S. shareholders will not reduce separate limitation interest of the designated payor corporation, and will not reduce earnings and profits for the purpose of the exception that applies to designated payor corporations with earnings and profits less than 10 percent of which is attributable to separate limitation interest.

Under the agreement, a "designated payor corporation" is any of three types of corporations (the first two of which were included in the Senate amendment and are defined in the same manner in the agreement): any U.S.-owned foreign corporation, any regulated investment company (RIC), and any other foreign corporation in which the taxpayer is a U.S. shareholder (a U.S. person who owns directly, indirectly, or constructively ten percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation) at any time during the taxable year of such foreign corporation. The last category includes any foreign corporation with a U.S. shareholder whether or not the foreign corporation is a controlled foreign corporation.

The conference agreement specifies rules for treating amounts included in U.S. taxable income as attributable to the taxable year of a designated payor corporation. Foreign personal holding company and Subpart F inclusions with respect to a designated payor corporation are attributable to the year of inclusion; interest paid or accrued by a designated payor corporation is attributable to the year that the designated payor corporation pays or accrues it; and dividends from a designated payor corporation are attributable to the year out of whose earnings and profits they are paid.

The order in which the agreement treats amounts attributable to separate limitation interest as income subject to the separate foreign tax credit limitation for interest is as follows. It first treats foreign personal holding company and Subpart F inclusions on account of a designated payor corporation as income subject to the separate foreign tax credit limitation for interest up to the amount of the separate limitation interest of the designated payor corporation. If the amounts so treated are less than the separate limitation interest of the designated payor, then interest paid or accrued by the designated payor corporation is treated as income subject to the separate foreign tax credit limitation for interest. If the interest so treated plus the amounts previously so treated are less than the separate limitation interest of the designated payor corporation, then any dividend paid out of the earnings and profits of the designated payor corporation for the taxable year is treated as income subject to the separate foreign tax credit limitation for interest. The conference agreement treats amounts paid by a designated payor corporation as first attributable to passive interest under the theory that it would be as easy for the ultimate interest recipient to have received the separate limitation interest directly as to have channeled it through a designated payor corporation. In addition, this "stacking" of interest prevents avoidance of tax through the use of back to back loans.

For example, a designated payor corporation that is also a controlled foreign corporation earns $150 of gross active business income during a year and incurs $125 of expenses in connection with that active business. In that year, it also earns $15 of separate limitation interest. There is no subpart F inclusion in the income of its U.S. shareholders with respect to that year because the foreign corporation's gross base company income ($15) is less than 10 percent of its gross income ($165). The foreign corporation incurs no interest expense or foreign tax during the year. Its earnings and profits ($40) consist of $25 of active business income and the $15 of separate limitation interest. It pays a dividend with respect to the earnings and profits of the year of $16.

In this example, the conference agreement treats the dividend as coming first out of separate limitation interest, so that $15 of the dividend is income subject to the separate foreign tax credit limitation for interest income, while $1 is not subject to the separate foreign tax credit limitation. Any later dividend with respect to that year's earnings will not be subject to the separate foreign tax credit limitation, as the $16 dividend has exhausted the pool of separate limitation interest for that year.

The conference agreement retains the rule of the Senate amendment requiring the Secretary to prescribe such regulations as may be necessary to carry out the purposes of this provision in the case of distributions or payments through one or more entities. For example, a U.S. owned foreign corporation that earns separate limitation interest but that pays interest to a related foreign party would reduce the amount of income subject to characterization as separate limitation interest. The income of the related foreign corporation might not be subject to U.S. tax, so the foreign tax credit limitation would not affect the related foreign person. The Secretary is to prescribe rules so that an inclusion in income of a U.S. taxpayer on account of the related foreign corporation will be subject to recharacterization as separate limitation interest. Such an inclusion could occur, for example, under the rules of Subpart F, on a dividend or interest payment by the related foreign corporation, or on an investment by the related foreign corporation in U.S. property.

For example, if a controlled foreign corporation ("CFC-1") earns $100 of gross separate limitation interest (that is foreign personal holding company income subject to Subpart F) but reduces its current year earnings and profits to zero by a $100 interest payment to a related foreign party ("CFC-2"), there would be no Subpart F inclusion for the year on account of CFC-1. If there were no Subpart F inclusion on account of CFC-2 (for instance, because foreign base company income made up less than 10 percent of the gross income of CFC-2), later dividends from CFC-2 would be subject to recharacterization, whether or not 10 percent of the earnings and profits of CFC-2 for the year at issue were attributable to the separate limitation interest that it received from CFC-1 or to other separate limitation interest.

For purposes of determining whether any interest received or accrued by the designated payor corporation is separate limitation interest, interest from a related party described in section 1504 (whether or not a foreign person) will be treated as separate limitation interest to the extent that the related payor earns (directly or indirectly) income that is separate limitation interest or that is attributable to separate limitation interest.

The application of the conference agreement rules is illustrated in the following example:

A foreign corporation wholly owned by a U.S. corporation owns assets with a total fair market value of $500, consisting of a $150 loan to its parent, a $100 certificate of deposit with a foreign bank, and active business assets worth $250. It earns $100 of gross income, consisting of $75 of gross income from an active business, $15 of gross bank interest that is not related to its active business, and $10 of gross interest on a loan to its wholly owned (2d tier) foreign subsidiary incorporated in another foreign country and engaged solely in active business. It incurs $50 of expenses in connection with its active business. It pays $10 of interest to its U.S. parent corporation and $5 of interest to an unrelated party. Its net income is $35. It pays no dividend out of this income.

The $15 of bank interest in this example is interest described in section 904(d)(2), so that, in the hands of the foreign corporation, it is subject to the separate limitation for interest. To determine that portion of this interest that is "separate limitation interest" for purposes of the provision, the interest decreases to the extent of properly allocable expenses. In determining separate limitation interest in this example, the U.S. owner of the foreign corporation allocates the $5 of interest expense that the foreign corporation paid to an unrelated party. The allocation may occur under any proper method, but the conferees intend that the same method of allocation apply for all purposes for any particular year. The taxpayer chooses the asset method (Reg. sec. 1.861-8(f)(1)(v), Reg. sec. 1.861-8(e)(2)(v).) Thus, it allocates $1.50 ($5x($150/$500)) against its $15 of gross bank interest income. Interest paid to its U.S. shareholder does not, under the conference agreement, reduce separate limitation interest. The conference agreement therefore treats $13.50 ($15 - $1.50) of the income of this foreign corporation as separate limitation interest.

The conference agreement first treats any Subpart F inclusion on account of this designated payor corporation as income subject to the separate foreign tax credit limitation for interest. Because more than 10 percent of the gross income of the foreign corporation in this example is foreign base company income, its U.S. owner, under subpart F, must include the foreign base company income of its foreign subsidiary in its income. In determining its Subpart F income, the U.S. owner of the foreign corporation allocates the $15 of interest expense that the foreign corporation incurred under the asset method, the method it chose for

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this year for all purposes. Thus, it allocates $7.50 ($15x($250/$500)) against its $25 of gross interest income, and $7.50 ($15x($250/$500)) against its $75 of gross active business income. There remain after the allocation of the $15 of interest expense $17.50 of interest income that is foreign personal holding company income under the Subpart F rules, so the Subpart F income that the U.S. owner of the foreign corporation must include in income for the year is $17.50. The U.S. owner treats $13.50 of the Subpart F inclusion as income subject to the separate foreign tax credit limitation for interest income. The $10 of interest that the designated payor corporation pays to its U.S. parent is not income subject to the separate foreign tax credit limitation for interest income in this example because the full $13.50 of the designated payor corporation's separate limitation interest has already been used in recharacterizing a portion of the subpart F inclusion as separate limitation interest.

Under the conference agreement, dividends and Subpart F inclusions recharacterized as interest for the purpose of the foreign tax credit limitation will retain their character as dividends and Subpart F inclusions for the purpose of determining whether a taxpayer is entitled to a deemed-paid foreign tax credit (secs. 902 and 960). However, the deemed paid taxes attributable to income recharacterized as separate limitation interest will be treated as taxes on separate limitation interest. In addition, any taxes deemed paid on such dividends and Subpart F inclusions and treated as dividends for the purpose of the deemed-paid credit (sec. 78), will be characterized in accordance with the income with respect to which the taxes were paid.

The conference agreement will generally take effect on the date of enactment. Generally, only interest income received or accrued by a designated payor corporation in taxable years beginning after that date will be treated as separate limitation interest. However, interest income earned by a regulated investment company with respect to investments by a taxpayer after the date of conference action, June 22, 1984, will be treated as separate limitation interest. In the case of a designated payor corporation that is not an applicable CFC (as defined in section 131(b)(2)(d) of the conference agreement), the agreement will not apply to any interest that the corporation receives or accrues on a term obligation that it held on March 7, 1984.

3. Income from factoring trade receivables

Present law

A seller who sells goods for the buyer's receivable (promise to pay) may sell that receivable to a third party—a factor—at a discount. If a U.S.-owned factor is in a tax haven, it may earn income free of U.S. tax. That income may be eligible for deferral, and it may be foreign-source income that is sheltered by excess foreign tax credits.

When a foreign subsidiary of a U.S. corporation makes a loan to its U.S. parent (or otherwise invests in "U.S. property"), that investment is taxable as a dividend to the U.S. parent (to the extent of the subsidiary's previously untaxed earnings and profits). It is unclear under present law whether this rule applies to a foreign factoring subsidiary that buys receivables from its U.S. parent. Thus, the foreign factoring subsidiary could transfer untaxed cash to its U.S. parent by buying the parent's receivables.

House bill

The House bill taxes the U.S. owner of a controlled foreign corporation on income earned when the controlled foreign corporation collects a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory or services. There is no tax if factoring income (and other tax-haven type income) is less than 10 percent of the controlled foreign corporation's gross income.

The House bill treats income from a related U.S. person's receivables (from domestic and foreign sales) as U.S. source income.

The House bill treats payments from a foreign subsidiary to a related U.S. person for receivables (from domestic and foreign sales) as investments in U.S. property.

The bill applies to transfers after March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill. However, it taxes the U.S. owner of a controlled foreign corporation earning factoring income whether or not factoring income and other tax-haven type income are less than 10 percent of the subsidiary's gross income. It also prevents tax-free factoring by companies in U.S. possessions.

Its rule for the source of factoring income is the same as that of the House bill, except that it treats income from factoring a related U.S. person's export receivables (other than export receivables from a sale through a DISC or FSC) as 50 percent U.S. source, 50 percent foreign source.

The Senate amendment contains the investment in U.S. property provision of the House bill, but the Senate amendment does not treat investments in export receivables (other than export receivables from a sale through a DISC or FSC) as investments in U.S. property.

Conference agreement

The conference agreement generally follows the House bill. It follows the Senate amendment, however, in imposing tax on the U.S. owner of a controlled foreign corporation earning factoring income without regard to a 10-percent threshold, and in adopting with modifications the rules of the Senate amendment that prevent tax-free factoring by companies in U.S. possessions.

The agreement treats any income (whether in the form of discount, stated interest, or some other form) arising from a trade or service receivable (defined to mean any account receivable or evidence of indebtedness arising out of the disposition by a related party of inventory or out of the performance of services by a related party) acquired directly or indirectly by a foreign corporation from a related person as if it were interest on a loan to the obligor under the receivable. This rule applies only for purposes of the foreign personal holding company rules, the Subpart F rules, and the foreign tax credit limitation. In applying this rule, the conferees intend that the source rules (Code sec. 861-863) be applied as though the income from a trade or service receivable were interest on a loan to the obligor under the receivable.

The application of the rule treating related person factoring income as interest income also will apply to determine the source of that income upon eventual inclusion of the income in the gross income of a U.S. person pursuant to the provision of the conference agreement that maintains the source of U.S.-source income that flows through a foreign corporation (Code sec. 904(g)). If the obligor under a receivable is a U.S. person, the factoring income will be U.S. source income upon inclusion in the gross income of a U.S. shareholder of the foreign corporation (unless the obligor pays foreign source income under the "80/20" rule (Code sec. 861(a)(1)(B)).

A foreign corporation earning income from a trade or service receivable of a U.S. obligor will not be taxable currently on that income (under Code sec. 881). In addition, the agreement does not allow, for example, the obligor under a receivable to treat any part of the purchase price of a capital asset as deductible interest.

Income from a receivable will be subject to the rules of the conference agreement whenever the receivable or an interest in the receivable is assigned to a foreign corporation by a related party. There will be an acquisition of a receivable, for the purpose of the rule contained in the conference agreement, whether or not the person earning the income from the receivable takes title to or physical possession of the receivable, and whether the related party that transfers the rights to income from a receivable does so with or without recourse.

The agreement includes the definition of "related party" contained in the Senate amendment, but expands that definition to include 10-percent U.S. shareholders and persons related to 10-percent U.S. shareholders. This expansion prevents tax-free related-person factoring by foreign corporations owned by several U.S. persons.

Related person factoring income under the conference agreement will be treated as interest described in section 904(d)(2), and therefore subject to the separate foreign tax credit limitation for interest. The income will be ineligible for any exception to application of the separate limitation. The conferees adopted this treatment so that foreign tax credits on non-interest nonfactoring income cannot offset U.S. tax on related person factoring income. Taxpayers can generally arrange to earn factoring income, like other financial income, in tax havens, and the conferees believe that it is appropriate to collect the full U.S. tax, unreduced by foreign tax credits on unrelated income, on factoring income.

The conferees intend to subject related person factoring income to tax in the hands of any controlled foreign corporation with earnings and profits. Therefore, related person factoring income will not benefit from exceptions to the Subpart F rules. As under the Senate amendment, it does not benefit from the 10-percent of gross income exception. In addition, it will not benefit from any banking and financing exceptions (sec. 954(c)(3)(B) and sec. 954(c)(4)(B)) or from the same country interest (and dividend) exception (sec. 954(c)(4)(A)).

The agreement modifies the Senate amendment's rules governing factoring in the U.S. possessions. The possessions tax credit (sec. 936, whose prime beneficiary is Puerto Rico) and rules allowing the U.S. Virgin Islands to reduce its tax rate on certain income (sec. 934) will not apply to factoring income unless the income from the receivable arises within the possession under the rule that treats the income as income from a loan to the obligor of the receivable.

The conference agreement provides that a receivable of a U.S. person that was acquired directly or indirectly from a related person who is a U.S. person constitutes U.S. property for the investment in U.S. property rules. Not only does this transaction makes funds available for use by U.S. shareholders, it is in substance a wholly domestic transaction. The conferees believe that this combination of effective repatriation and U.S. nexus makes this transaction one that should be subject to tax to the extent of untaxed earnings and profits.

For the purpose of this provision, the conferees intend that the substitution of any party for the obligor be disregarded. For ex-

ample, if a U.S. purchaser of goods pays for the goods by establishing a line of credit with a foreign bank whose note the seller of the goods takes and sells at a discount to its foreign subsidiary, the income from the bank's obligation in the hands of the foreign subsidiary will be U.S. source income, and the acquisition of the bank's obligation will constitute an investment in U.S. property.

The conferees understand that some taxpayers may contend that they will be able to circumvent the investment in U.S. property rule of the conference agreement by (1) directly or indirectly transferring earnings and profits from one foreign subsidiary to another foreign subsidiary, and (2) having the transferee invest those earnings and profits in U.S. property. The conferees recognize that current law imposes tax on the investment in U.S. property by the transferee, whether the transferee makes a direct or indirect loan to the transferor (Rev. Rul. 76-192, 1976-1 C.B. 205) or otherwise shifts earnings and profits to the transferee (such as by a contribution to the capital of a newly formed subsidiary with no earnings and profits).

The agreement requires the Secretary to prescribe regulations to prevent the avoidance of the provision's income inclusion rule and its investment in U.S. property rule. The conferees intend, for instance, that regulations treat a loan by a foreign corporation to a purchaser of goods or services of a related party like the acquisition by the foreign corporation of the purchaser's receivable, where the seller of the goods or services (or a related party) guarantees or secures payment to the foreign corporation.

The conference agreement generally applies to accounts receivable and evidences of indebtedness transferred after March 1, 1984. However, a special transitional rule applies to certain accounts receivable held by a certain type of financing entity.

4. Source of transportation income

Present law

Under present law, in general, the United States taxes all U.S. source income, but not all foreign source income, of U.S. persons. In general, the United States does not tax the foreign source income of foreign persons (such as foreign corporations). Under present law, transportation income can be treated almost entirely as foreign source income even if the transportation is between two U.S. points, if the route of transport lies primarily outside the United States' three mile territorial limit.

House bill

The House bill provides that all transportation income attributable to transportation which begins and ends in the United States (including, for this purpose, in any possession of the United States) is to be treated as U.S. source income. For these purposes, transportation income is defined as any income derived from or in connection with the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. The bill states that the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

The new sourcing rule is to be applied in accordance with regulations prescribed by the Secretary of the Treasury.

The new sourcing rule for transportation income will apply to transportation beginning after the bill's date of enactment in taxable years ending after that date.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment, with certain modifications. The conferees also agreed to certain clarifications of the new sourcing rule's application.

Transportation involving U.S. possessions

The conference agreement generally treats transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) as 50-percent U.S.-source income and 50-percent foreign-source income. Those U.S. possessions whose tax laws "mirror" the Internal Revenue Code will, because of the way the "mirror" Codes operate, treat this transportation income as 50-percent domestic-source and 50-percent foreign source. Thus, transportation income attributable to transportation that begins in the United States and ends in Guam, for example, will in effect be split between the United States and Guam for tax purposes. Each will subject to tax no more than half of the income.

Certain transportation income from United States-U.S. possession (and U.S. possession-United States) routes is not subject to the 50-percent sourcing rule. The agreement treats such transportation income earned from the leasing of aircraft eligible for the investment tax credit to U.S. persons (other than a member of the same controlled group of corporations) who are regularly-scheduled air carriers as wholly U.S.-source income.

Transportation income from transportation between U.S. possessions or within a possession is excluded from the scope of the new sourcing rule under the conference agreement and, thus, is not treated as either wholly U.S.-source income or as 50-percent U.S.-source income by operation of the new rule.

Regulations

The conference agreement makes clear that the new sourcing rule will become effective before regulations are issued, in the event regulations are not issued as of the new rule's effective date.

Clarifications

The conferees agreed to the following clarifications of the new sourcing rule's application: Transportation of cargo will not be considered to begin and end in the United States when it involves transportation from one U.S. point to another intermediate U.S. point before ultimate delivery of the cargo to a point in a foreign country, even where the cargo is transported to its ultimate destination on a different aircraft or vessel from the aircraft or vessel that carried the cargo to the intermediate U.S. point, if two requirements are met. The requirements are that the same taxpayer transport the cargo on both legs of the trip and that the cargo not pass through U.S. customs at the intermediate U.S. point. Similarly, if these requirements are met, transportation of cargo will not be considered to begin and end in the United States when, en route to a delivery point elsewhere in the United States, a stop at an intermediate U.S. point is made by a transporting aircraft or vessel which took on the cargo in a foreign country, even where the cargo is transported to its ultimate destination on a different aircraft or vessel from the aircraft or vessel that carried it to the intermediate U.S. point.

Like other round-trip travel from the United States, round-trip travel by a cruise ship, originating in the United States and calling only on foreign ports, is not transportation which begins and ends in the United States for purposes of the new sourcing rule.

The new source rule also does not apply to income for services performed in a foreign country that are connected indirectly with transportation beginning and ending in the United States. For example, income from the operation of the Panamanian pipeline (through which oil extracted in Alaska and bound for East Coast points may pass) will not be treated as U.S. source income under the new sourcing rule. Income from the operation of foreign storage facilities used to store cargo transported between U.S. points will not be subject to the new source rule. Income from services, such as refueling, performed outside the United States in connection with a trip beginning and ending in the United States also will not be treated as U.S. source income under the new provision.

5. Application of accumulated earnings tax to certain distributions received by U.S.-owned foreign corporations

Present law

The accumulated earnings tax may not apply to foreign corporations forming a two tier structure when the parent corporation is widely held by U.S. persons and the subsidiary corporation (wholly owned by the parent corporation) earns U.S. source income or U.S. business income.

House bill

Under the House bill, if 10 percent or more of the earnings and profits of a foreign corporation has a U.S. source or is effectively connected with a U.S. business, its interest payments and a pro rata portion of its dividends are treated as U.S. source in the hands of a U.S.-owned foreign corporation for the purpose of the accumulated earnings tax. The bill applies to distributions received by a U.S.-owned foreign corporation on or after May 23, 1983. For U.S.-owned foreign corporations in existence on May 23, 1983, the bill applies to taxable years beginning after 1984.

Senate amendment

The Senate amendment is generally the same as the House bill, with technical changes.

Conference agreement

The conference agreement follows the House bill, with technical modifications.

6. Repeal of 30-percent tax on portfolio interest paid to foreign persons

Present law

Payments of passive income (interest, dividends, royalties, etc.) to foreign persons generally are subject to a 30-percent U.S. withholding tax if the payments are not effectively connected with a U.S. trade or business conducted by the foreign person. Exemptions from the tax are provided in certain situations. Some U.S. tax treaties reduce the tax. In the case of interest, some treaties eliminate the tax.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) requires registration of debt obligations unless they are sold under procedures reasonably designed to prevent sale or resale to U.S. persons, they bear interest payable outside the United States only, and they indicate that U.S. holders are subject to tax penalties.

The U.S. estate tax applies to obligations of U.S. corporations, but not to obligations of foreign corporations.

House bill

No provision.

Senate amendment

The Senate amendment phases out the 30-percent withholding tax on interest paid on portfolio indebtedness by U.S. borrowers to nonresident alien individuals and foreign

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corporations. The rate of tax will be reduced to five percent for interest received after the date of enactment. The rate of tax will be reduced to four percent in 1985, three percent in 1986, two percent in 1987, and one percent for the period January 1 to June 30, 1988. Effective July 1, 1988, the withholding tax on interest received by nonresident alien individuals and foreign corporations on portfolio indebtedness will be repealed.

The phase-out of tax does not apply to interest paid to banks, controlled foreign corporations, or 10-percent or greater owners of the payor.

U.S. corporations that assume debt of foreign affiliates pay interest that is eligible for the tax phase-out if they meet compliance requirements that the affiliate would have had to meet (without necessarily meeting all the TEFRA requirements that would have applied to the U.S. corporation).

The Senate amendment also repeals the U.S. estate tax on obligations eligible for the reduced withholding tax rates.

These provisions apply to portfolio interest received after the date of enactment (and to estates of decedents dying after the date of enactment).

Conference agreement

The conference agreement repeals the 30-percent withholding tax on interest paid on portfolio indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations, and otherwise follows the Senate amendment, with the following modifications.

The conference agreement generally repeals the tax, effective on the date of enactment, rather than phasing out the tax over a four-year period as the Senate amendment would have. However, unlike the Senate amendment, the conference agreement repeals the tax only with respect to interest paid on portfolio obligations issued *after* the date of enactment. Thus, the 30-percent tax will continue to apply to existing obligations currently subject to the tax.

The conference agreement does not repeal the 30-percent tax for interest paid on obligations assumed by U.S. corporations from their affiliates or other entities. Since, under the conference agreement, interest on existing obligations is not exempted from the 30-percent tax, existing obligations of foreign or U.S. affiliates that U.S. corporations might wish to assume are not eligible for the repeal in any event.

Like the Senate amendment, the conference agreement provides that interest paid on an obligation not in registered form will be exempt from the 30-percent tax when the obligation is exempt from the TEFRA registration requirements because it is sold under procedures reasonably designed to prevent sale or resale to U.S. persons, bears interest payable outside the United States only, and indicates that U.S. holders are subject to tax penalties. However, the conference agreement authorizes the Secretary to exclude future obligations from this exemption from the TEFRA registration requirements without regard to whether the obligation is determined to be used frequently in avoiding Federal taxes. Thus, the Secretary has discretion to require registration.

Interest paid on an obligation in registered form will be exempt from the 30-percent tax under the conference agreement if the obligation satisfies the requirements for registered obligations set forth in the Senate amendment.

The conference agreement differs from the Senate amendment in exempting from the 30-percent tax interest otherwise eligible for the exemption that is paid to a controlled foreign corporation (unless paid by a related person, within the meaning of new Code section 864(d)(4)). However, such interest paid to a controlled foreign corporation will be includible in the gross income of the controlled foreign corporation's U.S. shareholders under subpart F (Code section 951) without regard to the 10-percent exception or any of the other exceptions otherwise provided under the subpart F rules. The conferees also intend that such interest in the hands of a controlled foreign corporation retain its U.S. source (under Code section 904(g), as amended by the conference agreement) upon Subpart F or other income inclusion, without regard to any exception from the Code section 904(g) rule available for other income.

The conference agreement retains the Senate amendment's rule that imposes tax on interest paid to certain foreign shareholders and banks. The conferees understand that taxpayers may attempt to circumvent the foreign shareholder/bank rule of the agreement by entering into "back to back" loans, wherein a foreign affiliate of a U.S. taxpayer (or a bank) lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. The conferees intend that the Internal Revenue Service, when appropriate, use means at its disposal to determine whether back to back loans exist.

Like the Senate amendment, the conference agreement eliminates any potential U.S. estate tax liability of nonresident alien individuals dying after the date of enactment in the case of obligations the income of which, if received by the decedent at the time of his death, would be exempt from the 30-percent tax under the provision. However, under the conference agreement, only obligations issued after the date of enactment will be eligible for the estate tax exclusion.

In connection with the repeal of the 30-percent tax, the conference agreement provides that, if certain requirements are met, interest paid to an "applicable CFC" (within the meaning of Code section 904(g), as amended by the conference agreement but without regard to the requirement that the CFC be in existence on March 31, 1984) on a U.S. affiliate obligation will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated. The requirements are that the payee was an applicable CFC on or before June 22, 1984, the U.S. affiliate obligation on which the interest is paid was issued before June 22, 1984, and on the date the interest is paid, the payee satisfies requirements based upon the principles set forth in four revenue rulings issued in connection with the Interest Equalization Tax (Rev. Rul. 69-377, 69-2 C.B. 231; Rev. Rul. 69-501, 69-2 C.B. 233; Rev. Rul. 70-645, 70-2 C.B. 273; and Rev. Rul. 73-110, 73-1 C.B. 454). No inference should be drawn from this rule regarding the proper resolution of other tax issues. The conferees do not intend this provision to serve as precedent for the U.S. tax treatment of other transactions involving tax treaties or domestic tax law.

7. Original issue discount in the case of foreign investors

Present law

Foreign investors are subject to tax on original issue discount upon receipt of coupon interest or disposition or retirement. Calculation of accrual and treatment of partnership debt and noncapital assets are unclear.

House bill

Under the House bill, foreign investors will calculate accrual of original issue discount like U.S. persons, whoever issued the debt, and whether or not the debt is a capital asset in the foreign investor's hands. The bill generally applies to payments made on or after the 60th day after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill, with technical modifications.

Conference agreement

The conference agreement follows the Senate amendment with a substantial modification. The modification reflects a concern expressed in the reports of the House Committee on Ways and Means and the Senate Committee on Finance: the mismatching of (1) an accrual basis U.S. OID debt issuer's tax deductions and (2) a foreign investor's income inclusion.

The agreement delays the interest deduction for interest accrued, but not paid, to related foreign parties with respect to an original issue discount obligation until actual payment. The conferees believe that there is no justification for mismatching in the case of related party OID debt. Such mismatching allows an economic entity that has divided itself into more than one legal entity to contract with itself at the expense of the U.S. Government.

An example illustrates the operation of the conference agreement. The foreign parent of a U.S. corporation lends the U.S. corporation money in exchange for a noninterest bearing discount bond that the foreign parent holds until maturity. (The conference agreement's repeal of the 30-percent withholding tax on interest paid to certain foreign investors does not apply to interest paid to foreign shareholders of a U.S. corporation.) Under the conference agreement, the U.S. corporation cannot deduct interest on the bond until the foreign parent collects the cash due on the obligation at maturity.

In the case of a discount obligation bearing stated interest, the obligor may deduct in a given year only the amount that is paid to related lender in that year. For example, the foreign parent of a U.S. corporation has lent the U.S. corporation money in exchange for an interest bearing discount bond. In a given year, the stated interest on the bond is $30, while the OID accruing on the bond is $150. The amount subject to U.S. tax in the hands of the foreign parent in that year is $100 (rather than $150), the $30 of stated interest plus $70 of accrued OID, because OID (under the conference agreement) is subject to U.S. tax only to the extent that the tax on the OID does not exceed the interest payment less the 30-percent withholding tax (without reduction on account of any income tax treaty) imposed on the interest payment. The deduction of the U.S. borrower is $30, whether or not the foreign lender benefits from an income tax treaty to which the United States is a party.

The conferees understand that the anti-abuse measure in the conference agreement will not end the abuse of mismatching. For the time being, however, the conferees have limited the deferral of deductions to the case of interest accrued to related parties. The conferees believe that further examination of the deductibility of OID accrued to foreign parties is appropriate. In addition, the conferees understand that taxpayers may attempt to circumvent the related party rule of the agreement by entering into "back to back" loans, wherein a foreign affiliate of a U.S. taxpayer lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. The conferees intend that the Internal Revenue Service, when appropriate, investigate the capitalization of foreign-owned U.S. corpo-

rations issuing OID debt to unrelated foreign parties to attempt to determine whether back to back loans exist.

This anti-abuse measure of the conference agreement applies to obligations issued after June 9, 1984.

8. Withholding on dispositions by foreigners of U.S. real property

Present law

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), foreign investors in U.S. real property interests are taxable by the United States on the gains realized when they dispose of these interests, just as are similarly situated U.S. persons. This rule is to be enforced through information reporting. The legislation overrides certain nonrecognition provisions of the Code to insure U.S. taxation of the gain.

House bill

No provision.

Senate amendment

Under the Senate amendment, the taxation of foreign investors on gains from the disposition of U.S. real property interests generally will be enforced through withholding. Purchasers of U.S. real property interests from foreign persons, certain of the purchasers' agents, and settlement officers will have a duty to withhold, but only if they have actual knowledge or have received formal notice that the seller is foreign. U.S. partnerships, trustees, executors, and certain foreign corporate transferors will have a duty to withhold.

Agents for the transferor of a U.S. real property interest will be required to withhold if they had reason to believe, or notice, that the transferor was a foreigner, and failed to notify the transferee. Transferors' agents have a duty to make reasonable inquiry about the transferor's status, but reliance in good faith on a transferor's representation negates the duty to withhold.

Withholding will not apply to a purchaser buying a principal residence for $200,000 or less, or to a sale of stock on an established U.S. market. Withholding also will not apply to a transferor who obtains a qualifying statement from the Secretary that he is exempt from tax, has provided adequate security for payment of the tax, or has otherwise made arrangements for payment the of tax.

The amount withheld is the lesser of the capital gains rate times the amount realized (price paid) for the transferred U.S. real property interest; the maximum tax liability on the sale (after proof of basis); or the amount that the U.S. withholding agent actually controls.

The Secretary can reduce or eliminate withholding on request in certain cases. The Senate amendment removes current information reporting obligations where withholding is required unless the Secretary specifically requires continued reporting. Tax imposed under FIRPTA that is not collected by withholding remains a liability of the foreign transferor.

The Senate amendment requires withholding for amounts paid on or after 30 days after enactment.

Conference agreement

The conference agreement follows the Senate amendment with substantial modifications.

Duty to withhold generally

Following the Senate amendment, the conference agreement generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person. The conference agreement generally imposes the obligation on the transferee. The conference agreement narrows the circumstances in which an agent of the transferor or transferee must withhold and generally eliminates any requirement that settlement officers withhold. It clarifies the withholding obligations of partnerships, trustees, and executors, and domestic U.S. real property holding corporations with respect to certain distributions by these entities.

The conference agreement differs from the Senate amendment in requiring withholding *unless* one of five exemptions applies. The Senate amendment generally would have required withholding only if the would-be withholding agent had actual knowledge or had received formal notice that the seller was foreign. The Senate amendment would have imposed a general requirement on the transferor to notify the transferee (as well as any transferee's agent or settlement officer) if the transferor was a foreign person. It also would have imposed a general requirement on any transferor's agent to make a reasonable inquiry concerning the transferor's status and to notify the transferee if the agent had reason to believe that the transferor might be a foreign person. The conference agreement eliminates these two general requirements.

Under the first of the five of exemptions from withholding provided under the conference agreement, withholding by the transferee generally will not be required if the transferor furnishes to the transferee, under penalty of perjury, an affidavit stating that the transferor is not a foreign person and stating the transferor's taxpayer identification number ("non-foreign affidavit"). The conference agreement authorizes the Internal Revenue Service to prescribe regulations requiring the transferee to furnish a copy of the non-foreign affidavit to the Internal Revenue Service. The conferees anticipate that any regulations requiring filing of the non-foreign affidavit with the Internal Revenue Service will also require filing of such other information as the Secretary deems appropriate (for example, a description of the real property interest transferred and the identity and taxpayer identification number of the buyer).

The receipt of a non-foreign affidavit will not relieve the transferee of withholding responsibility if the transferee has actual knowledge that the affidavit is false or he receives a notice from his agent or an agent of the transferor that the affidavit is false. A transferor's agent or transferee's agent with actual knowledge that the affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor will be deemed to have actual knowledge that any non-foreign affidavit is false. In moving to an actual knowledge test, the conference agreement generally imposes significantly less potential liability on agents than did the Senate amendment. The conferees believe that any agent deriving compensation from a foreign corporate principal in a real estate transaction will know that his or her principal is in fact foreign. The chances of ignorance in such a case are so remote that the conference agreement precludes a claim of ignorance. A transferor's agent or transferee's agent that does not give the required notice will be liable for withholding as if he were the transferee, up to the amount of compensation the agent receives in connection with the transaction. This liability for withholding is in addition to any penalties imposed under other provisions of the Code or other laws (both civil and criminal) in connection with the failure to give notice.

The receipt of a non-foreign affidavit also will not relieve the transferee of withholding responsibility if the Internal Revenue Service by regulations requires the transferee to furnish it with a copy of the non-foreign affidavit and the transferee fails to do so.

The conference agreement defines the term "transferor's agent" as any person who represents the transferor in any negotiation with the transferee or any transferee's agent related to the transaction, or in settling the transaction. The conference agreement defines the term "transferee's agent" as any person who represents the transferee in any negotiation with the transferor or any transferor's agent related to the transaction, or in settling the transaction. A settlement officer will not be treated as a transferor's agent or transferee's agent merely because he receives or disburses any portion of the consideration for the transaction or records any document in connection with the transaction.

As under the Senate amendment, any tax imposed on a foreign investor under FIRPTA in excess of amounts withheld will remain the liability of the foreign investor.

Amount withheld

Under the conference agreement, the amount to be withheld on the sale by a foreign investor of a U.S. real property interest generally is 10 percent of the amount realized (sales price). However, the amount withheld may not exceed the transferor's maximum tax liability, discussed below.

The 10-percent rate replaces the higher capital gains withholding rates provided in the Senate amendment. The 10-percent rate is expected to result in the withholding of an amount of tax that more closely approximates (in many cases) the net tax owed by a foreign investor on his gain (after basis is deducted) on a U.S. real property disposition.

The conference agreement eliminates the Senate amendment provision that limits a withholding agent's withholding liability to the portion of the sales proceeds within his control. Because withholding generally will be at a 10-percent rate only under the conference agreement, transferees will be more likely (than under the Senate amendment) to have sufficient sales proceeds within their control to satisfy the full withholding liability. When the initial cash consideration paid by a transferee in a U.S. real property transaction is *not* high enough to cover this withholding liability, the parties can request a "qualifying statement" from the Internal Revenue Service authorizing the transferee to withhold a lesser amount. A qualifying statement is to be issued in this situation if the requirements for such a statement are otherwise satisfied and no abuse is involved. (Qualifying statements are discussed in more detail below). Thus, on a real estate installment sale, for example, an amount equal to 10 percent of the total sales price (or the maximum tax liability, if less) is to be withheld at the time of the first cash payment unless a qualifying statement authorizing the transferee to withhold a lesser amount is obtained.

The "transferor's maximum tax liability" will be determined by the Secretary in the same manner as under the Senate amendment. The Secretary is to establish the transferor's maximum tax liability upon request. The conference agreement departs from the Senate amendment in permitting such a request to be made by the transferee as well as by the transferor. However, transferees may request a maximum tax liability determination only to cure overwithholding errors. The procedure is not intended to be utilized to relieve transferees from withholding responsibility *before* a transaction

occurs. In many cases, the fact that would establish that the transferor's maximum tax liability is less than the tax otherwise required to be withheld (namely, the transferor's basis in the transferred property) will not be known by the transferee unless and until the transferor furnishes the information to the transferee.

Transferees may request a determination of maximum tax liability before or after a disposition.

The conference agreement, unlike the Senate amendment, provides that a transferor may seek and obtain an early refund of any amounts withheld in excess of the transferor's maximum tax liability (subject to such terms and conditions as the Secretary may by regulations prescribe). This provision will allow a transferor to seek a refund before the transferor might otherwise file a federal income tax return. No interest will accrue on the amount of any early refund.

The conference agreement adopts the Senate amendment provision allowing the Secretary to reduce withholding under certain circumstances. A request for reduced withholding may be made by either the transferor or the transferee under the conference agreement.

The conference agreement increases to 90 days the 30-day deadline specified in the Senate amendment for action by the Internal Revenue Service on a request for establishment of the transferor's maximum tax liability or for reduced withholding. The conferees extended the deadline to 90 days because they were informed by the Internal Revenue Service that the 30-day deadline provided in the Senate amendment was unrealistic; Service resources would not permit it to complete action on most requests within 30 days. In some cases, the Service's action in response to these requests may not establish the amount of tax due.

Other exemptions from withholding

Domestic corporation furnishes non-U.S. RPHC affidavit

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)(A)(ii) (the shorter of (i) the period after FIRPTA's general effective date during which the transferor held the interest and (ii) the five-year period ending on the date of disposition of the interest) ("non-U.S. RPHC affidavit"). The conference agreement authorizes the Internal Revenue Service to prescribe regulations requiring the transferee to furnish a copy of the non-U.S. RPHC affidavit to the Internal Revenue Service.

The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if the transferee has actual knowledge that the affidavit is false or the transferee receives a notice from his agent or an agent of the transferor that the affidavit is false. The rules imposing a duty on agents to give notice in the case of a false affidavit, including the rule imposing withholding liability on agents when they fail to give the notice required, are the same in connection with false non-U.S. RPHC affidavits as they are in connection with false non-foreign affidavits.

The receipt of a non-U.S. RPHC affidavit also will not relieve the transferee of withholding responsibility if the Internal Revenue Service by regulations requires the transferee to furnish it with a copy of the non-U.S. RPHC affidavit and the transferee fails to do so.

This exemption is intended to apply only to dispositions of stock that is not regularly traded on an established securities market ("non-publicly traded stock"). A separate exemption, discussed below, is provided for dispositions of publicly traded stock.

Under the conference agreement and the provisions of FIRPTA, a purchaser of non-publicly traded stock in a domestic corporation is potentially liable for withholding unless he obtains either a non-U.S. RPHC affidavit from the corporation or a non-foreign affidavit from the seller. If the purchaser obtains neither, he will be liable for withholding if the seller is in fact a foreign person, the domestic corporation was in fact a U.S. RPHC during the base period specified in Code sec. 897(c)(1)(A)(ii)), and the purchaser does not receive a qualifying statement.

Transferee receives qualifying statement

The conference agreements, with some modifications, follows the Senate amendment in exempting from withholding transferees who receive a "qualifying statement".

The conference agreement defines a qualifying statement as a statement by the Secretary that the transferor is exempt from tax, that either the transferor or the transferee has provided adequate security for payment of the tax, or that either the transferor or the transferee has made other arrangements for the payment of the tax. The conference agreement differs from the Senate amendment in providing expressly that the *transferee's*, as well as the transferor's, provision of adequate security or making of other arrangements for the payment of the tax may form the basis for issuance of a qualifying statement. The conference agreement increases to 90 days the 30-day deadline specified in the Senate amendment for action by the Internal Revenue Service on a request for a qualifying statement.

Purchase price for residence below designated amount

The conference agreement liberalizes in two respects the exemption from withholding provided in the Senate amendment for sales of certain residences. The conference agreement requires that the amount realized by the transferor from the sale of the property not exceed $300,000; the Senate amendment would have required that the amount realized not exceed $200,000. The conference agreement requires that the property sold be used by the transferee as his residence; the Senate amendment would have required that the property be used by the transferee as his *principal* residence.

Stock transferred on established securities market

Under the conference agreement, no withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market. The conference agreement, unlike the Senate amendment, does not limit the exemption to stock regularly traded on established securities markets *located in the United States.*

Partnerships, trusts, estates and corporations

The conference agreement adopts the Senate amendment provisions requiring withholding in certain cases by U.S. partnerships, trustees, and executors, and certain foreign corporate transferors, with the following changes: First, for U.S. partnerships, trustees, and executors, the rate of withholding is reduced to 10 percent under the conference agreement. (For foreign corporate transferors, withholding is at the higher capital gains rate provided in the Senate amendment.) Second, the conference agreement makes minor technical modifications in the Senate amendment provisions.

In addition, as discussed in greater detail below, the conference agreement adds two new provisions clarifying that withholding by domestic U.S. RPHCs and domestic and foreign partnerships, trusts, and estates, respectively, is required in connection with certain distributions to foreign persons. The conference agreement also clarifies that transfers of partnership, trust, and estate interests may be subject to withholding: it specifies that, to the extent provided in regulations, transferees of partnership interests and beneficial interests in trusts and estates will be required to withhold.

As discussed in greater detail below, the conferees intend that foreign corporations be treated as foreign person for withholding purposes regardless of whether they elect to be treated as domestic corporations under Code section 897(i).

Distributions by domestic U.S. RPHCs to foreign shareholders

The conference agreement explicitly requires withholding by a domestic corporation that is (or, at any time during the base period specified in Code section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax to be withheld is 10 percent of the gross amount of the distribution received by the foreign shareholder. While the conference agreement's general withholding rule technically requires withholding by a domestic corporation in this case, the conferees wished to eliminate any uncertainty on this point.

Withholding by a domestic corporation is appropriate in this case because any earlier corporate-level dispositions of U.S. real property interests by the domestic corporation would have escaped tax under FIRPTA. This is because such dispositions by a *domestic* corporation are not by a "foreign person", even if all the domestic corporation's shareholders are foreign persons.

A qualifying statement granting exemption from withholding may be requested in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when Code section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in Code section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the FIRPTA rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under FIRPTA.

A qualifying statement granting exemption from withholding also may be requested in connection with a distribution by a domestic corporation of a U.S. real property interest where the Code accords the distributee foreign shareholder nonrecognition treatment on the distribution and this nonrecognition treatment is not overridden by FIRPTA (Code sec. 897(e)).

Taxable distributions by partnerships, trusts and estates to foreign persons

The conference agreement also explicitly requires withholding by a foreign or domestic partnership, trust, or estate when it makes a taxable distribution of a U.S. real property interest to a foreign person. In general, the amount of tax to be withheld is 10 percent of the fair market value at the time of the taxable distribution of the distributed U.S. real property interest. While the conference agreement's general withholding rule technically requires withholding in such a case, the conferees wished to eliminate any uncertainty on this point.

Under general Code rules, most distributions by partnerships, trusts, and estates are not taxable. However, FIRPTA authorizes the Secretary to prescribe regulations under which distributions of property by these entities (in exchange for the distributees' interests in these entities) *will* be taxable for FIRPTA purposes to the extent attributable to U.S. real property interests (Code sec. 897(g)).

Corporations making section 897(i) election

The conferees intend that foreign corporations electing under Code section 897(i) to be treated as domestic corporations for purposes of FIRPTA's substantive and reporting provisions continue to be treated as foreign persons for withholding purposes. This will simplify the administration of the withholding system, particularly the exemption procedure for persons who furnish non-foreign affidavits.

By treating a foreign corporation as a foreign person for withholding purposes despite its having elected to be treated as a domestic corporation for purposes of FIRPTA's substantive provisions, a liquidation-related sale of a U.S. real property interest by the foreign corporation may be subject to withholding. Because the corporation is treated as a domestic corporation for substantive FIRPTA purposes, however, it may elect tax-free treatment of the liquidation-related sale under Code section 337. The conferees intend that any tax withheld on such a qualifying section 337 liquidation-related sale be offset by means of a crediting procedure. The Internal Revenue Service is to prescribe regulations allowing foreign shareholders in a foreign corporation electing section 897(i) treatment to credit against their FIRPTA tax liability on a liquidating distribution any tax withheld on a qualifying section 337 liquidation-related sale of a U.S. real property interest.

Information reporting requirements

The conference agreement generally repeals the information reporting requirements of FIRPTA.

However, it authorizes the Secretary to require reporting by foreign persons holding direct investments in U.S. real property interests. For this purpose, a foreign person will be treated as holding direct investments in U.S. real property interests during any calendar year if the foreign person did not engage in a U.S. trade or business at any time during the calendar year and the fair market value of the U.S. real property interests held directly by the person at any time during the calendar year was $50,000 or more. A person "directly" holds a U.S. real property interest only if his disposition of the interest would be taxable under FIRPTA. Thus, persons not subject to FIRPTA may not be subjected to information reporting under the conference agreement. The Internal Revenue Service may not impose look-through or similar rules in connection with reporting, under which "deemed" or "constructive" holders of U.S. real property interests are required to report, except to the extent that those required to report would be subject to tax under FIRPTA.

The conferees do not believe that requiring reporting by foreign persons holding direct U.S. real property investments would be unduly intrusive or burdensome. U.S. law presently requires foreign investors in U.S. real property to furnish their names and countries of residence, as well as certain other information, to the U.S. Government, in certain circumstances. For example, the Agricultural Foreign Investment Disclosure Act of 1978 (7 U.S.C. secs. 3501-08) generally requires foreign persons who acquire U.S. agricultural land (other than certain parcels of one acre or less which generate less than $1,000 in annual gross sales) to file detailed reports on such acquisitions with the Department of Agriculture within 90 days of the transaction. Completed reports are made available for public inspection. Pursuant to the International Investment Survey Act of 1976 (22 U.S.C. secs. 3101-08), the Department of Commerce imposes various reporting requirements on foreign investors in U.S. businesses. For example, on the acquisition by a foreign company of a 10-percent (or more) ownership interest in a U.S. business with 200 or more acres of U.S. land or $1 million or more of either assets, gross sales or net income, the Department generally requires that the name and country of residence of the foreign company be reported and certain information about the U.S. business be provided. Information reported pursuant to the International Investment Survey Act generally may be used for analytical or statistical purposes only.

Effective date

The withholding rules apply to dispositions of U.S. real property interests that occur on or after January 1, 1985. The date on which a foreign transferor originally acquired a U.S. real property interest is irrelevant.

The changes in the information reporting requirements are effective retroactively to calendar year 1980.

9. Excise tax on insurance premiums paid to foreign insurers and reinsurers

Present law

The United States imposes excise taxes on premiums paid to foreign insurers not doing business in the United States. The rates are (per dollar of premium): four cents for casualty contracts, one cent for life contracts, and one cent for all reinsurance. The tax is collected by return. Payments to some insurers are exempt by treaty, but reinsurance premiums paid by treaty-protected insurers are subject to the tax (unless the recipient is exempt by treaty).

House bill

No provision.

Senate amendment

The Senate amendment makes the excise tax rate on casualty reinsurance equal to that on casualty insurance (four percent). In addition, the amendment adopts a new withholding mechanism for collecting the insurance excise taxes.

These provisions will apply to premiums paid after the date of enactment.

Conference agreement

The conference agreement does not include the Senate amendment. The conferees have decided not to restructure the insurance excise tax, to increase the tax on casualty reinsurance premiums, or to establish a new withholding mechanism at this time in the belief that further study of these proposed changes is in order.

In coming to their decision the conferees were not pursuaded by the argument that the Senate amendment would violate the income tax treaty between the United States and the United Kingdom. Rather, it is the conferees' view that the Senate provision would not violate any U.S. income tax treaty. It would have only collected a tax that the United States has the power to impose and collect under any U.S. income tax treaty and thus, would have been fully consistent with all U.S. treaty obligations.

In addition, the conferees are aware of assertions that negotiators for the United States and the United Kingdom, in connection with the negotiation of the existing income tax treaty between the two countries, may have reached an unwrittten understanding that the United States would not impose its insurance excise tax on premiums for the reinsurance of U.S. risks paid by U.K. insurers to reinsurers in other foreign countries. Unwritten understandings do not bind Congress. Only open covenants normally warrant Congressional recognition. The conferees do not agree with the suggestion that understandings unknown to Congress and not part of the public record during the ratification process become law in the United States.

However, the conferees recognize that close ties exist between the United States and the United Kingdom, and the conferees believe that Congress, as a matter of comity, should allow our treaty partner and ally every opportunity to establish that internal U.S. law should remain as it is. This concern is an important reason for the conference agreement's omission of the Senate amendment provision at this time. In light of this incident and other experiences, however, the conferees express concern over waiver of U.S. taxing jurisdiction by treaty. The conferees believe that, while income tax treaties provide benefits to U.S. business and U.S. tax administration, they have also caused substantial problems for our tax system, and they sometimes create opportunities for tax avoidance that Congress—in a spirit of comity—is reluctant to close. Therefore, the conferees urge further study of changes in the insurance excise tax, and urge those who support retention of the current system to develop additional reasons—beyond comity—to support their position.

10. Use of territories to avoid U.S. tax on foreign investors

Present law

Payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30-percent U.S. withholding tax. The United States does not tax payments of passive income to corporations organized in Guam, the Northern Mariana Islands, or the U.S. Virgin Islands. Some argue that foreigners who wish to invest in the United States may avoid both U.S. and territorial tax by channeling their investments through conduit corporations in these territories. Temporary Treasury regulations subject dividends and interest paid by territorial conduit corporations to territorial withholding tax. Guam is contesting these regulations in court.

House bill

The House bill (which differs substantially from the provision that the Committee on Ways and Means reported because of a technical Committee amendment to the pro- vision on the House floor) provides that interest, dividends, and other passive income paid from U.S. sources to a corporation organized in Guam, the Marianas, or the Virgin Islands will not be subject to U.S. tax if the recipient corporation meets two re-

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quirements: first, that at all times during the taxable year less than 25 percent in value of the stock of the corporation be owned directly or indirectly by foreign persons and second, that at least 20 percent of its gross income be shown to the satisfaction of the Secretary to have been derived from local sources for the three-year period ending with the close of the preceding taxable year of the corporation (or for such part of the three-year period as the corporation has been in existence).

For the purpose of the ownership requirement, the term foreign person means any person other than either a U.S. person or a person who would be a U.S. person if the general Internal Revenue Code definition of the United States included references to the U.S. possessions. That is, residents of the possessions will not be foreign persons for this purpose. In determining whether stock of a corporation that belongs to another corporation is owned indirectly by foreign persons, only foreign persons who own five percent or more in value of the corporate shareholder are considered as owning stock in the underlying corporation. This last rule will allow territorial subsidiaries of publicly traded U.S. corporations many of whose stockholders are nominees (but with less than 25 percent in value of their stock held by foreign persons owning 5 percent or more in value) to meet the ownership requirement for reduced withholding.

The 20-percent of gross income requirement makes it clear that a corporation formed in a possession of the United States is not eligible for reduced U.S. withholding tax on any U.S. source income if it could make payments of interest or dividends that are free of withholding tax in the possession. The purpose of this requirement is to assure collection of one tax on foreigners who invest in the United States. If 20 percent or more of the gross income of a corporation organized in Guam, the Marianas or the Virgin Islands during the applicable period were local source income, payments from its U.S. parent would not be subject to U.S. tax, but its payments to foreign investors would be subject to territorial withholding tax. On the other hand, U.S. withholding tax will apply to payments to a Virgin Islands corporation chartered in such possessions, unless its payments of interest and dividends to foreigners are subject to territorial tax. This rule will apply to payments after March 1, 1984.

The bill makes it clear that the Revised Organic Act of the Virgin Islands does not override its rules.

The House bill contains provisions that allow payment of dividends and interest from territorial corporations to U.S. persons without withholding tax whether or not the U.S. recipient of the payment meets either the ownership test or the gross income test.

The bill applies not only to Guam and to the Virgin Islands, but also to other territories (such as the Marianas) whose tax rules operate by reference to U.S. law or to territorial law.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill, with a technical correction. The correction makes it clear that the imposition of tax on certain Guamanian corporate recipients of U.S. source income does not have any effect on the Guamanian tax liability of U.S. recipients of Guamanian source income.

The conferees do not intend that any interplay of the tax laws of the United States and the territories allow foreign investors not resident in the territories to earn, directly or indirectly, U.S. income that escapes both U.S. and territorial tax. If Congress decides to allow use of the territories as conduits for foreign investors, or to allow other tax avoidance at variance with tax policy that Congress has expressed, Congress will do so specifically, and not by indirect application of U.S. tax rules that apply automatically in the territories.

The conferees believe that the relationship between the tax systems of the United States and those U.S. territories whose tax systems depend on the U.S. tax Code has created great uncertainty and possible opportunities for taxpayers to take positions that, if sustained, would result in tax avoidance. The conferees did not address this problem in the conference report because neither House of Congress addressed the problem in the legislation that the Congress considered. Neither taxpayers nor the courts, however, should construe the action of the conferees with respect to the specific problem of territorial conduit entities as indicating that any other tax avoidance device that depends on the laws of the territories whose tax laws generally depend on U.S. tax law as it changes (from time to time) yields the result that avoidance-seeking taxpayers seek.

11. Taxation of certain transfers of property outside the United States

Present law

Certain transfers of appreciated property to a foreign corporation can be made without recognition of gain to the transferor if the transferor establishes to the satisfaction of the Internal Revenue Service ("IRS") that the transfer did not have the avoidance of Federal income taxes as one of its principal purposes.

Transfers for use in a trade or business

Under IRS ruling guidelines (the "guidelines"), ordinarily, a favorable ruling is issued if the foreign transferee devotes the property to the active conduct of a trade or business, and has need for a substantial investment in fixed assets or will be engaged in the purchase and sale abroad of manufactured goods.

Tainted assets

Transfers of certain "tainted" assets are treated as taxable exchanges, regardless of whether the transfer is made for use in an active trade or business.

Incorporation of foreign loss branches

The guidelines require the recognition of gain on the transfer of the assets of a foreign branch to a foreign corporation, to the extent of previously deducted losses. *See* Rev. Rul. 78-201, 1978-1 C.B. 91. If the losses of the foreign branch contributed to an overall foreign loss that reduced U.S.-source income, a statutory provision may require not only recognition of gain but also recharacterization of the gain as U.S.-source income (sec. 904(f)). In the case of an overall foreign loss, the amount of gain required to be recognized under the guidelines is reduced by the amount of income required to be recognized by the statutory rule.

Declaratory judgment procedure

In the case of an actual controversy involving a determination or a failure to make a determination by the IRS as to whether a transfer had tax avoidance as a principal purpose, a taxpayer can litigate the determination in the Tax Court. In addition, the Tax Court is empowered to review any terms and conditions that the IRS seeks to impose upon a taxpayer in making the determination.

Excise tax on certain transfers not subject to section 367

An excise tax is imposed on certain transfers of property to foreign transferees in transactions that are not described in section 367(a). The excise tax is not imposed if the transferor establishes, before (sec. 1492) or after (sec. 1494) the transfer, to the satisfaction of the IRS that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Treatment of liquidating distributions by a domestic corporation

A liquidating distribution of appreciated property by an 80-percent owned domestic subsidiary into its foreign parent corporation (under sec. 332) is subject to the ruling requirement that is generally applicable to transfers of appreciated property to foreign corporations. The only statutory sanction for the failure to obtain the required ruling is the denial of the exception to the recapture rules (for depreciation, investment credits, and other items) that would otherwise be available.

House bill

The House bill eliminates the ruling requirement for transfers of appreciated assets abroad. Except as otherwise provided, transfers of appreciated property to foreign corporations are subject to tax.

Exception for property transferred for use in an active trade or business

Except as provided in regulations, no gain is recognized on the transfer of property to a foreign corporation for use in the active conduct of a trade or business abroad. The House bill contemplates that, prior to January 1, 1985, the Secretary will issue regulations prescribing the standards to be used in determining whether property is transferred for use in an active trade or business.

Tainted assets

Transfers of "tainted assets" (defined in a manner similar to that of the IRS guidelines) are ineligible for the trade or business exception. The House bill creates a new category of tainted assets: foreign currency or property denominated in a foreign currency.

Treatment of stock or securities

Transfers of stock or securities that fall within the active trade or business exception can be made without the recognition of gain. In the case of other transfers, the House bill contemplates that the present-law exceptions to the treatment of stock or securities as tainted assets will continue to apply.

Partnership interests

Except as provided in regulations, a transfer of an interest in a partnership is treated as a transfer of the transferor's pro rata share of the assets of the partnership.

Special rule for transfers of intangibles

Transfers of intangible assets in transactions that would otherwise qualify for nonrecognition of gain are treated as transfers for payments contingent on productivity, use, or disposition of the property. The transferor is treated as receiving payments over the useful life of the intangible property on an annual basis. Amounts included in gross income by reason of the special rule are treated as ordinary income from sources within the United States.

Incorporation of foreign loss branch

The active trade or business exception is inapplicable to certain transfers in connection with the incorporation of a foreign branch that has operated at a loss. Under the House bill, a tax is imposed on the lesser of (1) the excess of pre-incorporation losses

incurred by the foreign branch with respect to which a deduction was allowed to the taxpayer over the amount of such losses recaptured under section 904(f), or (2) the gain on the transfer.

Declaratory judgment procedure

The House bill repeals the declaratory judgment procedure for Tax Court review of section 367 rulings and ruling requests.

Excise tax rules

To preserve consistency between section 367 and the excise tax rules, the House bill provides that the excise tax will not be imposed if the taxpayer establishes to the satisfaction of the IRS that gain should not be recognized on the transfer under principles similar to the principles of section 367.

Treatment of liquidating distributions

To the extent provided in regulations to be prescribed by the Secretary, a domestic corporation recognizes gain on liquidating distributions of appreciated property to foreign persons.

Notification requirement

The House bill provides a notification requirement for section 367(a) transfers and a set of penalties for failures to comply.

The bill also extends the general three-year statute of limitations on assessment and collection of tax with respect to any tax imposed under section 367 where the taxpayer fails to give the required notice.

Effective date

The provisions of the House bill apply to transfers or exchanges made after December 31, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill with technical modifications.

Special rule for transfers of intangibles

If, subsequent to a transfer of an intangible to a foreign corporation, the U.S. transferor disposes of its stock in the foreign-transferee corporation, then part of the gain on disposition of the stock is treated as being U.S.-source ordinary income attributable to the disposition of the intangible. Similarly, if the foreign-transferee corporation disposes of the intangible, the U.S. transferor is deemed to receive a U.S.-source payment of ordinary income with respect to the intangible at that time.

Incorporation of foreign loss branch

The Senate amendment clarifies that, in the case of an overall foreign loss, the amount of gain required to be recognized is reduced by the amount of income required to be recognized by section 904(f)(3) in the current taxable year, but not amounts that were simply recharacterized as U.S.-source income by section 904(f)(1).

Treatment of liquidating distributions

Under the Senate amendment, a domestic corporation recognizes gain on liquidating distributions of appreciated property to foreign persons, except as otherwise provided in regulations to be prescribed by the Secretary.

Effective date

The Senate amendment provides a transition rule for transfers with respect to which a ruling request under section 367(a) was filed with the IRS before March 1, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment with technical modifications.

Transfers for use in a trade or business

The conference agreement generally follows the Senate amendment.

Transfers of appreciated property of a domestic branch.—The conferees intend that regulations to be prescribed by the Secretary will require gain recognition on the transfer of assets that were used in the United States, to the extent of depreciation deductions previously claimed by the taxpayer with respect to the transferred property. This result is consistent with the treatment of transfers of property of a foreign branch that has operated at a loss (discussed below).

Tainted assets

The conference agreement follows the Senate amendment.

Except as provided in regulations, gain is recognized on the transfer of (1) property described in section 1221 (1) or (3) of the Code (relating to inventory, copyrights, etc.), (2) installment obligations, accounts receivable, or similar property, (3) foreign currency or other property denominated in a foreign country, (4) intangible property (as defined for purposes of the special rules relating to intangibles), and (5) property with respect to which the transferor is a lessor at the time of the transfer, except where the transferee is the lessee.

Treatment of stock or securities

The conference agreement follows the Senate amendment.

The conference agreement contemplates that certain transfers of stock or securities will fall within the exception for transfers for use in an active trade or business.

With respect to stock that is transferred to a foreign corporation in a transaction that constitutes a section 351 exchange as well as a type B reorganization, the conferees expect that, in developing regulations, the Secretary will carefully consider whether there are cases where the transfer should be treated as a section 351 exchange.

Treatment of partnership interests

The conference agreement follows the Senate amendment.

Special rules for transfers of intangibles

The conference agreement follows the Senate amendment.

The conferees intend that disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor's interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor. The amount of U.S.-source ordinary income will depend on the value of the intangible at the time of the second transfer.

The conferees wish to clarify that, as under present law, gain will generally be recognized under section 367(a) on tranfers of marketing intangibles (such as trademarks or trade names) for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States.

Incorporation of foreign loss branch

The conference agreement follows the Senate amendment with two technical modifications. First, in applying the rule requiring gain recognition, a pre-incorporation loss is reduced by taxable income derived by the foreign branch in a taxable year after the taxable year in which the loss was incurred and before the close of the taxable year of the transfer. Second, the conference agreement provides for the characterization of the recognized gain (as ordinary income or capital gain) by reference to the character of the previously incurred losses. For example, if a branch incurred a capital loss (or a foreign oil extraction loss) in an earlier year, its later incorporation would yield capital gain (or foreign oil extraction income). The conferees intend that, on incorporation of a loss branch with appreciated intangibles, the transfer of intangibles will generally be subject to the special rule for intangibles, not the loss branch rule. In all other respects, the conferees intend that the provision for transfers of foreign loss branches be applied in a manner consistent with the IRS's published rulings under present law. Thus, for example, losses that result in gain recognition on incorporation include expenses directly related to a branch's property that was not transferred but abandoned as worthless. *See* Rev. Rul. 80-247, 1980-2 C.B. 127. Similarly, in applying the statutory provision, the profits and losses of divisions that are separate business operations cannot be combined. *See* Rev. Rul. 81-82, 1981-1 C.B. 127. As under current law, the basis of transferred assets will be the same as the basis of the assets in the hands of the transferor immediately prior to the exchange, increased by the amount of gain recognized to the transferor on the exchange. *See* Rev. Rul. 78-201, 1978-1 C.B. 91.

Declaratory judgment procedure

The conference agreement follows the Senate amendment.

Excise tax rules

The conference agreement follows the Senate amendment with modifications. First, the conference agreement clarifies that, as under present law, the taxpayer is to make the showing required under section 1492 before the transfer. Second, the conference agreement makes clear that all of the principles of section 367 (including the special rule for intangibles) are applicable for purposes of the excise tax rules.

Treatment of liquidating distributions

The conference agreement follows the House bill. Present law will continue to apply until regulations are promulgated.

Notification requirement

Under the conference agreement, the notification requirement is extended to liquidating distributions to foreign persons.

Effective date

The conference agreement follows the Senate amendment with two modifications.

Ruling requests under the excise tax rules.—The conference agreement expands the scope of the transition rule for transfers with respect to which a ruling request was filed before March 1, 1984 to cover ruling requests under sections 1492 and 1494 of the Code.

Special rule for certain transfers of intangibles.—The conference agreement provides a special rule for transfers of intangibles that occur after June 6, 1984 (the date of conference action) and before January 1, 1985 (the general effective date). Transfers of intangibles during this period will be treated as made for tax avoidance purposes. Subject to terms and conditions prescribed by the Secretary, however, the Secretary is authorized to waive the application of the special rule. The conferees anticipate that the Secretary will waive application of the rule if taxpayers agree to apply to the transfer the rules applicable to post-December 31, 1984, transfers under the bill. The Secretary may also waive application of the rule in other cases under the existing guidelines. The conferees intend, however, that the Secretary carefully examine transfers of intangibles before giving such a waiver. Transfers of intangibles that are not fully developed or that are not essential to the active conduct of a trade or business should not be given a waiver. This rule will not apply to transfers with respect to which a ruling request was filed before March 1, 1984, or

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with respect to which a ruling was obtained before June 6, 1984.

12. Amendments relating to foreign personal holding companies

Present law

To determine whether a foreign corporation is a foreign personal holding company, a U.S. person is considered to own the stock of his nonresident alien spouse, blood relative, or partners. Interposition of a foreign entity between a U.S. taxpayer and a foreign personal holding company arguably prevents application of the foreign personal holding company rules.

House bill

The House bill ends attribution of ownership of stock owned by a nonresident alien to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants ("blood relatives"). It disregards the interposition of foreign partnerships and other foreign entities between U.S. taxpayers and foreign personal holding companies. It generally applies to taxable years beginning after December 31, 1983. It provides a transitional rule to allow certain existing structures until the end of 1984 to unwind.

Senate amendment

The Senate amendment includes the House family attribution provision; it also ends attribution of stock owned by a nonresident alien to the alien's U.S. partners who are not shareholders (or relatives of shareholders) in the foreign corporation. It includes the House provision that disregards the interposition of foreign entities between U.S. taxpayers and foreign personal holding companies. It generally applies to taxable years begining after March 15, 1984, and includes the same transitional rule as the House bill.

Conference agreement

The conference agreement generally follows the Senate amendment with respect to attribution of stock ownership from nonresident alien individuals, but limits the application of the provision ending attribution from nonresident aliens who are blood relatives of U.S. persons. In cases where a U.S. person is a blood relative of the nonresident alien individual who owns stock, the conference agreement will attribute the stock of the nonresident alien to his or her U.S. blood relatives. For example, under the conference agreement, as under current law, a foreign corporation 40 percent of whose shares belong to a U.S. citizen and 60 percent of whose shares belong to the nonresident alien sister of the U.S. citizen may be a foreign personal holding company. The conferees see the possibility of significant abuse in such a case, and whenever a nonresident alien's U.S. blood relative owns stock in a foreign corporation, but do not believe that such a strong possibility exists when none of the nonresident alien's blood relatives owns stock in a foreign corporation. The conference agreement follows the Senate amendment with respect to attribution from nonresident aliens who are partners of U.S. persons.

The conference agreement includes the provision in the House bill and the Senate amendment that disregards the interposition of foreign entities between U.S. taxpayers and foreign personal holding companies. The managers intend that, as under current law, to the extent that the grantor of (or a transferor to) a trust is taxable on its income, then that person (and not a beneficiary of the trust) will be treated as the owner of the trust for the purposes of the foreign personal holding company rules. For example, the grantor of a revocable trust is taxable on its income (sec. 674); the grantor will be considered its owner for the purposes of the foreign personal holding company rules.

These foreign personal holding company provisions apply to taxable years beginning after December 31, 1983, and include the transitional rule contained in the House bill and the Senate amendment.

13. Coordination of Subpart F with foreign personal holding company provisions

Present law

When the foreign personal holding company rules and the controlled foreign corporation rules (of Subpart F) overlap, the foreign personal holding company rules take priority. Taxpayers have contended that being subject to foreign personal holding company tax for a year exempts them from tax under Subpart F that year, even on an investment of (previously untaxed) earnings and profits in U.S. property. Foreign personal holding company income includes dividends and interest from a related corporation that operates a trade or business in the recipient's country, but the controlled foreign corporation rules (of subpart F) do not taint this kind of income.

House bill

The House bill repeals the rule that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It provides a new rule for coordination of the two sets of provisions: a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would otherwise be taxable under both Subpart F and the foreign personal holding company rules. This provision of the House bill applies to taxable years of U.S. shareholders beginning after the date of enactment.

Senate amendment

The Senate amendment includes the House provision coordinating the foreign personal holding company rules and the Subpart F rules. In addition, the Senate amendment removes dividends and interest from a related corporation that operates its trade or business in the recipient's country from the foreign personal holding company income calculation. This provision of the Senate amendment applies to taxable years of foreign corporation beginning after March 15, 1984.

Conference agreement

The conference agreement includes the provision in the House bill and the Senate amendment coordinating the foreign personal holding company rules and the Subpart F rules. This provision is effective for taxable years of foreign corporation beginning after date of enactment.

The conference agreement includes the provision in the the Senate amendment that removes dividends and interest from a related corporation that operates a trade or business in the recipient's country from the foreign personal holding company income calculation, but adds a technical amendment. The technical amendment specifies that the provision will not apply to dividends or interest from a corporation that is a foreign personal holding company. This provision is effective for taxable years of foreign corporations beginning after March 15, 1984.

14. Gain from sale or exchange of stock in certain foreign corporations

Present law

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the corporation's voting stock may be treated as a dividend (sec. 1248(a)). Gain is recharacterized as dividend income to the extent of the corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a controlled foreign corporation. Similarly, a U.S. corporation that disposes of stock in a transaction governed by section 311, 336, or 337 (by distributing the stock as a dividend-in-kind or in the course of liquidation) is required to recognize its pro rata share of post-1962 earnings and profits as dividend income. The amount of dividend income required to be included in the U.S. corporation's income is equal to the difference between the fair market value of the stock and its basis, subject to the post-1962 earnings and profits limitation.

House bill

Under the House bill, if shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast. For purposes of applying section 1248, the foreign corporation is viewed as having issued the stock to the U.S. corporation and the U.S. corporation is treated as having distributed that stock to its shareholders. Under the rules of section 1248 provided in present law, the U.S. corporation is thereby required to recognize dividend income. The amount of dividend income is equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corporation's basis for its stock in the foreign corporation, subject to the post-1962 earnings and profits limitation.

Under an amendment to section 959 (relating to the exclusion of gross income of a controlled foreign corporation's previously taxed earnings and profits) in a different section of the House bill, the foreign corporation's earnings and profits that are recognized by the U.S. corporation as dividend income under section 1248 are treated as previously taxed income.

The provision is effective for exchanges after the date of enactment.

Senate amendment

The Senate amendment generally is the same as the House bill, except that no provision is made for the treatment of the earnings and profits of the foreign corporation as previously taxed income.

Conference agreement

The conference agreement follows the House bill.

15. Technical amendments to section 1248 (ordinary income treatment on disposition of stock of certain foreign corporations)

Present law

When a U.S. person disposes of stock of a controlled foreign corporation, some of his gains may be taxed as ordinary income, not as a capital gain (Code section 1248). There may sometimes be double counting of ordinary income and foreign tax credits. There may be different treatment of a U.S. person's indirect ownership of a controlled foreign corporation and a U.S. person's direct ownership.

House bill

The House bill prevents double counting of ordinary income and foreign tax credits on account of the disposition of stock in a foreign corporation. This provision applies to transactions occurring after the date of enactment (or after October 9, 1975, at taxpayer's election). The bill also treats a U.S. person's indirect ownership of a controlled foreign corporation like direct ownership.

This provision applies to transactions occurring after the date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

16. Foreign investment companies

Present law

More than fifty-percent U.S.-owned foreign companies registered under the Investment Company Act or engaged primarily in investing or trading in securities (with certain exceptions) are defined as foreign investment companies, sales of whose shares are taxed at ordinary income rates.

House bill

The bill redefines foreign investment companies as companies engaged primarily in investing or trading in securities or commodities (or interests in either), and changes the ownership test to 50-percent or more U.S. ownership. This new definition applies to sales and exchanges on or after September 29, 1983. For stock held on that date, it applies to sales and exchanges more than one year after date of enactment.

Senate amendment

The Senate amendment is the same as the House bill except that the Senate amendment has a different effective date. The redefinition of foreign investment companies in the Senate amendment applies to sales and exchanges on or after October 31, 1983. For stock held on that date, it applies to sales and exchanges more than one year after date of enactment.

Conference agreement

The conference agreement follows the House bill.

17. Foreign collapsible corporations

Present law

Overview

The collapsible corporation rules of section 341 are designed to prevent the use of a specific tax-avoidance device: the use of a corporation to convert business profits that would otherwise be taxed as ordinary income to capital gain. Under present law, Congressional intent underlying section 341 may be circumvented in some circumstances by use of a foreign corporation.

Background

The reports of the Committee on Ways and Means and the Committee on Finance that accompanied the 1950 legislation enacting section 341 describe a collapsible corporation as "a device . . . used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation." [1]

Because U.S. persons are subject to Federal income tax on their worldwide income, there is an incentive to make use of collapsible corporations to engage in activities conducted abroad, as well as activities conducted within the United States.

Statutory rules and legislative history

General rules.—The efficacy of the collapsible corporation as a tax-avoidance device depends on the combination of two tax results: (1) avoiding a tax at the corporate level and (2) obtaining capital gain treatment at the shareholder level. In 1950, Congress acted to prevent taxpayers from obtaining the combination of tax results that underlies the utility of a collapsible corporation.

Section 341(a) generally treats a shareholder's gain on the sale or exchange of stock in a collapsible corporation as ordinary income. Section 341(b)(1) defines the term collapsible corporation to include a corporation that is formed or availed of principally for the manufacture, construction, or production of property, with a view to a sale or exchange of stock by its shareholders before the realization by the corporation of a substantial part of the taxable income to be derived from the property, and the realization by the shareholders of the gain attributable to the property. Thus, the statutory definition of collapsible corporation looks to whether a corporation can be expected to realize the gain inherent in its property in the normal course of business.

The provisions of section 341 make no distinction between domestic corporations and foreign corporations. Thus, the collapsible corporation rules are applicable to a foreign corporation that is used as the vehicle for the proscribed tax avoidance scheme. Rev. Rul. 56-104, 1956-1 C.B. 178.[2]

Section 341(e) exceptions for nonabusive situations.—In 1958, Congress refined the collapsible corporation rules to provide exceptions for situations that were not intended to be covered by the initial legislation. The report of the Senate Finance Committee acknowledges that "the purpose of-[section 341] . . . is to prevent income which would otherwise be taxed at ordinary income rates from being converted into income taxable at capital gain rates merely by use of the corporate entity." [3] The statutory definition of collapsible corporation, however, by its terms and as interpreted, could result in the application of section 341 to tax a shareholder's gain as ordinary income even if the corporation's property would constitute a capital asset in the hands of the shareholder.[4] The 1958 legislation, which added section 341(e) to the Code, was designed, in part, to reverse this result.

The facts of Revenue Ruling 72-24, 1972-1 C.B. 103, disclosed that a foreign corporation was a collapsible corporation within the meaning of section 341(b). Section 341 was not applied, however, because of the application of section 341(e). In applying section 341(e), the Internal Revenue Service treated the foreign corporation as if it were a domestic corporation.

Section 341(f) consent to recognize gain at the corporate level.—Section 341(f)(1) permits capital gain treatment on disposition of stock in a collapsible corporation if the corporation consents to recognize gain on the disposition of its "subsection (f) assets" (generally, assets other than capital assets) when realized, even in a transaction that would otherwise qualify for nonrecognition of gain. Section 341(f)(3) provides an exception to the requirement of corporate-level gain recognition for certain tax-free corporate organizations, reorganizations, and liquidations, if the transferee gives a section 341(f)(1) consent.

The theory of section 341(f) is that section 341 should not apply if the corporation continues in existence and realizes the gain on its property.[5] To insure the result on which section 341(f) is premised, the statute mandates recognition of gain on dispositions that would otherwise be tax-free.

Treasury regulations provide that, in the case of a foreign corporation that gives a section 341(f) consent, any gain on the corporation's disposition of a subsection (f) asset is considered gross income that is effectively connected with a U.S. trade or business (Treas. Reg. sec. 1.341-7(e)(3)). A foreign corporation is subject to the regular corporate income tax with respect to income that is effectively connected with a U.S. trade or business. The regulatory provision may have no practical effect, however, where the foreign corporation's income is not subject to U.S. tax (because the corporation has no U.S.-source income and is not engaged in a U.S. trade or business) and the stock is sold to a foreign person.

House bill

Under the House bill, to the extent provided in regulations prescribed by the Secretary, a foreign corporation will be prohibited from making a section 341(f) consent.

The provision is effective on the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill, with a technical modification. Under the Senate amendment, to the extent provided in regulations prescribed by the Secretary, a section 341(f) consent will not be given effect where the consent is given by a foreign corporation.

Conference agreement

The conference agreement follows the Senate amendment with one modification. Under the conference agreement, by statute, a section 341(f) consent will not be given effect where the consent is given by a foreign corporation.

There is no policy reason to allow the use of the collapsible corporation device by U.S. taxpayers simply because the corporation is organized under the laws of a foreign country to engage in an activity abroad. This result may occur, however, where the stock of a foreign collapsible corporation is sold to a foreign person and the section 341(f) consent procedure is used. The conferees intend that a section 341(f) consent given by a foreign corporation will not be given effect if the consenting corporation is not engaged in a U.S. trade or business and stock in the corporation is sold to a foreign person. The conferees recognize that there may be cases in which a section 341(f) consent given by a foreign corporation should be given effect. Accordingly, the conference agreement authorizes the Secretary to prescribe regulations setting forth circumstances in which it would be appropriate to give effect to a section 341(f) consent given by a foreign corporation.

The conferees are informed that taxpayers have taken the position that section 341 should not apply to a foreign corporation that derives no U.S.-source income, and that section 341(f) properly provides a means to accomplish this result. This position is premised on the notion that the primary purpose of section 341 is to insure the collection of a Federal corporate income tax. To the contrary, the legislative history makes clear that section 341 is designed to prevent the conversion of ordinary income to capital gain by use of a corporation; the avoidance of tax at the corporate level is incidental to the conversion technique. Thus, the fact

[1] H.R. Rept. No. 2319, 81st Cong., 2d Sess. 196 (1950); S. Rept. No. 2375, 81st Cong., 2d Sess. 88 (1950).

[2] Congress has addressed the issue of the extent to which U.S. taxpayers can use foreign corporations to defer U.S. tax on foreign-source income in sections 951-964 ("Subpart F") and 1248 of the Code. Under these provisions, the earnings and profits of certain foreign corporations are taxed as ordinary income to U.S. shareholders who own ten percent or more of the corporation's stock. Because the classic collapsible corporation has insignificant earnings and profits, neither Subpart F nor section 1248 prevents the use of a foreign corporation for the proscribed device.

[3] S. Rept. No. 1983, 85th Cong., 2d Sess., 31 (1958).

[4] *See Braunstein v. Commissioner*, 347 U.S. 65 (1963) (holding that there is no implied exception for this situation).

[5] H.R Rept. No. 1308, 88th Cong., 2d Sess., 3 (1964).

that the income of a foreign collapsible corporation is not subject to U.S. tax does not present a reason to permit the corporation's shareholders to circumvent section 341 by use of a section 341(f) consent.[6]

18. Stapled stock; stapled entities

Present law

Shares in one corporation may be transferable only in tandem with shares of a "sister" corporation. These shares are "stapled." A U.S. corporation owning a foreign corporation may avoid the controlled foreign corporation rules and the anti-boycott rules by spinning off the foreign corporation. Management may retain control if the stock of the two corporations is stapled. In addition, U.S. corporations may avoid restrictions on RICs and REITs by stapling their stock with stock of other U.S. entities. In addition, U.S. corporations may seek multiple surtax exemptions, accumulated earnings tax credits, etc., by stapling.

House bill

Under the House bill, new rules apply to entities 50 percent or more of which can be transferred only in tandem with interests in another entity. Generally, where a foreign and a domestic corporation are stapled entities, the foreign corporation will be treated as domestic. A foreign entity stapled on June 30, 1983, can elect to be treated as the subsidiary of its U.S. sister rather than as a U.S. corporation; stapled entities cannot claim non-U.S. status by virtue of a treaty unless they were entitled to treaty benefits on June 30, 1983. All stapled entities will be treated as one in determining whether any one is a REIT or RIC.

In determining controlled corporation status or stock ownership, one stapled corporation will be treated as owning the other. In addition, the Secretary may prescribe regulations to prevent tax avoidance or evasion through stapling. Generally, the provision is effective on the date of enactment. However, for interests stapled on June 30, 1983, the provision will not apply until January 1, 1985 (January 1, 1987, in the case of a stapled foreign corporation). This provision will not apply to certain Puerto Rican corporations or REITs whose interests were stapled on June 30, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement generally follows the House bill, but adds a special effective date for certain purposes for certain stapled mortgage REITs.

19. Insurance of related parties by a controlled foreign corporation

Present law

Income of a controlled foreign corporation from the performance of services for a related person outside the country of its incorporation is currently taxable to its U.S. shareholders. Treasury Regulations may deem the place of performance of insurance services to be the location of the insurance company's office so that income from insuring related parties' risks may not be currently taxable to the insurer's U.S. shareholders.

House bill

No provision.

Senate amendment

The Senate amendment specifies that income from the performance of insurance services by a controlled foreign corporation for a primary insured who is related to the insurer arises in the country where the risk is located. This income will be taxable currently to the corporation's U.S. taxpayers.

This provision will apply to taxable years of controlled foreign corporations beginning after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment but expands the definition of "related party" for purposes of the provision to include 10-percent U.S. shareholders (and persons related to them) of a controlled foreign corporation performing insurance services. The purpose of the expansion is to impose tax on an insurance company owned (directly or indirectly) by a relatively small number of U.S. shareholders that use it in whole or in part to insure their foreign risks or foreign risks of parties related to them.

20. Definition of resident alien

Present law

All individuals who are not U.S. citizens are either resident aliens or nonresident aliens of the United States. Residence depends on an alien's subjective intent. Resident aliens, like U.S. citizens, are subject to U.S. tax on worldwide income (although the foreign tax credit may reduce or eliminate U.S. tax on foreign source income). Nonresident aliens are generally subject to U.S. tax only on income that arises in the United States and on income from U.S. businesses.

When an individual changes his status from resident alien to nonresident alien (or vice versa), his or her taxable year consists of two separate periods. During one period, the United States will tax worldwide income; during the other period, the United States will normally tax only U.S. source income.

House bill

Under the House bill, an alien will be a resident if either (1) he is a lawful permanent resident of the United States (the "green card test"), or (2) the sum of (a) the days present during the current year, (b) one-third times the days present during the preceding year, and (c) one-sixth times the days present during the second preceding year equals or exceeds 183 (the "substantial presence test"). Presence as a commuter from Canada or Mexico will not count. Residence for fewer than 31 days in a year precludes residence under the substantial presence test for that year.

The substantial presence test will not count days of diplomats or certain other representatives of foreign governments (indefinitely), teachers or trainees (generally for 2 years only), or students (generally for 5 years only). The test will not apply to an individual who is unable to leave the United States because of a medical condition that arose while he or she was present in the United States.

There is an exception to the substantial presence test for individuals present for fewer than 183 days during the year who establish closer connections with a foreign country than with the United States and a tax home there for the year. This closer connections/tax home exception will not be available for any applicant for an immigrant visa.

Residence under the green card test will begin on the day the alien entered the United States. *De minimis* presence before start or after termination of substantial presence will generally be disregarded under the substantial presence test.

A taxpayer who has not established a taxable year for any period prior to the time he becomes taxable in the United States will be taxed on a calendar year basis.

The bill applies to taxable years beginning after December 31, 1984. For the substantial presence test, days of presence in 1983 will count only for aliens who had been residents (under existing law) in 1983 and 1984; days of presence in 1984 will count only for residents (under existing law) in 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill, with modifications. First, if an individual is a resident of the United States for three consecutive years under the new statutory definition and is a resident of the United States during one of the next three years, then he or she will be subject to U.S. tax for all intermediate years on the same items of income that would be taxed to a U.S. citizen who renounced U.S. citizenship for the principal purpose of avoiding U.S. tax (sec. 877). This rule will apply regardless of the subjective intent of the alien. The conferees adopted this modification because of a concern that, under the mechanical tests for residence that the conference agreement provides, long-time U.S. residents may leave the United States for a short period, dispose of assets free of U.S. tax, and resume U.S. residence. The conferees have adopted for this purpose the rules that tax certain U.S. citizens who renounce U.S. citizenship because of the clarity of that body of law, although the conferees believe that those rules merit reexamination (especially to the extent that those rules allow disposition of foreign assets held during U.S. citizenship or residence free of U.S. tax).

Second, days that an alien is present in transit without visa for 24 hours or less (for example, in a U.S. airport en route from Canada to South America) would not count as days of U.S. presence for the purpose of the substantial presence test.

Third, the substantial presence test will not count days of an individual who is unable to leave the United States because of a medical condition that arose while he or she was present in the United States.

The conferees do not intend that the conference agreement override treaty obligations of the United States. For example, an alien who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under a United States income tax treaty will be eligible for the benefits that the treaty extends to residents of the treaty partner. However, notwithstanding the treatment of the alien as a resident of the other country for treaty purposes, the conference agreement will treat the alien as a U.S. resident for purposes of the internal tax laws of the United States. For example, if the alien owns more than 50 percent of the voting power of a foreign corporation, the foreign corporation will be a controlled foreign corporation (sec. 957).

The conferees do not intend that the definitions of resident alien and nonresident alien in the conference agreement affect the determination whether a trust or an estate is a U.S. or a foreign trust or estate (secs. 7701(a)(30) and (31)) except insofar as that determination itself turns on the residence or nonresidence of particular alien individuals.

The conference agreement allows the Secretary to prescribe regulations to carry out the purpose of this subsection. In particular, the conferees understand that regulations may be necessary to coordinate U.S. taxing jurisdiction with the taxing jurisdictions of U.S. possessions the basis of whose tax law is the Internal Revenue Code.

[6] The conferees acknowledge that it may be appropriate for Congress to review the relationship between the Subpart F provisions, section 1248, and section 341.

21. Treatment of community property income of nonresident aliens

Present law

A married couple both of whom are nonresident aliens may use foreign community property laws to split the U.S. earned income of one spouse for computing U.S. tax liability. A similar couple residing in a common law country could not split income in this way.

House bill

The House bill ends the ability of nonresident alien individuals to use foreign community property laws to split the U.S. earned income of one spouse.

The bill applies to taxable years beginning after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

23. Foreign sales corporations

Present law

In general

Present law provides tax deferral for the exporting income of Domestic International Sales Corporations (DISCs) and their shareholders. A DISC typically is a domestic subsidiary of a U.S. company engaged in exporting property produced in the United States.

The amount of the deferral is limited generally to 42.5 percent of DISC income that exceeds the average DISC income in a base period. (Most recent data show that the average DISC deferral for all DISCs is 34 percent of DISC income or 17 percent of the combined taxable income of the DISC and its parent.) Deferral is provided for both export profits and export investment income. The tax on accumulated DISC income may be deferred indefinitely until the income is actually distributed or the DISC fails to qualify as a DISC.

Deferred income

Under the DISC rules, deferral of tax is provided for income from (1) the sale or lease for use outside the United States of export property, (2) services related or subsidiary to the sale or lease of export property, (3) certain engineering and architectural services, (4) certain managerial services, including managerial services provided to unrelated DISCs to aid them in deriving export receipts, provided that at least 50 percent of the gross receipts of the DISC that provides the services are from exporting, (5) interest on any obligation that is a qualified export asset, (6) certain dividends, and (7) the sale of export assets.

Export property

DISC benefits are provided for export property, which generally includes property manufactured, produced, grown, or extracted in the United States. DISC benefits are not allowed, however, for property leased by a DISC for use by any member of a controlled group that includes the DISC, patents or intangibles, subsidized property, property in short supply, or oil, gas, coal, uranium, and other depletable minerals. The amount of the deferral on the sale of military goods is half the amount otherwise allowed.

Transfer pricing

DISC deferral is available on a percentage of income allocated to it under special transfer pricing rules. Transfer prices are based on either special rules or arm's-length pricing under Code section 482. Under the special rules, transfer prices are based on either 50 percent of combined taxable income of the DISC and its related party, or 4 percent of gross receipts from the transaction; in either case, the DISC also earns 10 percent of export promotion expenses.

Amount of benefit

The amount of the DISC benefit depends on the method used to determine transfer prices. If transfer prices are based on 50 percent of combined taxable income, deferral is no more than 21.25 percent of income earned by DISC and parent on the transaction. If transfer prices are based on 4 percent of gross receipts, total deferral is no more than 1.7 percent of gross receipts. If transfer prices are based on arm's-length rules, deferral is no more than 42.5 percent of DISC income.

Incremental rules limit the tax deferral to income attributable to export gross receipts that exceed 67 percent of the average gross receipts in a 4-year base period. The incremental rules do not apply to small DISCs with adjusted taxable income of $100,000 or less.

Qualifications

To qualify for the deferral, a DISC must be incorporated under the laws of any of the States or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

The gross receipts test requires that at least 95 percent of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. The gross assets test requires that at least 95 percent of the corporation's assets qualify as export assets. Qualified export assets include inventories, export property, necessary operational equipment and supplies, trade receivables from export sales (including certain commissions receivable), producers' loans, working capital, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association.

A DISC's taxable year need not conform to the taxable year of any of its shareholders. A wholly owned DISC will frequently have a taxable year ending one month after its parent's taxable year ends. This difference in taxable years allows an additional 11 months of deferral of income that is deemed distributed to the parent.

If a DISC fails to meet the qualifications for any reason, the DISC provisions provide for recapture of the DISC benefits received in previous years. Recapture of accumulated DISC earnings (because the DISC has become disqualified) is spread over a period equal to 2 years for each year that the DISC was in existence (up to a maximum of 10 years).

Source of income from export sales

The United States taxes U.S. taxpayers on their U.S. and foreign source income, but allows a foreign tax credit for foreign taxes on foreign source income. The foreign tax credit limitation reflects the principle that the credit cannot exceed U.S. tax on foreign source income. In general, in calculating the limitation, most foreign source income is grouped together in a general category known as the "all other" category; a separate limitation or "basket" applies to certain income from deemed DISC distributions (and, separately, to certain interest). In most cases, an export sale will not attract foreign tax so long as the U.S. seller does not maintain a fixed place of business or perform substantial activities in the country of destination. The separate limitation is designed to prevent taxpayers from reducing U.S. tax on low or untaxed distributions from DISCs by crediting foreign taxes on non-DISC income against the U.S. tax on distributions from DISCs.

Cooperatives

A cooperative is allowed to be a shareholder of a DISC. However, farmers who are members of cooperatives do not generally benefit directly or indirectly from DISC deferral. The farmers do not benefit directly because if the deferred income is distributed to the cooperative, it must be distributed currently (and taxed) to the farmer. Also, the cooperative does not benefit from the deferral because a cooperative must distribute its income to its members and patrons to benefit, under the rules for cooperatives, from the exemption from tax. Thus, deferred DISC income (or other pre-tax income) is generally not available to satisfy the particular working capital requirements of the cooperative.

Export Trade Corporations

Export trade corporations (ETCs) are controlled foreign corporations that are allowed to defer a portion of their income from exporting. In 1971, the ETC provisions were replaced by DISC. Only those ETCs in existence at that time are allowed to continue operating as ETCs.

If an ETC fails to meet the requirements to continue operating as an ETC, the previously untaxed income will continue to be deferred provided the income is invested in export assets.

House bill

No provision.

Senate amendment

In general

The Senate amendment exempts from tax a portion of the export income of a Foreign Sales Corporation (FSC) if certain foreign presence and economic process tests are met. Generally, 17 percent of export income will be exempt from tax if the optional administrative pricing rules are used to allocate income to the FSC, or 34 percent of FSC income if FSC income is based on arm's-length (sec. 482) transfer pricing rules. Exemption is provided for export profits but not for export investment income.

A FSC will generally be a foreign subsidiary (a corporation organized outside the U.S. customs area) that meets certain foreign presence tests.

Exempt income

Exemption from tax is provided on a portion of the income from (1) sale or lease of export property for use outside the United States, (2) services related or subsidiary to the sale or lease of export property, (3) certain engineering and architectural services, and (4) export management services, including services provided to unrelated FSCs or DISCs, even if the FSC providing the services is not itself engaged in exporting.

The Senate amendment does not provide exemption from tax on investment income and carrying charges. Investment income includes dividends, interest, royalties, rents, and certain other passive income. Carrying charges include any amounts in excess of the price for an immediate cash sale and any other unstated interest.

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

Export property

FSC benefits are provided for property manufactured, produced, grown, or extracted in the United States. Unlike DISC, FSC benefits are allowed for coal and uranium products and other depletable products (other than oil and gas). FSC benefits are not allowed for property leased by a FSC for use by any member of a controlled group of which the FSC is a member, patents or other intangibles, subsidized property, property in short supply, and oil and gas products. The exemption on the sale of military goods is half the amount otherwise allowed (same as DISC).

Transfer pricing

FSC exemption is available for income allocated to it under special transfer pricing rules. Transfer prices are based on either optional administrative rules or arms length pricing under section 482. Under the administrative pricing rules, transfer prices are based on either 23 percent of the combined taxable income of the FSC and its related supplier, or 1.83 percent of gross receipts derived from the transaction.

The administrative pricing rules may be used only if the FSC (or its agent) perform all the activities of the economic processes test.

Amount of benefit

Generally, the Senate amendment provides an exemption of tax on 17 percent of export profits with no exemption on nonexport profits or passive income. The amount of the FSC benefit depends, however, on the method used to determine transfer prices. If transfer prices are based on 23 percent of combined taxable income, the exemption is 17 percent of combined taxable income (17/23 of FSC income). If transfer prices are based on 1.83 percent of gross receipts, the exemption is 1.35 percent of gross receipts (17/23 of FSC income). If transfer prices are based on the arm's length pricing rules (sec. 482), exemption is limited to 34 percent of FSC income.

A FSC's nonexempt export income (generally 6 percent of FSC income) will be subject to U.S. tax unless it is determined without reference to an administrative pricing rule, in which case it will be taxed in the same manner and to the same extent as income earned by a foreign corporation that is not a FSC. Interest, dividends, royalties, other investment income and carrying charges will be subject to U.S. tax.

A FSC will not be allowed an investment tax credit or certain other credits. A foreign tax credit will not be allowed with respect to foreign taxes on export income (other than nonexempt export income determined without reference to an administrative pricing rule), but will be allowed with respect to other foreign taxes.

Qualifications

To qualify as a FSC, the corporation must meet the following requirements: (1) a FSC must be organized outside the U.S. customs area. If a FSC is organized in a foreign country, that country must be either a party to an exchange of information agreement with the United States, or an income tax treaty partner if the Treasury certifies that the exchange of information program under the treaty is satisfactory; (2) a FSC may have no more than 25 shareholders; (3) a FSC may not have preferred stock; (4) a FSC must maintain an office outside U.S. customs territory and maintain a set of the permanent books of account at that office; (5) a FSC must have at least one director who is not a U.S. resident; (6) a FSC may not be a member of a controlled group of which a DISC is a member; (7) a FSC must elect to be a FSC; and (8) the taxable year of a DISC or FSC must conform to the taxable year of the majority shareholder.

A FSC that elects to be a small FSC must also satisfy all these requirements.

Foreign presence and economic processes

FSC benefits are provided only if (1) the management of the corporation takes place outside the United States and (2) if the economic processes with respect to each transaction take place outside the United States.

The management of the corporation is treated as outside the United States if all meetings of the board of directors and shareholders are outside the United States, the principal bank account is outside the United States, and all dividends and certain expenses are paid out of this bank account.

Economic processes are treated as outside the United States if (1) the FSC (or its agent) participates outside the United States in the solicitation, negotiation, or making of the contract, and (2) if the foreign direct costs of the transaction incurred by the FSC equal or exceed 50 percent of the total direct costs (or 85 percent of direct costs of 2 activities). For purposes of this test, the costs of 5 activities are considered: advertising or sales promotion, processing customer orders and arranging for delivery, transportation, determination and transmittal of a final invoice or statement of account and the receipt of payment, and assumption of credit risk.

Burden of proof

The burden of proof that the foreign presence and economic processes tests are satisfied will be shifted to the Secretary of the Treasury if an officer of the corporation signs an affidavit stating that the requirements have been met (and how they have been met). The officer must be a citizen and resident of the United States, and the statement must be made under penalty of perjury.

Distributions to shareholders

A FSC will not be required or deemed to make distributions to its shareholders. Actual distributions to shareholders must be made first out of export income; the FSC may have income that is not export income, for example, investment income. Distributions will be treated as being made first out of earnings and profits attributable to export income, and then out of any other earnings and profits. Any distribution made by a FSC which is made out of earnings and profits attributable to export income to a shareholder which is a foreign corporation or a nonresident alien individual will be treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States, and as U.S. source income. Thus, such distributions will be subject to Federal income tax.

Export income and investment income of a FSC will not be subject to the rules of subpart F. In addition, the Secretary of the Treasury is authorized to exclude property related to the export activities of the FSC from the subpart F rules relating to investments by controlled foreign corporations in U.S. property.

Dividends received from a FSC

A domestic corporation will generally be allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to export income. However, a 100 percent dividends-received deduction will not be allowed for nonexempt export income determined without reference to an administrative pricing rule (sec. 923(a)(2) nonexempt income) or a dividend received by a cooperative with respect to export income that is treated as exempt income.

Source of income from export sales

Income (other than nonexempt export income determined without reference to an administrative pricing rule) will be taken into account under a separate limitation for purposes of determining the foreign tax credit limitation of a FSC.

Foreign taxes on FSC dividends paid to the FSC's shareholders that are attributable to export income (other than nonexempt export income determined without reference to an administrative pricing rule) will be treated as noncreditable foreign taxes. In addition, such dividend income will be taken into account for purposes of the foreign tax credit limitation under a separate limitation.

The bill provides a special rule governing the source of income earned by a person related (within the meaning of sec. 482) to a FSC from transactions giving rise to export gross receipts of a FSC. That related person's foreign source income from such a transaction may not exceed the amount which would be treated as foreign source income earned by that person if the analogous DISC pricing rule applied.

Small business

Small FSC.—FSC benefits are available for the export income (up to $5 million of export gross receipts) of a corporation that elects to be a small FSC. A small FSC must be a foreign corporation that meets the requirements to be a FSC. However, a small FSC is not required to satisfy the foreign presence and economic process tests. A FSC may not elect to be a small FSC if it is a member of a controlled group that includes a FSC (unless the other FSC also elects to be a small FSC).

Small DISC.—A small DISC may continue to defer income attributable to $10 million or less of export gross receipts. The incremental rules would not apply. An interest charge that is tied to the T-bill rate is imposed on the amount of tax deferred.

Deferred DISC income

Under the Senate amendment, tax is forgiven on accumulated DISC income. This forgiveness will apply only to actual distributions made after December 31, 1984, by a DISC (or former DISC) that is a qualified DISC on December 31, 1984.

Export Trade Corporations (ETC's)

Tax is forgiven on the previously untaxed income of an export trade corporation if the company elects to discontinue operating as an ETC. Tax is not forgiven on the previously untaxed income of an ETC that does not qualify as an ETC on December 31, 1984, even though the income is invested in qualified assets.

Cooperatives

The Senate amendment provides indirect benefits to farmers who are members of cooperatives that export agricultural products. Farmers will not be taxed on exempt income until it is actually distributed. Thus, the cooperative may use the exempt income as working capital. (Normally, a cooperative must use income that has been taxed (at the farmer level), but not distributed, as working capital). Farmers will be taxed currently, however, on the non-exempt income (generally 6 percent of FSC income).

Special rules

A FSC may not claim benefits under an income tax treaty between the United States and a foreign country. No tax may be imposed on foreign trade income by a possession of the United States.

Transition rules

The taxable year of any DISC which includes January 1, 1985, will close on December 31, 1984, at which time there will be a deemed distribution of DISC income that normally would be deemed distributed at the end of the DISC's taxable year. Thus, shareholders may be including in income almost 2 years of DISC earnings in the current year. These distributions will be spread over 4 years. Special transition rules are provided for taxpayers with long-term contracts. Assets of a DISC (or ETC) generally may be transferred tax-free to a FSC.

Effective date

The provisions generally apply to transactions after December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment, with modifications. The conferees agreed to reduce the percentage of export income which will be exempt from tax and to clarify (in connection with the factoring provision) that income of a controlled foreign corporation from loans to finance the purchase of its related party's goods is Subpart F income subject to the separate foreign tax credit limitation for interest.

The conference agreement does not contain the Senate amendment's provision expanding the benefits for managerial services beyond those available under DISC. Thus, the agreement requires that a FSC or DISC have at least 50 percent of its income from exporting before income from managerial services provided to an unrelated party will be accorded beneficial treatment.

The exemption for the combined taxable income method under the conference agreement is 16 percent of combined taxable income. The exemption for the gross receipts method is 16/23ds of 1.83 percent, or approximately 1.27 percent of gross receipts (not to exceed 32 percent of FSC income). The limit on the exemption using sec. 482 rules is 32 percent of FSC income. The provision of the conference agreement that decreases the benefits for certain corporate preference items reduces the exemption by an additional 1/17th for corporate shareholders.

The conference agreement adopts the Senate amendment's special rules for small businesses which allow exporting companies with relatively small export gross receipts to elect to be a small DISC with an interest charge or a small FSC. The conferees wish to express concern that without a special effort by the Administration many small businesses which wish to export property will avoid making an election to become a FSC or a small DISC because they fear that such an election will lead to undue complexity and a large administrative burden. Consequently, the conferees hope that small business will be given special encouragement and assistance by the Commerce Department in establishing and operating small FSCs and small DISCs.

The agreement requires tax records (including invoices) to be kept in an office in a country which is either a party to an exchange of information agreement with the United States or an income tax treaty partner, which the Treasury certifies as having an acceptable exchange of information program under the treaty. The conferees intend that a foreign country, to qualify for this treatment, not be a country that has a statute (or other stated policy) which denies the IRS access to the home office of the FSC for audit purposes. Therefore, the conferees intend that the Treasury assure itself of access to the home office of a FSC before certifying a treaty partner or before entering into an exchange of information agreement.

The agreement requires any DISC established after Senate committee action to conform its taxable year to that of its majority shareholder.

The agreement deletes the rule of the Senate amendment that shifts the burden of proof to the IRS on certain issues upon a taxpayer affidavit. The conference agreement does not include the Senate provision shifting the burden of proof to the IRS in connection with enforcement of the foreign presence requirements. The conferees agree with the Senate's rationale for this provision which is to avoid uncertain application of the detailed and technical foreign presence rules thereby reducing administrative burdens on both the IRS and taxpayers. Nevertheless, the conferees believe that the Senate provision created an undesirable precedent. The conferees, however, intend for the IRS to administer the foreign presence provisions of FSC in a manner which facilitate the establishment of FSC and carry out the objectives of the statute.

The agreement modifies the rule governing benefits for sales of military property and services related to such sales to conform to the DISC rule and allow such income one-half of the benefits otherwise allowable.

The conferees agreed to ask the Treasury Department for a study on services. Neither the present DISC provisions nor the FSC benefits allowed under the conference agreement give special tax benefits for the export of services performed in the United States. The conferees think that this policy should be reviewed so that an informed decision can be made regarding the appropriate treatment of income from the export of services in the future. In particular, the conferees expect the study to consider the revenue impact of FSC benfits for services. The conferees direct the Secretary of the Treasury, in consultation with the office of the United States Trade Representative, to undertake a study of the advisability of providing the benefits allowed under the FSC election for profits from services performed in the United States and sold outside the United States. The Treasury Department is to report on the results of this study to the Senate Committee on Finance and the House Committee Ways and Means no later than six months after enactment.

The conference deletes the present law requirement for DISC reports after 1984 and substitutes a requirement for FSC reports.

The conference agreement will allow U.S. territories to impose tax on income of FSCs that arises after January 1, 1987, and includes a technical correction that would prevent FSCs established in the U.S. Virgin Islands from arguably escaping all tax on nonexempt income. The agreement makes it clear that the so-called "mirror Code" tax rules in place in certain U.S. possessions will not apply for purposes of denying the United States taxing jurisdiction under the FSC legislation.

The agreement contains a technical amendment that insures that the provision forgiving the tax on accumulated DISC income will not allow forgiveness of tax on accumulated DISC income that was subject to tax because of a revocation or disqualification prior to requalification and prior to the earning of income that is eligible for forgiveness.

The agreement contains a technical amendment conforming the treatment of second-tier Export Trade Corporations for purposes of the transition rule to that of first-tier Export Trade Corporations.

In view of the rule that a FSC cannot be a member of a controlled group of corporations of which a DISC is a member, the agreement contains a provision that, under regulations to be prescribed by the Secretary, a FSC election will automatically terminate an inconsistent DISC election.

The agreement treats deemed distributions for taxable years of DISCs that begin in 1984 as occurring over 10 years rather than over four years as contemplated in the Senate amendment. The conferees expect that regulations will allow taxpayers to accelerate this inclusion if taxpayers elect to do so.

The provision that clarifies present law to make it clear that a resident of a treaty partner country cannot avoid tax (under sec. 996(g)) on DISC distributions is effective on June 22, 1984.

The provision allows regulatory authority to extend rules allowing waiver of foreign presence requirements in the case of certain contracts entered into before January 1, 1985.

J. Compliance Provisions

1. Provisions relating to tax shelters

a. Registration of tax shelters

Present law

There is no requirement that tax shelters register with the Internal Revenue Service. As a result, the Internal Revenue Service lacks complete and systematic information on which to base its decisions about which shelters should be audited.

House bill

No provision.

Senate amendment

The Senate amendment provides that anyone who organizes a tax shelter must register the shelter with the Internal Revenue Service by supplying information that briefly describes the investment and identifies the promoter. A tax shelter is defined as any investment with respect to which representations are made that the investment will result in deductions in excess of income, or credits in excess of half the income attributable to the investment, in any of the first 5 years. The shelter also must either be required to register with a Federal or State agency or be offered to "sophisticated investors" (i.e., when the aggregate amount invested exceeds $200,000 and there are 10 or more investors). The Secretary can prescribe regulations to provide exemptions from the registration requirement. The registration form must be filed with the Internal Revenue Service by the earlier of 15 days after the shelter is first offered for sale or December 31 of the year it is first offered for sale.

Once the tax shelter registration form is filed with the Internal Revenue Service, the Internal Revenue Service will provide a tax shelter identification number to the promoter. The promoter must furnish the number to each investor, and the investor must furnish the number on its tax return.

The penalty for failure to register is $500 plus 1 percent of the amount invested that exceeds $1 million. The penalty for each failure by the promoter to furnish the number to investors is $100. The penalty for each failure by the investor to furnish the number on its tax return is $50, unless the failure is due to reasonable cause.

The provision is generally effective on September 1, 1984, with respect to interests sold on or after that date. The Secretary may postpone the date these provisions take effect by regulations.

Conference agreement

The conference agreement follows the Senate amendment with modifications. Under the agreement, anyone who organizes a tax shelter must register the shelter by

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completing a registration form prescribed by the Internal Revenue Service, on which information that briefly describes the investment and identifies the promoter must be supplied. A tax shelter is considered registered when the registration form is mailed to or otherwise filed with the Internal Revenue Service in the manner required. This must be done not later than the day on which the first offering for sale of interests in the tax shelter occurs.

A tax shelter is required to be registered by the person having principal responsibility for organizing the tax shelter. In many cases, the tax shelter organizer will be the tax shelter promoter. The tax shelter organizer need not, however, be the promoter or general partner. For example, if a person structures or develops a series of related schemes from which he or a related party will benefit through service contracts or asset purchases, that person will be treated as the tax shelter organizer, even though each of the different arrangements is managed or promoted by a different individual.

If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. Such a person who is secondarily liable for registering the shelter must do so not later than the day on which the first offering for sale of any interest in the shelter is made. Requiring registration before this date will enable State securities regulators to prohibit offerings of unregistered shelters in their States. In the event that persons who are principally and secondarily liable for registering a shelter fail to do so, any person participating in the management or sale of the investment must register the shelter. Registration by the manager or seller does not relieve the organizer or promoter of liability for the penalties for failure to register.

Ordinarily, the rendition of professional advice by an unrelated attorney or accountant would not constitute the organization of a tax shelter. However, if, for example, the attorney's or accountant's fee is based, either in part or in whole, upon the number or value of units sold, the Internal Revenue Service might reasonably conclude that the attorney or accountant is an organizer, promoter, or seller of a tax shelter, since he participates in the entrepreneurial risk borne by other promoters.

A tax shelter is defined as any investment (including service contracts and leasing contracts) with respect to which a person could reasonably infer from the representations made or to be made in connection with any offer for sale of any interest that, as of the close of any of the first 5 years, the ratio with respect to any investor of (A) the aggregate of deductions and 200 percent of the credits potentially allowable to (B) the aggregate of the cash invested and the adjusted basis of other property contributed by the investor (reduced by any liability to which that property is subject) is greater than 2 to 1. For purposes of computing this ratio, amounts borrowed from a participant in the organization, sale, or management of the shelter or a related person to a participant are not considered to be cash invested. The Secretary is given authority to prescribe regulations that include or exclude amounts in the aggregate of cash invested and the adjusted basis of contributed property. In addition, for registration to be required, a tax shelter must be (1) required to register under a Federal or State law regulating the offering or sale of securities, (2) offered for sale pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating securities, or (3) a substantial investment.

An investment is a substantial investment if the aggregate nominal amount that may be offered for sale to all investors exceeds $250,000 and 5 or more investors are expected. The aggregate nominal amount offered for sale includes all cash, all contributions of property, and all loans, whether recourse or nonrecourse. The aggregate nominal amount offered for sale is not the same as the investment amount used to compute the tax shelter ratio.

For purposes of this definition, similar investments organized by the same person are aggregated. For example, assume a sponsor of tax shelters develops generally similar investment plans or arrangements involving 8 different partnerships, each investing in a different item (such as a separate master recording or film), each with a different general partner, and each with 3 limited partners. If each partner invests $1,000 cash and $10,000 in nonrecourse obligations, there will be 32 investors (1 general partner plus 3 limited partners times 8 partnerships) and an aggregate investment of $352,000 (32 partners times $11,000). Thus, each partnership will constitute part of a substantial investment. If, in this example, representations are made that $1,000 in tax credits and $3,000 in deductions are available to each limited partner in the first year, the sponsor will be required to register all of the partnerships.

The Secretary is given authority to issue regulations to provide exemptions from registration. The conferees intend that this authority be exercised to exclude only transactions with respect to which registration would not be useful to the Internal Revenue Service. The Secretary is also given authority to provide necessary and appropriate rules to carry out the purposes of this provision with respect to foreign tax shelters.

The conferees emphasize that none of the terms used in this new provision is intended necessarily to be limited to the meaning ascribed to it under Federal or State laws regulating securities. For example, the term "offered" as used in this provision refers to any representation, whether oral or written, relating to the tax shelter; it includes any advertisement relating to the tax shelter. An act may constitute an offer for sale under this provision which does not constitute an offer under Federal or State securities laws. Similarly, the term "filing of a notice" refers to any provision of a document to any Federal or State agency regulating securities in connection with offerings or sales of investments even if provision of the document is not required by the agency.

The conferees anticipate that the Internal Revenue Service will provide for registration using a form which will require that information such as the following be provided: identifying information relating to the tax shelter and the organizer, the type of business organization of the shelter and its accounting method, information concerning the business activities and principal asset of the shelter, the form and source of financing, information regarding Federal or State securities registration, the tax shelter ratio, the number and cost of investment units available, the acquisition cost per unit, and the date the first unit may be offered for sale. The conferees anticipate that the Secretary will require this form to be filed in machine-readable format under his present law authority to require that returns be filed on magnetic media or in another machine-readable format. The conferees believe that registration will become a routine task during the organization of tax shelters.

The conference agreement also provides that the Secretary may require that, when a promoter discloses to potential investors the fact of registration with the Internal Revenue Service, the promoter and seller must also indicate that this registration does not imply approval of the investment or of the claimed tax benefits by the Internal Revenue Service.

Any person who claims any deduction, credit, or other tax benefit by reason of a tax shelter that is required to register must include the tax shelter identification number on the return claiming the benefit in the manner the Secretary requires. This could be done, for example, by requiring that the number be included next to the location on the return where the benefit was claimed, or by requiring that it be included on a separate form to be attached to the return. It can also be required to be attached to an application for a tentative refund ("quickie refund").

The penalty for failure to register is the greater of $500 or 1 percent of the aggregate amount invested in the shelter, up to a maximum of $10,000 with respect to any one shelter. The maximum does not apply in cases of intentional disregard of the registration requirement. No penalty is imposed if the failure to register is due to reasonable cause. Reasonable cause for failure to register not later than the day on which the first offering for sale of interests in the shelter occurs would generally exist with respect to a person who participates in the sale of an investment and who is required to register the investment under new section 6111(d)(1)(C) if this person registered the shelter as soon as practicable after discovering that the investment had not been registered under new section 6111(d)(1)(A) or (B). Persons (such as promoters) required to furnish an identification number and who fail to do so are subject to a penalty of $100. The penalty for each failure by the investor to furnish the number on its tax return is $50, unless the failure is due to reasonable cause.

Registration is required for any tax shelter with respect to which any interest is first sold to an investor on or after September 1, 1984. Only the aggregate of interests which may be offered for sale on or after September 1, 1984, must be considered in determining whether a substantial investment would be required to register. This will occur when there are expected to be 5 or more investors on or after September 1, 1984, and the aggregate amount which may be offered for sale on or after September 1, 1984, exceeds $250,000. If a shelter is required to be registered, the tax shelter identification number must be furnished to all investors, regardless of whether they invested before, on, or after September 1, 1984. With respect to interests sold before September 1, 1984, however, the number must be furnished by December 31, 1984. The Secretary would not have authority to postpone the effective date.

b. Promoter lists

Present law

There is no specific requirement that promoters and sellers of tax shelters maintain lists of investors that are available for inspection by the Internal Revenue Service. Thus, when the Internal Revenue Service identifies an abusive tax shelter, it may be able to identify taxpayers who invested in the shelter only through enforcement of summonses or not at all.

House bill

The House bill provides that anyone who organizes or sells an interest in a tax shelter must keep a list, in the manner and to the

extent provided in regulations, of each person who was sold an interest in the shelter. A tax shelter is defined as any plan or arrangement that the Secretary determines (by regulations) has the potential for tax avoidance or evasion. The organizer or seller of the shelter is subject to a penalty of $50 for each failure to include a person on a list, up to a maximum of $50,000 in any calendar year. The provision is effective on the date of enactment.

Senate amendment

The Senate amendment provides that tax shelter promoters must maintain lists of investors in each separate promotion. Exceptions are provided from the listing requirement for promotions of partnerships or S corporations. Also, the Secretary is to provide regulations to eliminate duplicative lists. A tax shelter is defined as any plan or arrangement with respect to which representations of tax benefits are made. The penalty provision is the same as that of the House bill. The provision is effective with respect to sales and organizations occurring after December 31, 1984.

Conference agreement

The conference agreement contains a modified form of the House bill and the Senate amendment. Thus, any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter must maintain lists of purchasers. The list will include the name, address, and taxpayer identification number of the purchaser, as well as any other information that the Secretary may, by regulations, require.

In particular, the conference agreement requires that any promoter or seller of a tax shelter for which registration is required must maintain lists of the persons purchasing an interest in the tax shelter and must make these lists available to the Internal Revenue Service when requested. The agreement also permits the Secretary to require (by regulations) that organizers and sellers of other tax shelter arrangements that have a tax avoidance potential maintain customer lists, regardless of whether the Secretary also extends the registration requirement. In designating these other arrangements, the Secretary may, for example, specifically identify types of investments, or he may provide that any investment falling within a modified form of the definition of tax shelter for registration purposes is subject to the listing requirement. The Secretary may exercise this authority by requiring, for example, that any plan or arrangement that would be subject to tax shelter registration if the tax shelter ratio were 1 to 1 rather than 2 to 1 must maintain lists of investors.

If a potentially abusive tax shelter is sold in a series of transactions, a list of customers must be maintained at each level in the series. For example, if a tax shelter organizer develops several types of tax shelters which he sells to several promoters, the organizer must maintain lists identifying the promoters. When the promoters sell the tax shelters to investors, the promoters must similarly maintain lists identifying the investors. If an investor sells his interest to another investor, the selling investor must maintain information identifying the purchasing investor. The Secretary may provide that the selling investor may obtain less identifying information than would otherwise be required on the buying investor or may maintain that information for a shorter period of time than 7 years, so long as those rules also prevent abuse by taxpayers attempting to avoid the purpose of this provision, which is to facilitate clear identification of all purchasers of potentially abusive tax shelters.

The provision is effective with respect to any interest sold for the first time to an investor on or after September 1, 1984. Thus, if an investor sells an interest he bought before September 1, 1984, to another investor on or after September 1, 1984, the seller is not required to maintain lists. If a promoter sells some interests to investors before September 1, 1984, and other interests on or after that date, the promoter must maintain lists of all sales occurring on or after September 1, 1984. The sale of an entity by an organizer to another organizer or promoter is not considered to be a first sale. Thus, if an organizer sells an entity before September 1, 1984, to another organizer or promoter ("the buyer"), and the buyer sells interests in the entity on or after September 1, 1984, the buyer must maintain lists of customers.

No inference should be drawn from the conference action that there is any restriction placed on the authority of the Secretary under present law to require that books and records be kept, to prescribe the form in which those books and records must be kept, or to obtain customer lists through use of administrative summonses.

c. Increase in penalty for promoting abusive tax shelters

Present law

A promoter who, in connection with the organization or sale of a tax shelter, makes false or fraudulent statements or gross valuation overstatements is liable for a penalty of the greater of $1,000 or 10 percent of the income derived or to be derived from the organization or sale.

House bill

The House bill increases the penalty from 10 percent to 20 percent of the income derived or to be derived from the organization or sale. The increase is effective on the date of enactment.

Senate amendment

The Senate amendment increases the penalty to the greater of $2,000 or 20 percent of the income derived or to be derived from the activity. It also provides that making or furnishing a statement or a gross valuation overstatement incidental to the activities or operation of an abusive tax shelter is subject to this penalty. This change will make these activities subject to injunction under section 7408. These changes are effective for actions occurring after the date of enactment.

Conference agreement

The conference agreement follows the House bill with respect to the increase in the penalty from 10 to 20 percent. With respect to statements incidental to the operation of an abusive tax shelter, the conference agreement provides that activities subject to the penalty for aiding the understatement of tax liability under section 6701 will be subject to injunction under section 7408. The conferees believe that this more directly accomplishes the intention of the Senate amendment without limiting injunctive relief solely to promoter activities. Injunctive relief can be granted with respect to activities subject to penalty under either section 6700 or section 6701, or both, as appropriate. Both amendments take effect on the day after the date of enactment.

No inference should be drawn that the general injunctive power of the district courts under section 7402(a) is, in any way, limited by the action to enjoin promoters of abusive tax shelters (sec. 7408) or the action to enjoin income tax return preparers (sec. 7407). This is in accordance with *U.S. v. Landsberger*, 692 F.2d 501 (8th Cir., 1982).

d. Increased rate of interest for tax shelter cases

Present law

Interest must be paid by the taxpayer on underpayments of tax and by the United States on overpayments of tax at the statutory rate (generally, the prime rate, compounded daily). There is no different interest rate for tax shelter cases.

House bill

No provision.

Senate amendment

In the case of tax shelter items, the rate of interest paid to taxpayers on refunds or due the IRS on underpayments is 150 percent of the statutory rate (generally, the prime rate, compounded daily). This rule applies to items arising from any plan or arrangement the principal purpose of which is the avoidance or evasion of tax in which more than 34 persons participate. The provision is effective for interest accruing after December 31, 1984.

Conference agreement

The conference agreement contains a modified form of the Senate amendment, which increases the interest rate on tax shelter underpayments to 120 percent of the otherwise applicable rate and modifies the definition of tax shelter in the Senate amendment.

The increased interest rate applies to an underpayment of tax attributable to one or more tax, motivated transactions, if the amount of the underpayment exceeds $1,000. A tax motivated transaction is (1) any valuation overstatement of 150 percent or more, (2) any activity with respect to which a loss or an investment tax credit is disallowed by reason of the at-risk rules, (3) any tax straddle, or (4) any use of any accounting method specified in regulations as potentially resulting in a substantial distortion of income. The conferees anticipate that the following deductions and other claimed tax benefits might be considered by the Secretary to arise from accounting methods that may result in a substantial distortion of income:

(1) Deductions disallowed under section 464, relating to farming syndicates;

(2) In the case of a cash method taxpayer, interest deductions disallowed under section 461(g), relating to prepaid interest;

(3) Interest deductions disallowed because they exceed the effective rate of interest, such as under the rule of 78's;

(4) Improper deductions for syndication expenditures;

(5) Deductions disallowed under section 267(a)(2), relating to transactions between related taxpayers with different accounting methods;

(6) Failure to take into account deferred rental payments in accordance with the principles section 467, as added by this Act; and

(7) Deductions disallowed under the principles of section 461(i), as added by this Act, relating to prepayments of expenses by tax shelters.

In addition, the Secretary is given regulatory authority to specify other types of transactions that will be treated as tax motivated. He shall take into account the ratio of tax benefits to cash invested, the method of promoting this type of transaction, as well as other factors he considers relevant.

The provision is effective with respect to interest accruing after December 31, 1984, regardless of the date the return was filed.

The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assess-

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able for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256). Additionally, the conference agreement did not follow the provision of the House bill permitting certified public accountants and enrolled agents to represent a taxpayer in a small tax case because the Tax Court stated that permitting this would jeopardize the integrity of the small tax case process, which is working well.

The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. The positive response that the Court has made to several recent GAO recommendations is encouraging and the conferees expect the Court to implement swiftly these and other appropriate management initiatives. The conferees also note favorably the steps the Court has begun to take in consolidating similar tax shelter cases and dispensing with lengthy opinions in routine tax protester cases. The Court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided.

The Internal Revenue Service also has significant responsibilities in reducing the Tax Court backlog. The Service's settlement policy should be fair and flexible, and only appropriate cases should be litigated. Although in the recent past the Service has offered to settle many tax shelter cases by permitting taxpayers to deduct out of pocket expenses, the Service no longer routinely offers this as a settlement. This is a constructive change in policy, in that a taxpayer should not expect to be able to deduct out of pocket expenses regardless of the circumstances of his case. The Service should assert, without hesitancy in appropriate circumstances, the penalties that the Congress has provided. In particular, the negligence and fraud penalties are not currently being applied in a large number of cases where their application is fully justified. The conferees note with approval the steps the Service has recently taken to eliminate the backlog in the Appeals Division.

2. Information reporting provisions

a. Returns relating to mortgage interest received in a trade or business

Present law

There is no requirement that recipients of mortgage interest report interest received to the Internal Revenue Service.

House bill

A person who, in the course of his trade or business, or a governmental agency that receives interest on obligations secured by real property must report to the Internal Revenue Service payments from a payor aggregating $600 or more and provide a copy of that report to the payor. Present law penalties for other failures to file information returns and furnish statements apply (generally, $50 per failure except in cases of intentional disregard). The provision is effective with respect to amounts received after December 31, 1984, except that no penalty is imposed on persons reporting for failure to furnish identification numbers with respect to an obligation in existence on December 31, 1984, for amounts received before January 1, 1986.

Senate amendment

The Senate amendment generally is the same as the House bill, except that the reporting threshold is $2,300 and the provision is effective with respect to amounts received after December 31, 1984, and except for technical differences.

Conference agreement

The conference agreement follows the House bill, with modifications. Thus, recipients of $600 or more of mortgage interest with respect to any obligation secured by real property will be required to report that interest to the Internal Revenue Service. The conferees choose the lower reporting threshold of the House bill because more complete reporting reduces the likelihood that the Internal Revenue Service will have to contact a taxpayer concerning claimed deductions.

At the same time, the agreement seeks to eliminate any unnecessary burden to interest recipients. The agreement provides that reporting is required only on payments received from an individual. Under the agreement, the $600 aggregate annual reporting threshold will apply on an obligation by obligation basis. Interest received on two different obligations secured by the same real property does not have to be aggregated into one report; thus, interest on each obligation may be reported separately. The agreement also provides that the Secretary may provide exceptions from this reporting requirement where such exceptions are consistent with effective reporting of mortgage interest and the matching of these reports with a specific line on the tax return. Therefore, the Secretary may, if he considers it appropriate, provide for an exception from reporting for interest paid on credit cards that are secured by real property. This exception would be appropriate if the Secretary determines that such interest is most likely to show on returns as interest on credit cards rather than home mortgage interest. The conferees do not intend that the Secretary except from reporting interest that is reported on Schedule A as home mortgage interest. The agreement also provides the Secretary with authority to issue regulations to eliminate duplicative reports.

The conferees anticipate that recipients of mortgage interest will require the payor to furnish his taxpayer identification number as part of the mortgage loan approval or closing process for mortgage loans entered into after December 31, 1984.

With respect to mortgage loans in existence on December 31, 1984, the conferees anticipate that the Secretary will require recipients of mortgage interest to request, at least once a year, from each payor the payor's taxpayer identification number, unless the recipient already has the payor's number in its accounting system. The conferees anticipate that the Secretary will permit these requests for a payor's taxpayer identification number to be included in the recipient's regular mailings of either payment coupon booklets or annual statements to the payor. Recipients will not be required to make separate mailings of these requests, unless the recipient does not otherwise contact the payor at least once each calendar year. The conferees anticipate that the first request will be made as soon as practicable, but in no event later than with the first mailing by the recipient to the payor in 1985. The conferees also anticipate that recipients will notify payors that the Internal Revenue Service requires the payor to furnish its taxpayer identification number in order to verify the payor's deduction for mortgage interest and that the payor is subject to a $50 penalty by the Internal Revenue Service if the payor fails to furnish its taxpayer identification number. If the interest recipient makes the annual requests described above, and properly and promptly processes the responses, it will not be subject to any penalty for failure to include a TIN on its information return to the Internal Revenue Service because the payor's failure to supply the requested number will constitute reasonable cause for failure to supply the number to the Internal Revenue Service.

The conferees intend that the Secretary coordinate the requirement that a statement be furnished to the payor under this provision with other requirements, such as those of Federal mortgage programs, that similar statements be furnished, so that duplicative reporting is minimized.

b. Returns relating to cash received in a trade or business

Present law

Under the Bank Secrecy Act, certain banks and other financial institutions are required to report cash transactions of more than $10,000.

House bill

No provision.

Senate amendment

A person engaged in a trade or business who receives, in the course of the trade or business, $10,000 or more in cash or foreign currency in one or more related transactions must report it to the Internal Revenue Service and provide a statement to the payor. Amounts required to be reported under the Bank Secrecy Act are excepted from this reporting requirement. Present law penalties for other failures to file information returns and statements apply (generally, $50 per failure except in cases of intentional disregard). The provision is effective for amounts received after December 31, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment. Thus, reporting is required only for payments of more than $10,000 that are received by a person in the course of his trade or business. Reporting is not required on payments (a) that are received in a transaction reported under the Bank Secrecy Act if the Secretary determines that the report under this provision would duplicate the report under Bank Secrecy, or (b) that are received by certain specified financial institutions within the meaning of the Bank Secrecy Act.

With respect to these specified financial institutions, the conferees do not intend to affect the detailed reporting rules and exceptions which Treasury has developed. The other categories of financial institutions that are not specified as exempt from reporting under this provision have generally been exempted by Treasury from Bank Secrecy reporting. Examples of these other entities are certain dealers in precious metals, stones, or jewels, pawnbrokers, loan or finance companies, insurance companies, and travel agencies. These entities are required to report under this new provision. To the extent that Treasury also requires that they report transactions under Bank Secrecy, the Secretary can provide that duplicative reports that would be made on those transactions pursuant to this provision need not be made.

The conferees understand that the Treasury is considering extending certain Bank Secrecy Act reporting to casinos and other establishments. To avoid duplicative reporting requirements, the Secretary has discretion under the conference agreement and the Bank Secrecy Act to review the obligations imposed under the Bank Secrecy Act and to eliminate any reporting required under the conference agreement if the Bank Secrecy reporting, in substance, provides for the reporting of transactions required to be

reported under the conference agreement with respect to the information that must be provided to the Treasury.

Under this provision, any taxpayer required to report under this provision who is in a trade or business and who, in the course of the trade or business, receives more than $10,000 in cash in one or more related transactions must report those transactions. For example, assume that an individual purchases a $8,000 item and a $1,500 item at an auction. The auction house adds a 10% buyer's premium and the local sales tax, at a 5% rate. The taxpayer pays his $10,972.50 bill in cash. The auction house must report on that transaction. The auction house could not avoid the reporting requirement by presenting two separate bills of $9,240 and $1.732.50.

c. Provisions relating to individual retirement accounts

Present law

The trustee of an IRA is required to report to the IRS and to the owner of the IRA on contributions or withdrawals made. Each failure to provide a report on a contribution or withdrawal is subject to a $10 penalty. Contributions must be made by the due date (including extensions) of the return for the year to which the contributions relate.

House bill

The report must identify the years to which IRA contributions relate, effective for contributions made after April 15, 1984, relating to years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment.

Senate amendment

The report must identify the years to which IRA contributions relate effective for contributions made after 30 days after enactment for taxable years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment. Contributions must be made by the due date of the return (without extensions), effective for contributions made more than 30 days after the date of enactment, for taxable years beginning after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment, except that the provision is effective for contributions made after December 31, 1984. The conferees wish to clarify that the trustee may require that the owner of the IRA certify as to which year a contribution relates and that, except in unusual circumstances, the trustee may rely on that certification.

The date by which this report must be provided to the Internal Revenue Service and the periods to which the report relates are to be specified by the Secretary in regulations. The conferees intend that generally trustees will be required to report only once a year on the cumulative total of contributions relating to a particular taxable year. The Secretary may, however, provide for more frequent reporting if he determines that it is appropriate to do so. As to the date by which the report must be provided to the Internal Revenue Service, the Secretary could, for example, require reporting by the end of May on all IRA contributions relating to the taxable year with respect to which the individual's tax return was due on the preceding April 15.

d. Returns relating to foreclosures and abandonments of security

Present law

There is no specific requirement of reporting on foreclosures and abandonments of security.

House bill

Under the House bill, any person who, in connection with a trade or business, or any government agency that acquires in full or partial satisfaction of indebtedness any interest in property that is security for the indebtedness or has reason to know that the property that is security for the indebtedness is abandoned, must report the foreclosure or abandonment to the IRS and the payor. No reporting is required if the indebtedness is less than $15,000 or arises from consumer loans for personal property. Present law penalties for other failures to file information returns and statements apply (generally, $50 per failure except in cases of intentional disregard). The provision is effective for foreclosures and abandonments after December 31, 1984.

Senate amendment

The Senate amendment is generally the same as the House bill, except that there are no exceptions for consumer loans or loans of less than $15,000. Additionally, the Senate amendment requires that a taxpayer allowed a bad debt deduction or an addition to a reserve for bad debt must report the deduction or addition to the Internal Revenue Service and to the payor.

Conference agreement

The conference agreement follows the House bill, except that the exception from reporting for indebtedness of less than $15,000 is removed. The exception for consumer loans is retained.

e. Returns relating to exchanges of partnership interests

Present law

A sale or exchange of a partnership interest generally is treated as a sale or exchange of a capital asset. However, sales or exchanges of partnership interests involving unrealized receivables or appreciated inventory will result in ordinary income (to the extent of the receivables and inventory) to the transferor. There is no reporting required on exchanges of partnership interests.

House bill

The transferor partner must notify the partnership of the sale or exchange of a partnership interest involving unrealized receivables or appreciated inventory. Once the partnership has been so notified, it must report to the IRS, the transferor, and the transferee on the sale or exchange. Present law penalties for other failures to file information returns with the IRS and to furnish statements to taxpayers apply to failures by the transferor partner to report to the partnership and to failures by the partnership to report to the IRS, the transferor, and transferee. The provision is effective for exchanges after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

f. Statements required in the case of certain substitute payments

Present law

There is no reporting required on substitute payments if a broker lends securities of a customer held in street name in connection with a short sale. If in a short sale there is a payment of interest or dividends on the borrowed obligation, the borrower generally is required to make a payment to the lender of the obligation in lieu of the interest or dividends (a "substitute payment"). Absent reporting, the dividends received deduction or an interest exclusion may be claimed twice, even though only the purchaser in the short sale is entitled to the deduction or exclusion.

House bill

A broker is required to furnish a statement to the taxpayer if the broker lends securities for use in a short sale and the broker receives a dividend payment relating to the securities on behalf of the customer. The provision is effective for payments made after December 31, 1984.

Senate amendment

A broker is required to furnish a statement to the taxpayer if the broker lends securities for use in a short sale or similar transaction and the broker receives a dividend payment, tax-exempt interest, or other items that the Secretary prescribes by regulations, relating to the securities on behalf of the customer. The Secretary is given regulatory authority to require that a copy of the statement be furnished to the Secretary. The conferees expect the Secretary to exercise this authority for all types of payments with respect to which such a copy could be useful to the Secretary. The Secretary should also provide that no return regarding payments of dividends (sec. 6042(b)(1)(B)) need be made if it unnecessarily duplicates any return required to be made under this provision. This provision is effective for payments after December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

g. Reporting of State and local tax refunds

Present law

State and local governments must report to the IRS all tax refunds greater than $10. In addition, they must furnish a statement reporting the amount of the refund to the taxpayer in January of the year following the year of the refund.

House bill

The House bill codifies existing regulations by providing that no reporting to the Internal Revenue Service or the taxpayer is required if the taxpayer did not itemize deductions. Reports relating to itemizers must be furnished in January of the year following the year of the refund. The provision is effective for payments of refunds made after December 31, 1982.

Senate amendment

The Senate amendment provides that statements to taxpayers can be provided with the payment of the refund rather than in January of the year following the year of the refund and maintains the present law requirement of reporting to the Internal Revenue Service and the taxpayer of all tax refunds. It also provides penalties parallel to present law penalties for failures to furnish other statements to taxpayers (generally, $50 per failure except in cases of intentional disregard). The provision is effective for payments of refunds made after the date of enactment.

Conference agreement

The conference agreement follows the House bill, with a technical modification providing that no statement is required to be furnished to the taxpayer if the taxpayer did not itemize deductions. All refunds, whether made to itemizers or non-itemizers, however, still must be reported to the Inter-

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nal Revenue Service. The conferees anticipate that reporting to the Internal Revenue Service will not be burdensome on the States since most States have entered into exchange of information agreements that already provide that this information is to be furnished to the Internal Revenue Service. The conferees emphasize their belief that reporting by the State and local governments to the taxpayer in January is a significant compliance tool. The conferees anticipate that the Secretary would seriously consider terminating any exchange of returns or return information under section 6103 with a State that does not report refunds to the taxpayer.

The provision is effective with respect to payments of refunds, and credits and offsets made, after December 31, 1982. However, the conferees expect that no punative action will be taken against any State or local government or any officer or employee of a State or local government who failed to provide, before January 1, 1985, to taxpayers a statement required to be made under this provision.

h. Furnishing of TIN under backup withholding

Present law

Under the Interest and Dividend Tax Compliance Act of 1983, backup withholding applies unless a taxpayer's identification number is supplied "in the manner required."

House bill

No provision.

Senate amendment

The Senate amendment codifies existing regulations by providing that the Secretary's authority to require that a TIN be furnished under penalties of perjury is restricted to interest, dividends, patronage dividends, and amounts subject to broker reporting. The provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

3. Other compliance provisions

a. Modifications to charitable contribution rules and incorrect valuation penalties

Present law

Substantiation requirements

Present law provides expressly that a charitable contribution is deductible only if verified in the manner required by Treasury regulations (sec. 170(a)(1)). There are no specific statutory requirements that donors must obtain appraisals to verify the fair market value of donations of property, or that donees which resell donated property must furnish information reports to the IRS and the donor.

Overvaluation penalties

Present law imposes a graduated penalty for valuation overstatements on income tax returns (sec. 6659), including overvaluations of charitable donations, as follows—

(1) for claimed valuations of 150 percent or more, but not more than 200 percent, of the correct value, 10 percent of the tax liability understatement;

(2) for claimed valuations of 200 percent or more, but not more than 250 percent, of the correct value, 20 percent of the tax liability understatement; and

(3) for claimed valuations exceeding 250 percent of the correct value, 30 percent of the tax liability understatement.

The penalty does not apply if the tax liability underpayment is less than $1,000, or if the overvalued property had been held by the taxpayer for more than five years. (The penalty does apply in instances where a value is claimed for a charitable donation of property but in fact no property was actually contributed.) The IRS may waive the penalty for good faith valuations having a reasonable basis. The penalty does not apply to undervaluations for estate and gift tax purposes.

House bill

No provision.

Senate amendment

Substantiation requirements

Section 170 is amended to provide that individual (and certain corporate) donors must obtain an independent appraisal, and attach a summary of the appraisal to the return, where the claimed value of donated property exceeds $2,000 ($5,000 under an aggregation rule). The appraisal requirement does not apply for donations of securities for which market quotations are readily available on an established securities market.

For failure to comply with the appraisal requirements, the taxpayer's deduction is reduced under the Senate amendment by the greater of (i) the amount of appreciation or (ii) 10 percent of the deduction otherwise allowable. However, the IRS, in its discretion, could waive this disallowance if the taxpayer establishes that there was reasonable cause for failure to comply.

If the donee charity sells property for which an appraisal is required within two years after receipt, the donee must file an information report on such sale with the IRS and provide a copy to the donor.

These provisions are effective for contributions made after 1984.

Modifications to incorrect valuation penalty

The section 6659 penalty is modified by deleting the exception for property held for more than five years, and by extending the penalty to incorrect valuations for estate and gift tax purposes, effective for returns filed after 1984.

The penalty is extended to undervaluations for estate and gift tax purposes by providing that if the claimed value of any property is 66⅔ or less of the correct value, a graduated penalty applies as follows—

(1) For claimed valuations of 66⅔ or less, but not less than 50 percent, of the correct value, 10 percent of the tax liability understatement;

(2) For claimed valuations of less than 50 percent but not less than 40 percent of the correct value, 20 percent of the tax liability understatement;

(3) For claimed valuation of less than 40 percent of the correct value, 30 percent of the tax liability understatement. The penalty does not apply if the tax liability underpayment is less than $1,000. The IRS may waive the penalty for good faith valuations having a reasonable basis.

Disallowance rule for charitable deduction overvaluations

Under the Senate amendment, a sliding-scale charitable deduction disallowance rule applies (in addition to the overvaluation penalty) if the claimed value of donated property that is subject to the appraisal requirement exceeds the correct value by at least 50 percent, as follows—

(1) for claimed overvaluations of 150-175 percent of the correct value, one-half of the appreciation is disallowed;

(2) for claimed overvaluations of 175-200 percent of the correct value, all the appreciation is disallowed; and

(3) for claimed overvaluations exceeding 200 percent of the correct value, no deduction is allowed.

This provision applies to returns filed after 1984.

Conference agreement

Substantiation requirements

The conference agreement follows the Senate amendment, with the following modifications:

(1) In lieu of amending section 170 to set forth therein the substantiation requirements and to provide a special sanction for failure to comply, the conference agreement requires (by statutory provision outside the Code) that the Treasury Department must issue temporary or final regulations under section 170 before January 1, 1985 incorporating the substantiation requirements as set forth in this section of the conference agreement. Accordingly, pursuant to present law (sec. 170(a)(1)), which expressly allows a charitable deduction only if the contribution is verified in the manner specified by Treasury regulations, no deduction is allowed for a contribution of property for which an appraisal is required under the conference agreement unless the appraisal requirements are satisfied.

(2) The conference agreement increases the dollar threshold for the appraisal requirements from $2,000 to $5,000 for a single item of property ($10,000 in the case of stock), and deletes the aggregation rule in determining dollar thresholds except for similar items of property donated to one or more charities.

(3) The conference agreement limits applicability of the donee reporting requirement to dispositions of donated property where the claimed value of such property (or of all similar items of donated property) exceeds $5,000, whether donated to one or more charities.

Under the conference agreement, the substantiation requirements which must be set forth in Treasury regulations are as follows. These requirements apply to charitable contributions made after December 31, 1984.

General rule

The statute imposes appraisal and information reporting requirements where the amount claimed as a charitable deduction exceeds certain dollar amounts for a charitable contribution of property, other than contributions of securities for which (as of the date of the contribution) market quotations are readily available on an established securities market (referred to as "publicly traded securities"). These requirements apply to charitable deductions claimed under section 170 by an individual, a closely held corporation, or a personal service corporation. In the case of partnerships or S corporations, the requirements apply where a partner or S corporation shareholder includes a deduction on his or her return on account of a charitable contribution of such property by the partnership or S corporation.

The donor appraisal requirements apply if the amount claimed as a charitable deduction by the taxpayer on his or her return for a year exceeds $5,000 for any single item of such property ($10,000 in the case of a donation of stock other than publicly traded securities), or in the aggregate for similar items of property (such as a group or number of stamps or coins, lithographs, or books), whether donated to one or more donees. For example, the substantiation requirements apply if the taxpayer claims on his or her return for the year a deduction of $2,000 for rare books given to College *A*, $2,500 for rare books given to College *B*, and $900 for rare books given to College *C*. The donee information reporting requirements apply if the amount claimed as a charitable deduction by the taxpayer on his or her return for a year exceeds $5,000 for any single item of such property (with no higher

amount in the case of donations of stock) or in the aggregate for similar items of property donated to one or more donees.

Deductions for cash donations or for donations of property not subject to the substantiation rules of the bill remain subject to any substantiation requirements prescribed pursuant to regulations under section 170.

Appraisal

For donations of property as to which the donor appraisal requirements apply, the donor must obtain and retain a qualified written appraisal by a qualified appraiser for the property contributed and must attach a signed appraisal summary to the return on which the deduction is first claimed (with such other information as prescribed by regulations).

The appraisal must be made by a person who is qualified to make appraisals of the type of property donated. (The conferees expect that in developing the substantiation regulations, the Treasury will consult, to the extent practicable, with charitable organizations, appraisers and appraisal associations, and others.) The appraisal cannot be made by the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, or any person related to or regularly employed by any of the foregoing. Thus, for example, a taxpayer who acquired a painting from an art dealer could not use an appraisal from that dealer, persons regularly employed by the dealer, or related persons (within the meaning of sec. 267(b)). In appropriate circumstances, an appraiser who is regularly retained by a party could be considered, pursuant to Treasury regulations, as an employee of that party for purposes of this appraisal requirement where a longstanding relationship with the appraiser would cause a reasonable person to question the independence of the appraiser.

Appraisals for which the fee is based on a percentage of the appraised value cannot qualify. However, appraisals are not disqualified where all or a portion of the fee is based on a sliding scale if the portion of the fee based on a sliding scale is paid to a generally recognized association which regulates appraisers. This exception applies only if no persons have a beneficial interest in the association.

The appraisal must include a description of the donated property, the fair market value of the property on the date of contribution, the specific basis for the valuation (e.g., comparable sales), and the qualifications of the appraiser. Also, the appraisal must state that it is being prepared for tax purposes, and must be signed by the appraiser, whose tax identification number must be listed. Accordingly, the appraiser is a person to whom the civil tax penalty for aiding and abetting an understatement of tax liability (sec. 6701) could apply.

The appraisal must be received by the donor before the due date (including extensions) of the return on which the deduction is claimed. The donor must attach to the return on which the deduction is claimed a summary of the written appraisal, with such information and in a form prescribed by the Treasury Department. The appraisal summary must be signed by the appraiser and list the appraiser's tax identification number, and must be acknowledged by the donee (see discussion below under "Information report by donee on disposition"). The donor must retain the appraisal itself.

In addition, the donor must include in the return statements of the cost basis and the acquisition date of the donated property, and any other information to the extent required by Treasury regulations. If there is reasonable cause why the donor does not have information on the cost basis or acquisition date, the donor may substitute an explanatory statement, pursuant to Treasury regulations, with the return.

Under the conference agreement, the IRS is authorized and directed by the Congress to revise the individual income tax return for 1985 to add a separate line for claiming deductions for donations of property as to which a qualified appraisal is required. The instructions for the return are to include instructions as to the appraisal requirement. If the IRS, in processing returns as filed, finds that the taxpayer claimed deductions on the separate line relating to donations of property for which a qualified appraisal is required but failed to attach the summary appraisal, then the IRS (to the extent administratively practicable) is to so notify the taxpayer and request the filing of the summary. The deduction is not disallowed for a good faith failure to comply with the substantiation requirements if the taxpayer in fact had timely obtained a qualified appraisal and furnishes the IRS with an appraisal summary.

Information report by donee on disposition

If the donee charity sells, exchanges, or otherwise transfers within two years of the date of receipt certain donated property, the donee must furnish an information report to the IRS (with a copy to the donor) setting forth the donor's name, address, and tax identification number, a description of the property, the date of contribution, the amount received on the disposition, and the date of disposition.

The donee information reporting requirements apply if the amount for which a deduction was claimed under section 170 by the taxpayer on his or her return for a contribution of property (other than publicly traded securities) exceeds $5,000 for any single item of such property or in the aggregate for similar items of such property donated to one or more donees. (There is no higher threshold with respect to stock donations.) Penalties under section 6678 apply for failure to comply with the information reporting requirements.

To facilitate the donee's carrying out of the information reporting requirement, which is based on the amount claimed by the donor on his or her return for donations of property, the regulations are to provide that the donor (as part of the donor appraisal requirements) must (1) submit the appraisal summary to the donee for the donee's acknowledgment signature and (2) inform the donee of any donations of similar items made during the same year. The donee's acknowledgment signature on the summary appraisal solely represents acknowledgment of receipt of the items described in the summary appraisal, and in no way is to be construed as indicating the donee's agreement with or acceptance of the amount claimed for the donated property on the appraisal summary. The regulations are to provide appropriate rules for situations where the donor is unable to obtain acknowledgment by the donee.

Modifications to incorrect valuation penalty

The conference agreement follows the House bill, with two further modifications (in addition to deletion of the five-year exception, and extension of the penalty to incorrect valuations for estate and gift tax purposes). The additional modifications (unlike the general modifications adopted by the conference agreement) apply only in the case of an underpayment attributable to overvaluing any property for which a deduction is claimed under section 170 other than securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

Under the first additional modification, the section 6659 penalty is increased to a flat 30 percent of the tax liability understatement where the claimed valuation is 150 percent or more of the correct value.

Under the second additional modification, the IRS may not waive any portion of the penalty unless (1) the taxpayer shows (as required under the present-law waiver provision) that there was a reasonable basis for the claimed valuation and that the claim was made in good faith, and (2) the IRS determines both that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and that, in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

Disallowance rule for charitable deduction overvaluations

The conference agreement does not include the special disallowance rule in section 154(b) of the Senate amendment.

The conferees understand that the Treasury Department remains concerned whether the substantiation and penalty provisions of the bill will prove sufficient to preclude taxpayers from overvaluing charitable donations of property. This concern relates both to tax shelter promotions which exploit the deductibility of appreciation in capital-gain assets, and to other situations where individuals buy items on their own initiative specifically for contribution after expiration of the capital gains holding period, or overvalue items which they have held for long periods before donating them to a charity.

The conferees expect the Treasury and IRS to monitor the effectiveness of the new provisions and to notify the tax-writing committees if there are any continuing valuation problems which should be addressed by legislation. In this connection, the conferees note that the Treasury has authority under section 170(a)(1) to specify by regulations the manner in which charitable contributions must be substantiated in order to be deductible. The conferees encourage the Treasury and IRS to utilize fully the compliance tools available under present law with respect to improper or overvalued claims of charitable deductions, such as negligence and fraud penalties, and other administrative procedures such as the findings of the Art Advisory Panel. Also, the conferees expect the Treasury and IRS to call the attention of the tax-writing committees to any other compliance problems relating to charitable deductions—for example, where the taxpayer or return preparers may claim a deduction based on records of checks drawn in the name of a charity, but where in fact the checks represented payments for goods (purchased directly from the charitable organization or at a fund-raising auction or bazaar) rather than charitable contributions—and to recommend any appropriate legislative solutions.

b. Authorization to disregard appraisals of persons penalized for aiding in understatements of tax liability

Present law

The Secretary of the Treasury may prescribe rules governing the admission of lawyers and accountants to practice before the Internal Revenue Service and may bar individuals from practice if he finds them to be incompetent, disreputable, or grossly negligent. Present law does not provide any comparable authority with respect to the appearance of professional appraisers in pro-

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ceedings before the Internal Revenue Service.

House bill

The Secretary of the Treasury is authorized to bar from appearing before the Internal Revenue Service or the Treasury Department, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax (sec. 6701) has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary is also given authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. The provision applies to appraisers with respect to whom penalties are assessed under section 6701 after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

c. Mailing of deposits of taxes

Present law

Employers are required to deposit taxes in any designated financial institution. They may treat a deposit as timely made if it is mailed as required 2 days prior to the due date. The mailing of deposits to remote depositories by certified or registered mail can result in delays in depositing of up to 2 weeks.

House bill

No provision.

Senate amendment

Deposits in excess of $20,000 by large employers must be made by the due date, regardless of the method of delivery. A large employer is any employer required to deposit tax more than once a month. The Senate amendment is effective for deposits required to be made after June 30, 1984.

Conference agreement

The conference agreement follows the Senate amendment, effective for deposits required to be made after July 31, 1984.

d. Interest on certain additions to tax

Present law

Interest on penalties and additions to tax is generally imposed only for the period from the date of notice and demand to the date of payment. An interest-like element is added to the negligence and fraud penalties for the period from the last day prescribed for payment of the tax to the date of assessment (or payment, if earlier). No comparable element is added to the failure to file, gross valuation overstatement, and substantial understatement penalties.

House bill

No provision.

Senate amendment

Interest is imposed on the amount of the following penalties as of the due date of the return:

(1) failure to file (sec. 6651(a)(1));

(2) gross valuation overstatement (sec. 6659);

(3) valuation understatement for purposes of the estate or gift taxes (sec. 6660); and

(4) substantial understatement (sec. 6661).

The Senate amendment is effective for interest accrued after the date of enactment with respect to penalties assessed after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

e. Penalty for fraudulent withholding exemption certificate or failure to supply information

Present law

An individual who supplies false or fraudulent withholding information or willfully fails to supply information is subject to a criminal penalty, which is in lieu of any other penalty (except a civil fine).

House bill

No provision.

Senate amendment

The Senate amendment provides that the criminal penalty for supplying false or fraudulent withholding information or willfully failing to supply information is in addition to any other penalty. Thus, for example, prosecution for willful evasion (sec. 7201) is not barred where prosecution for a false certificate (sec. 7205) is also possible. The Senate amendment is effective for acts and failures to act occurring after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment. No inference should be drawn with respect to the correct interpretation of prior law on this issue; however, to the extent that *United States v. Williams*, 644 F. 2d 696 (8th Cir., 1981)) might be considered authority to the contrary, the rationale of that decision no longer applies.

f. Penalty for frivolous proceedings before the Tax Court

Present law

Prior to the enactment of TEFRA, the Tax Court had discretionary authority to award damages of up to $500 for proceedings instituted merely for delay. TEFRA raised the maximum to $5,000 and expanded the basis of the award to include proceedings maintained for delay. These changes were not effective for cases pending in the Tax Court at the time of TEFRA's enactment.

House bill

No provision.

Senate amendment

The Senate amendment provides that expanded damages can also be awarded against taxpayers with proceedings pending before the Tax Court as of 120 days after the date of enactment, regardless of when instituted.

Conference agreement

The conference agreement follows the Senate amendment.

g. Failure to request change of method of accounting

Present law

A taxpayer is not permitted to change its accounting method without the consent of the Secretary. Some taxpayers using an improper method argue there is no requirement to request permission to change from an improper to a proper method. They assert the failure of the Secretary to consent to a change in method as a defense to any penalty arising from use of the improper method.

House bill

No provision.

Senate amendment

The Senate amendment provides that if the taxpayer does not request a change in accounting method, the absence of the Secretary's consent cannot be asserted as a defense to any penalty or addition to tax. The provision is effective for taxable years beginning after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment. No inference should be drawn with respect to the validity of the defense asserted by some taxpayers under present law.

The conferees understand that the Internal Revenue Service's general practice is to permit a taxpayer who has not been notified that its return is going to be examined and who wishes to change from an improper method of accounting to a proper method for its taxable year that includes the date of enactment, but is precluded from doing so because the deadline for requesting a change in accounting method for its current taxable year has passed, is generally not subject to a penalty arising from use of the improper method in the current taxable year, provided that the taxpayer files a request for permission to change methods as soon as practicable, but in no event later than the due date (with extensions) of the taxpayer's return for its current taxable year.

h. Clarification of change of venue for certain tax offenses

Present law

There is a conflict among the United States courts of appeal regarding the availability of transfer of venue when the mails are used as part of the offense being prosecuted. Some hold that transfer is required only when the sole basis for venue in a particular district is receipt by the Internal Revenue Service of mailed materials. Others hold that transfer is permitted when the mails are used as part of the offense, even though venue is not based on the mailing.

House bill

No provision.

Senate amendment

The Senate amendment provides that transfer of venue is required only when the sole basis for venue in a particular district is receipt by the Internal Revenue Service of mailed materials. The provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment. Thus, defendants will not be able to force transfer of venue to an inconvenient forum solely because the mails were used as part of the alleged offense. The conferees note that the Internal Revenue Service and the Department of Justice generally attempt to establish venue for a criminal tax prosecution in the judicial district of the taxpayer's residence or principal place of business, because prosecution in that judicial district usually has the most significant deterrent effect. The conferees do not intend a change in that general policy. The conferees also note, however, that the Service and the Department may have valid reasons for bringing a prosecution in another district. Examples of this are multiple defendant cases or cases where venue for non-tax charges is established in a district other than the place of residence or business. The conferees do not intend to restrict the Service and the Department in instances such as these.

i. Statute of limitations relating to contributions to the capital of a corporation

Present law

A contribution in aid of construction to a regulated public utility that is not included

in the utility's rate base, and that is expended before the end of the second taxable year following the year of receipt, is not included in the utility's gross income. If it is not expended by the end of the second year, it is includible in the utility's income in the year of receipt. The statute of limitations is 3 years (absent fraud) from the filing of the return.

House bill

No provision.

Senate amendment

The Senate amendment extends the statute of limitations for the year of receipt with respect to the issue of the inclusion of the contribution in income and related adjustments to 3 years from the end of the second year following the year of receipt. The provision is effective for failures to meet the expenditure rule occurring after December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment with modifications. It provides that the statute of limitations for the assessment of any deficiency (and any ancillary adjustments) attributable to any contribution to the capital of a corporation does not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer that the contribution has been expended in the required manner, that the taxpayer intends not to make the required expenditure, or that the taxpayer has failed to make the required expenditure. This provision is similar to the rule that applies in the case of rollovers of gain on the sale of a principal residence (sec. 1034(j)).

j. Disclosure of returns and return information to certain cities

Present law

Disclosure of returns and return information can be made to States for tax administration purposes provided that appropriate safeguards against disclosure are provided. Disclosures to cities are not permitted.

House bill

No provision.

Senate amendment

The Senate amendment provides that any city with a population in excess of 2,000,000 that imposes a wage or income tax may, if the Secretary in his sole discretion so provides, receive returns and return information for the same purposes for which States may obtain information under present law, subject to the same safeguards as apply to States under present law. Cities that receive information must reimburse the Internal Revenue Service for its costs in the same manner as a State must under present law. Population is determined on the basis of the most recent decennial United States census data available. The Senate amendment is effective on the date of enactment.

Conference agreement

The conference agreement does not include the Senate amendment.

k. Tax shelter study

Present law

There is no specific provision in present law requiring the Secretary to study various aspects of tax shelters.

House bill

No provision.

Senate amendment

The Senate amendment requires the Secretary to submit a report to Congress by December 1, 1984, on various aspects of tax shelters, including a minimum tax imposed on investments, at-risk and recapture rules, basis adjustment for tax credits, and deductibility of artificial accounting losses.

Conference agreement

The conference agreement does not include the Senate amendment. The conference agreement provides that the Secretary will include the substance of the Senate amendment's report in the Treasury study of alternative tax systems. (See also item XI.1. "Study of alternate tax systems.")

K. Depreciation and Related Provisions

1. Depreciation of real property

Present law

With certain exceptions, most real property placed in service by the taxpayer after 1980, can be depreciated under ACRS over as short as 15 years. In general, components of a building qualifying as recovery property must be depreciated in the same manner as the building itself. However, under section 168(e)(4), certain buildings placed in service by taxpayers after 1980, do not qualify as recovery property.

House bill

No provision.

Senate amendment

The minimum recovery period for real property (other than low-income housing) eligible for a 15-year recovery period under present law is increased. For recovery property placed in service by the taxpayer after March 15, 1984, and before January 1, 1985, the minimum recovery period is 20 years. For recovery property placed in service by the taxpayer after December 31, 1984, and before January 1, 1986, the minimum recovery period is 19 years. For recovery property placed in service by the taxpayer after December 31, 1985, the minimum recovery period is 18 years. Recovery allowances are to be determined in accordance with tables to be prescribed by the Treasury. Any property covered by the provision can also be recovered on the straight-line method over the minimum recovery period.

Numerous conforming changes are made. In addition, rules are provided relating to the depreciation of components added to buildings previously placed in service.

The provision is effective for property placed in service by the taxpayer after March 15, 1984. However, the provision does not apply to property the construction of which was commenced by the taxpayer on or before March 15, 1984. Nor does the provision apply to property that the taxpayer was under a binding contract, entered into before March 16, 1984, to construct or acquire. Furthermore, if the taxpayer transfers his rights in any such property under construction or such contract to construct or acquire property to another taxpayer, the provision does not apply to the property in the hands of the transferee-taxpayer so long as the property was not placed in service before the transfer by the transferor-taxpayer. None of the transitional rules applies unless the property is placed in service before January 1, 1987.

Conference agreement

The conference agreement generally follows the Senate amendment except that for all real property subject to the conference agreement, the minimum recovery period is 18 years. In addition, technical amendments are made in the rules regarding new components added to buildings previously placed in service.

Under the conference agreement, the recovery allowance tables to be prescribed by the Treasury under the provision are to adopt a mid-month convention. That is, real property placed in service by the taxpayer during a month is to be treated as placed in service in the middle of such month. A similar convention is to be applied for the month of disposition.

The conferees wish to clarify certain transitional rules of the Senate amendment. Assume, for example, that taxpayer A signed a binding contract on March 10, 1984 to have a building constructed. On December 1, 1984, A assigns the contract to B. On March 15, 1985, B assigns the contract to C. The building is originally placed in service by C, on November 1, 1985. It is the conferees' intent that, since neither A nor B placed the property in service, the provision not apply to the building in C's hands. Furthermore, the conferees intend that demolition is to be treated as commencement of construction if both the demolition and the formally approved plan of construction are consistent with the recommendations of a feasibility study evidenced by internal documents of the taxpayer in existence when demolition commenced.

A partnership may have commenced construction of, or signed a binding contract to acquire or construct, real property on or before March 15, 1984. Subsequently, but prior to the time the property is placed in service, interests in the partnership may be sold or exchanged. If, by reason of such sales or exchanges, there is a termination of the partnership and the creation of a new partnership under section 708(b)(1)(B) (relating to sales or exchanges of 50 percent or more of the total interests in a partnership's capital and profits), the partnership is to be treated as having transferred its rights in its contract or the property to the new partnership (through its partners) for purposes of the transitional rule.

In addition, the conferees anticipate that the Treasury will promulgate regulations applying the provision in the case of transfers of partnership interests after a partnership has placed property in service. It is contemplated that, in the case of a termination of the partnership under section 708(1)(B), the regulations will provide that the new 18-year recovery period applies to the property in the hands of the new partnership. If there is no such termination but the partnership has a section 754 election (relating to optional basis adjustments) in effect, it is contemplated that the regulations will provide that any increase in the basis of the partnership's real property will be subject to the new 18-year recovery period (other than in cases where the anti-churning rules of section 168(e)(4) apply).

Under the conference agreement, for purposes of the transitional rules, property will not be treated as placed in by a taxpayer holding such real property as section 1221(1) property (relating to inventory and similar property) merely because the property is held for rental or rented for a short period prior to the time it is sold. However, that rule will cease applying under the provision to any such property of the taxpayer held by it on January 1, 1985. No such taxpayer is entitled to take depreciation deductions with respect to such property. No inference is intended as to whether property held by a taxpayer as section 1221(1) property depreciated by the taxpayer.

The conferees also intend that, for purposes of the transitional rules, a contract with respect to the property is to be treated as binding only if it is enforceable under State law and does not limit damages to a specified amount that is relatively minor. A contract that limits damages to an amount equal to at least 5.0 percent of the total contract price will not be treated as limiting damages in an amount that is relatively small. A contract is binding even if subject to a condition, so long as the condition is not within the control of either party. For

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purposes of the transitional rule, a contract will not be treated as ceasing to be binding merely because any term is to be determined by a standard beyond the control of either party or there is a bilateral agreement to reduce the purchase price of the property by no more than 20 percent or change the financing terms.

Under the conference agreement, property contracted for by the taxpayer before May 1, 1984, will not be subject to the provision if bonds to finance the property were issued before 1984, and an architectural contract with respect to such property was executed before March 15, 1984.

2. Rehabilitation tax credits

Present law

Tax credits are allowed with respect to qualified rehabilitation expenditures incurred in the substantial rehabilitation of certain buildings. In the case of a building which is at least 30 years old, but not 40 years old (and not a certified historic structure), a 15-percent credit is allowed, and depreciable basis is reduced by the full amount of the credit. In the case of a building which is at least 40 years old (and not a certified historic structure), a 20-percent credit is allowed, and depreciable basis is reduced by the full amount of the credit. In the case of a certified historic structure, a 25-percent credit is allowed, and depreciable basis is reduced by only one-half of the credit.

House bill

No provision.

Senate amendment

In the case of a building which is at least 30 years old but not 40 years old (and not a certified historic structure), the credit is reduced to 10 percent (and a full basis adjustment continues to be required). In the case of a building which is at least 40 years old (and not a certified historic structure), the credit is reduced to 15 percent (and a full basis adjustment continues to be required). No change is made in the amount of the credit with respect to a certified historic building, but a full basis adjustment is required for depreciation purposes. It is clarified that the credit applies only in the case of expenditures for real property (or additions or improvements to real property).

The provision has the same effective date as the Senate amendment regarding depreciation of real property.

Conference agreement

The conference agreement does not include the provision in the Senate amendment.

3. Depreciation recapture and installment sales

Present law

In a disposition of depreciable real or personal property, some or all of the gain may be taxed at the time of the disposition as ordinary income under the depreciation recapture rules of sections 1245 and 1250. The ordinary income will equal all or a part of prior depreciation deductions taken with respect to the property involved. For example, in the case of a sale of personal property, all recognized gain generally is taxed as ordinary income under the depreciation recapture rules of section 1245 to the extent of all prior depreciation deductions with respect to the property.

If the disposition is an installment sale, generally no gain or depreciation recapture income is taxed currently if no principal payments are made or deemed made on the installment obligation currently. Depreciation recapture income is taxed only as principal payments are made on the installment obligation. Typically, a portion of each principal payment will be treated as a recovery of basis and not taxed. Generally, the portion of each principal payment not so taxed equals the amount of the payment times a fraction the numerator of which is the taxpayer's adjusted basis in the property sold and the denominator of which is the total purchase price.

Under section 453(i), relating to certain depreciable property with respect to which the taxpayer elected first year expensing, depreciation recapture income is recognized in the year of an installment sale.

House bill

No provision.

Senate amendment

In any disposition of depreciable real or personal property, all depreciation recapture income under sections 1245 and 1250 generally is recognized currently, even if the transaction is an installment sale. In determining how much of any principal payment constitutes a recovery of basis gain, the taxpayer's adjusted basis in the property disposed of is treated as including the amount of the depreciation recapture income.

The provision is effective with respect to dispositions made after March 15, 1984 (April 13, 1984, in the case of a disposition of personal property). However, the provision does not apply to dispositions pursuant to contracts which were binding on March 22, 1984 (April 12, 1984, in the case of personal property). Nor does the provision apply to dispositions pursuant to an agreement in principal before March 23, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment. In addition, section 453(i) is repealed, since, with the new provision, it is no longer needed. Finally, under the conference agreement, the provision is effective with respect to dispositions after June 6, 1984.

4. Movies

Present law

Present law contemplates that qualified movies (i.e., motion picture films and video tapes created primarily for use as public entertainment or for educational purposes) are generally (1) to be depreciated under the income forecast method or a similar method, and (2) entitled, with respect to certain costs, to a 6⅔ percent investment credit under section 48(k). Present law also contemplates that other movies are generally (1) to be depreciated under the income forecast method or a similar method, and (2) entitled to no investment credit.

Existing Code language may be inconsistent with the foregoing. Some taxpayers are depreciating movies under ACRS, and some, including some who are depreciating them under an income forecast method or a similar method, are claiming regular investment credits.

House bill

No provision.

Senate amendment

Movies are not recovery property and so do not qualify for either ACRS depreciation or, except as is provided in section 48(k), the regular investment credit. These rules are effective as of the effective date of section 168. However, these rules do not apply to qualified movies placed in service before December 31, 1984, for which at least 20 percent of the costs of production were incurred prior to March 16, 1984, and for which ACRS was claimed.

The Senate amendment also provides that the general basis adjustment rules of section 48(q) apply to qualified movies but that the general at-risk rules of sections 46(c)(8) and (9) do not. These rules have the same effective dates as section 48(q) and sections 46(c)(8) and (9), respectively.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the rule to the effect that movies are not recovery property does not apply to any qualified movie placed in service before March 15, 1984, if ACRS was claimed with respect to such movie on a return filed before March 16, 1984. Therefore, the provision does not itself operate to disallow investment credits with respect to any such movie. Furthermore, the rule to the effect that movies are not recovery property does not apply to any qualified movies placed in service before 1985, so long as (1) ACRS is claimed with respect to such movie, and (2) 20 percent of the production costs for such movie were incurred prior to March 16, 1984. However, investment credit with respect to any such movie is to be determined solely under the rules of section 48(k).

No inference is intended as to the proper treatment of movies under present law.

5. Sound recordings

Present law

It is unclear whether sound recordings and similar property are eligible for depreciation under the accelerated cost recovery system or for the investment tax credit. It is also unclear whether the distribution of sound recordings and similar property outside the United States causes the property to be treated as used predominantly outside the United States for depreciation or investment credit purposes.

House bill

No provision.

Senate amendment

Taxpayers are provided with two options with respect to each sound recording, generally as defined in section 280(c)(2). First, taxpayers can elect to depreciate a sound recording under the 3-year property ACRS rules and take a 6-percent investment credit (if the property is otherwise eligible for the credit), or second, they can depreciate it under the income forecast method or a similar method and take no investment credit. Unless all taxpayers with an ownership interest in the sound recording elect the first option, the second option will apply.

If the first option is elected, all capital costs, including all non-U.S. production costs, and all contingent amounts (e.g., royalties to songwriters) incurred in the year the property is placed in service or the year thereafter, are to be recovered under the rules applicable to 3-year recovery property (except that contingent amounts incurred in the second year are to be recovered over 3 years beginning with that year). Contingent amounts incurred in other years are not to be treated as 3-year property for depreciation purposes. For purposes of determining any investment credit, basis or cost includes only production costs (including contingent amounts) allocable to the United States (including possessions of the United States). However, basis or cost does not include any contingent amounts which are not eligible for treatment as 3-year property for depreciation purposes.

The rules of section 48(q) (relating to adjustments in the depreciable basis of property on account of the investment credit) apply to sound recordings, but not the general investment credit at-risk rules.

The distribution of a sound recording outside the U.S. is not to be treated as a use of the property outside the U.S.

The provision applies to sound recordings placed in service after March 15, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

No inference is intended as to the proper treatment of sound recordings under present law.

L. Miscellaneous Reform Provisions

1. Tax-benefit rule

Present law

Present law excludes from income amounts recovered which previously were deducted but did not produce a tax benefit. The exclusion fails to properly reflect economic reality in certain cases.

House bill

The House bill clarifies the application of the tax benefit rule with respect to the recovery of amounts previously deducted. The bill also provides for an increase in tax when amounts relating to credits are recovered. This rule does not apply to the investment tax credit or the foreign tax credit since specific rules are applicable to those credits.

The provision applies to amounts recovered after December 31, 1983.

Senate amendment

The Senate amendment is the same as the House bill, except that it does not contain the provision relating to credits.

Conference agreement

The provision generally follows the House bill. An increase in tax with respect to credits will arise only where an amount was paid or incurred, and there is a subsequent price adjustment, or similar adjustment, with respect to that amount.

No change is made to the present law rules relating to what constitutes the recovery of an item previously deducted and no inference is intended as to the scope of those rules under present law.

2. Interest-free and below-market interest rate loans

Present law

Under present law, an interest-free or below-market interest rate loan without consideration, such as a loan to a family member, results in a gift from the lender to the borrower for Federal gift tax purposes. *Dickman* v. *Commissioner*, 465 U.S. . 52 U.S.L.W. 4222 (Feb. 22, 1984). There are no cases that have directly held that such a loan also has any income tax consequences. To date, the courts have only addressed the gift tax consequences.

The Internal Revenue Service has taken the position that, in the case of an interest-free or below-market interest rate loan to an employee or shareholder (other than a loan to which section 482 applies), the borrower derives an economic benefit that should be included in income for Federal income tax purposes. Notwithstanding the Internal Revenue Service's position, the Tax Court has consistently held that these non-family interest-free or below-market interest rate loans do not result in taxable income. *J. Simpson Dean* v. *Commissioner*, 35 T.C. 1083 (1961); *Greenspun* v. *Commissioner*, 72 T.C. 931, *aff'd*, 670 F. 2d 123 (9th Cir. 1982).

House bill

Overview

Under the House bill, an interest-free or below-market interest rate loan (referred to herein as a "below-market loan") is recharacterized as an arms-length transaction in which the lender (1) made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate, and (2) made a payment to the borrower. The payment by the lender to the borrower is treated as a gift, dividend, contribution to capital, payment of compensation or other payment depending on the substance of the transaction. The bill is generally applicable to any below-market loan unless, under regulations, it is established to the satisfaction of the Secretary that the loan does not have as one of its principal purposes the avoidance of Federal taxes. Under the bill, a demand loan is treated as a below-market loan if no interest is payable on the loan, or interest is payable at a rate less than the applicable Federal rate. A term loan is treated as a below-market loan if the amount of the loan exceeds the present value of all payments due under the loan. A demand loan is any loan which is payable in full at any time upon the demand of the lender. A term loan is any loan that is not a demand loan.

The provision applies to family loans and other below-market loans. A family loan is any below-market loan with respect to which the deemed payment by the lender to the borrower is in the nature of a gift.

Timing and amount of transfers

Loans other than family loans and demand loans

Under the House bill, in the case of any below-market loan other than a family loan or a demand loan, the lender is treated as transferring to the borrower and the borrower is treated as receiving from the lender an amount equal to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan. This transfer is treated as occurring on the date the loan is made. In addition, the excess of the amount of the loan over the present value of the payments due is treated as original issue discount. As a result, the lender is treated as receiving interest income at a constant interest rate over the life of the loan. Similarly, the borrower is treated as paying the same amount of interest. The interest which the borrower is treated as paying would be deductible to the same extent as interest actually due on the loan from the borrower. Thus, no deduction would be allowed for interest if the borrower does not itemize his or her deductions for the relevant year or his or her deductions would be disallowed under other provisions of the code (e.g., sections 163(d) or 265).

Family loans and non-family demand loans

In the case of a below-market family loan or a below-market demand loan that is not a family loan, the borrower is treated as transferring to the lender and the lender is treated as receiving from the borrower an amount equal to the foregone interest on an annual basis. This foregone interest is included in income by the lender and deductible by the borrower to the same extent as interest actually due on the loan from the borrower.

In addition, in the case of a demand loan, the lender is generally treated as transferring to the borrower, and the borrower is treated as receiving from the lender, an amount equal to the foregone interest on an annual basis. In the case of a family term loan, the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all principal and interest payments due under the loan. The deemed transfer by the lender to the borrower is treated as a gift, a payment of compensation, a dividend, contribution to capital, or some other payment depending on the substance of the transaction. Thus, in the case of a below-market loan from one family member to another in a transaction in which the lender does not receive any other consideration for the use of its money, the transfer from the lender to the borrower would be a taxable gift. In the case of a demand loan from a closely held corporation to a controlling shareholder, the transfer would be treated as a distribution with respect to the stock of the distributing corporation and be taxed to the shareholder as a dividend to the extent of the distributing corporation's earnings and profits under section 301.

Under the House bill, the term foregone interest means, with respect to any period during which a loan is outstanding, the excess of (1) the amount of interest which would have accrued on the loan during the period if interest accrued on the loan at the applicable Federal rate, over (2) any interest actually due on the loan properly allocable to such period.

Applicable Federal rate

Under the House bill, the applicable Federal rate is a rate determined by reference to the term of the loan, as set forth below.

Term	Applicable Federal Rate
Less than 3 years	The Federal short-term rate.
Over 3 years but not over 9 years.	The Federal mid-term rate.
Over 9 years	The Federal long-term rate.

The Federal rates are determined by the Secretary within 15 days after the close of 6-month periods ending on September 30 and March 31, respectively, and reflect the average market yield during such 6-month periods on outstanding marketable obligations of the United States with comparable maturities. The applicable Federal rate is compounded semiannually.

The determination reflecting the average yield for a 6-month period ending on September 30 is applicable during the 6-month period beginning on January 1 of the succeeding calendar year. The determination reflecting the average yield for the period ending on March 31 is applicable during the 6-month period beginning on the following July 1.

Under the House bill, the applicable Federal rate that is used to compute amounts of foregone interest is the rate for the day on which the loan is made. For purposes of computing amounts of foregone interest, a demand loan is treated as a series of one-day term loans. Thus, in the case of a demand loan, foregone interest must be computed on a daily basis. Further, in the case of a demand loan, the applicable Federal rate is always the Federal short-term rate.

Exceptions and limitations

Exceptions for non-tax motivated transactions

The House bill provides that, under regulations to be prescribed by the Treasury, the provision does not apply to a loan if it is established to the satisfaction of the Secretary that the loan does not have as one of its principal purposes the avoidance of any Federal taxes.

Special limitations for family loans

Under the House bill, in the case of a family loan, the amount treated as transferred by the borrower to the lender is limited to the amount of income, if any, realized by the borrower which is attributable to the loan.

Other exceptions

The bill provides that the provision does not apply to any loan to which sections 483 or 1274 apply.[7]

[7] Below-market loans that are made in connection with transactions to which sections 483 or 1274 apply are to be governed by those sections.

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Regulations

Under the House bill, the Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including (but not limited to) regulations providing for adjustments to the provisions for cases in which, by reason of varying rates of interest, conditional interest payments, waivers of interest, or other circumstances, the provisions of this section do not carry out its purposes.

Effective dates

In general, the provisions of this section apply to term loans made after March 1, 1984, and to amounts outstanding on demand loans after such date. However, a demand loan outstanding prior to March 1, 1984, will not be subject to the provision if it is repaid prior to the 60th day after the date of enactment. Any renegotiation, extension, revision or modification of any of the terms of a loan after March 1, 1984, is treated under the bill as the issuance of a new loan.

Senate amendment

Overview

Generally, the Senate amendment follows the approach of the House bill in that under the Senate amendment a below-market loan is recharacterized as an arms-length transaction in which the lender (1) made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate, and (2) made a gift, distributed a dividend, made a contribution to capital, paid compensation, or made another payment to the borrower which, in turn, is used by the borrower to pay the interest. The Senate amendment, however, applies to gratuitous transactions (referred to as "gift loans"), certain specifically enumerated categories of non-gratuitous transactions,* and other transactions only under regulations. Further, the Senate amendment provides specific exceptions for certain loans. Under the Senate amendment any loan described in one of the enumerated categories or in regulations is subject to the provision unless one of the specific exceptions is applicable.

Timing and amount of transfers

Gift loans

With respect to gift loans, the Senate amendment generally adopts the approach of the House bill to family loans and demand loans.

Non-gift loans

For non-gift loans that are term loans, the Senate amendment generally adopts the approach of the House bill for loans other than family loans and demand loans. For non-gift loans that are demand loans, the Senate amendment generally adopts the House bill approach to family loans and demand loans.

Designated market interest rate

The designated market interest rate under the Senate amendment is the same as the applicable Federal rate under the House bill.

Exceptions and limitations

Special exceptions and limitations for gift loans

Under the Senate amendment, a number of limitations and exceptions are provided for certain gift loans made directly between natural persons. For purposes of these exceptions and limitations, a husband and a wife are treated as one person.

Minimum outstanding balance.—As a general rule, under the Senate amendment, no amount is treated as transferred from the lender to the borrower, or retransferred from the borrower to the lender, for any day during which the aggregate amount owed by the borrower to the lender does not exceed $10,000 (taking into account all loans by the lender to the borrower regardless of the rate of interest).

Net investment income limitations.—As a general rule, under the Senate amendment, no amount is treated as retransferred from the borrower to the lender for any day if (1) the borrower's net investment income for the year in which the day falls does not exceed $1,000, and (2) the aggregate outstanding balance on all loans from the lender to the borrower on such day does not exceed $100,000 (taking into account all loans by the lender to the borrower regardless of the rate of interest).

In addition, if the borrower has net investment income for the year in excess of $1,000, the maximum amount that can be treated as retransferred from the borrower to the lender for any day during a year in which the aggregate of all amounts owed by the borrower to the lender does not exceed $100,000, is limited to the borrower's net investment income for the year. Except as otherwise provided in regulations, determinations made under these provisions are to be made on the basis of the borrower's taxable year.

Under the Senate amendment, net investment income is the excess of investment income over investment expenses. The term investment income is defined, in general, by reference to section 163(d). Thus, investment income is the sum of: (1) gross income from interest, dividends, rents and royalties; (2) net short-term capital gain attributable to the disposition of property held for investment; and (3) amounts treated under section 1245 (relating to dispositions of certain depreciable property), 1250 (relating to dispositions of certain depreciable realty) and 1254 (relating to dispositions of interests in oil, gas and geothermal property) as ordinary income. In addition, net investment income includes any amount included in income under the original issue discount provisions of the Code, and any amount that would be included if such provisions were applicable to all "deferred payment obligations." The term "deferred payment obligations" is defined to include bonds with market discount, short-term government obligations, annuities and any similar obligations producing a determinable investment return which economically accrues currently but is not recognized until a subsequent year. Any income, gain or other amount derived from the active conduct of a trade or business, however, is not treated as investment income. Generally, investment expenses include amounts allowable as deductions under sections 162 (relating to trade or business expenses), 164(a) (1) or (2) (relating to bad debts), 167 (relating to depreciation), 171 (relating to amortizable bond premium), 212 (relating to expenses incurred in connection with the production of income), and 611 (relating to cost depletion).

Except as otherwise provided in regulations, determinations made under these provisions are to be made on the basis of the borrower's taxable year.

Tax avoidance transactions.—The minimum balance exception and the net investment income limitations do not apply if a principal purpose of a loan is the avoidance of Federal taxes. Second, the exception and limitations do not apply to the extent that the proceeds of a loan are used to purchase or carry marketable securities other than bonds or other evidences of indebtedness. Third, the minimum balance exception and the rule that provides that no amount is treated as retransferred from the borrower to the lender in cases in which the borrower has less than $1,000 of investment income do not apply to the extent that the proceeds of a loan are used to purchase or carry passive income-producing assets, unless the Secretary determines that there is no tax avoidance purpose.

Also, the Senate amendment provides that the Secretary will prescribe regulations to prevent abuse of the net investment income limitation through the deferral or other distortion of a borrower's net investment income.

Special exception for employment-related loans

Generally, under the Senate amendment, no amounts are treated as transferred by the lender to the borrower, or retransferred by the borrower to the lender, with respect to any term loan to a person providing services (including independent contractors) if the aggregate amount of loans outstanding between the borrower and the lender on the date on which the loan is made is $10,000 or less. Further, in general, no amount is treated as transferred by the lender to the borrower, or as retransferred by the borrower to the lender, with respect to a demand loan for any day on which the aggregate amount of loans outstanding between the borrower and the lender is $10,000 or less. For this purpose, the aggregate amount of loans outstanding includes all loans by the borrower to the lender regardless of the rate of interest.

Other exceptions

The Senate amendment is the same as the House bill.

Regulations

The Senate amendment follows the House bill. The Senate amendment, however, provides authority to issue certain regulations under the Federal estate tax.

Effective date

In general, the provisions of the Senate amendment apply to term loans made after February 1, 1984, and to amounts outstanding on demand loans after the date of enactment.

Conference agreement

Overview

The conference agreement generally follows the approach of the Senate amendment. Thus, the conference agreement applies to certain enumerated categories of transactions and others under regulations. Further, specific exceptions and limitations are provided. The distinction between term loans and demand loans contained in the House bill and the Senate amendment is retained, as is the rule treating term gift loans as demand loans for income tax purposes. Payments deemed made under this provision are treated as if actually made for all purposes of the Code.

The conference agreement contains a number of technical modifications to the Senate amendment.

Loans subject to the provisions

The conference agreement generally applies to term or demand below-market loans that are gift loans, compensation-related loans, corporation-shareholder loans, and tax-avoidance loans. In addition, under regulations, the conference agreement applies to other transactions that are, in substance, below-market loans if the interest arrangements have a significant effect on the tax liability of either the borrower or the lender. It is intended that the term "loan" be interpreted broadly in light of the purposes of

*The enumerated non-gratuitous transactions are (1) loans by corporations to shareholders of such corporations, and loans by shareholders to their corporations, and loans by shareholders to employees, corporations, (2) loans by employers to employees, and (3) loans made to independent contractors by persons for whom such contractors perform services.

the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans.

Gift loans.—A gift loan is any below-market loan where the foregone interest is in the nature of a gift. In general, there is a gift if property (including foregone interest) is transferred for less than full and adequate consideration under circumstances where the transfer is a gift for gift tax purposes. A sale, exchange, or other transfer made in the ordinary course of business (i.e., a transaction which is bona fide, at arms length and free from any donative intent) generally is considered as made for and full and adequate consideration. A loan between unrelated persons can qualify as a gift loan.

The conferees wish to clarify that if a taxpayer makes a below-market demand loan to a trust and the loan is treated as a revocable transfer of property for purposes of subpart E, the provisions of subpart E govern.[9] The conferees anticipate that regulations may be issued describing the circumstances under which a loan to a trust will be treated as a revocable transfer.

Compensation-related loans.—A compensation-related loan is any below-market loan made in connection with the performance of services directly or indirectly between (1) an employer and an employee, or (2) an independent contractor and a person for whom such independent contractor provides services.

For purposes of determining the timing and amount of the transfers deemed made under the provision, a compensation-related term loan is treated as a demand loan if the benefit derived by the employee from the interest arrangement is (1) non-transferable and (2) conditioned on the future performance of substantial services by the employee. A benefit is treated as non-transferable and conditioned on future performance under this provision if it would be treated as non-transferable and conditioned on future performance under section 83, if that section were applicable. For example, a benefit is conditioned on the future performance of substantial services if, on the termination, for any reason, of the employee's employment, the interest rate is increased so that the rate for the remaining term of the loan equals or exceeds the applicable Federal rate.

The conferees wish to clarify that an arrangement will be treated as a compensation-related loan only if, in substance, there is a debtor-creditor relationship between the employee and the employer at the time the loan is made. For example, if an employer makes a payment to an unrelated third-party lender to buy-down a mortgage loan for an employee, and taking into account all the facts and circumstances, the transaction is, in substance, a loan by a third-party lender to the employee, and a payment by the employer to secure a valuable benefit for the employee, the payment by the employer to the lender is to be treated as compensation under generally applicable principles of tax law. To that extent, the below-market loan rules do not apply. However, if the transaction is, in substance, a loan by the employer made with the aid of services provided by the third-party lender acting as an agent of the employer, there is a compensation-related loan subject to this provision.

Also, under the conference agreement, if an employee receives payment from a customer for services rendered on behalf of an employer, and is permitted to retain the money for a period without paying interest at a rate equal to or greater than the applicable Federal rate, there is generally a compensation-related loan. For example, if an investment banker is permitted by an issuer to retain the proceeds from a public offering of stock or debt for a period without paying interest, there is a below-market loan from the issuer to the banker. To the extent the benefit is in lieu of a fee for services, the loan is a compensation-related loan.[10]

The conferees also wish to clarify that, in the case of a compensation-related loan, the deemed payment by the lender to the borrower is treated as wages for purposes of chapter 21, chapter 22 and chapter 23. Further, unless otherwise provided in regulations, a payment must be included in gross income by the borrower, even if the borrower is likely to be entitled to an offsetting deduction. Finally, even though there is no requirement that there be wage withholding for purposes of chapter 24, a payment must be reported under the appropriate information reporting provision.

Corporation-shareholder loans.—A corporation-shareholder loan is any below-market loan made directly or indirectly between a corporation and any shareholder of such corporation.

Tax avoidance loans.—A below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any Federal tax by either the borrower or the lender. Tax-avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan, rather than a loan requiring the payment of interest at a rate that equals or exceeds the applicable Federal rate and a payment by the lender to the borrower.

Other below-market loans.—A loan that is not a gift loan, compensation-related loan, corporation-shareholder loan or tax avoidance loan may be subject to these provisions under regulations if the interest arrangement has a significant effect on the tax liability of the borrower or the lender.

The interest arrangement of a below-market loan has an effect on the tax liability of the borrower or the lender if, among other things, it results in the conversion of a non-deductible expense into the equivalent of a deductible expense. For example, if a member of a club makes a non-interest bearing refundable deposit to the club in lieu of part or all of his or her membership fee, the member is paying the fee with money that has not been included in his income (i.e., the investment income from the proceeds of the deposit), and has, in effect, converted the fee into the equivalent of a deductible expense.

The conferees anticipate that in determining whether an effect is significant, the Treasury will consider all the facts and circumstances including (1) whether items of income and deduction generated by the loan offset each other, (2) the amount of such items, (3) the cost to the taxpayer of complying with the provision and (4) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

Timing and amount of transfers

Loans other than gift loans and demand loans

The conference agreement generally adopts the approach of the House bill to loans other than family loans and demand loans.

Gift loans and non-gift demand loans

The conference agreement generally adopts the approach of the House bill to family loans and non-family demand loans.

For purposes of determining the timing and amount of the deemed transfers by the borrower to the lender, term gift loans are treated as demand loans.[11] Thus, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, an amount equal to the foregone interest on an annual basis. For example, assume that on January 1, P, a calendar year taxpayer, makes a $200,000 loan to S, a calendar year taxpayer, for two years at 5 percent simple interest payable annually. If the applicable Federal rate is 12 percent compounded semiannually, the amount treated as transferred by the lender to the borrower for gift tax purposes would be $24,760 (i.e., the excess of $200,000 over the present value of all payments due under the loan discounted at the applicable Federal rate). The amount treated as retransferred by the borrower to the lender on the last day of each of the two calendar years would be $14,720 (i.e. the excess of interest computed at the applicable Federal rate (compounded semiannually) over interest actually payable on the loan). This amount, which would be included in income by the lender and, subject to the rules governing the deductibility of interest, deductible by the borrower, would be in addition to the $10,000 actually due each year under the terms of the loan.

The conferees wish to clarify that a term loan with deferred interest at a rate equal to or greater than the applicable Federal rate, and a related gift to defray all or a part of the interest payable on the loan, may be the economic equivalent of an interest-free (or below-market) loan with a principal amount equal to the sum of the actual stated amount of the loan and the amount of the gift. The conferees anticipate that under regulations such a transaction will be treated in accordance with its substance.

Foregone interest

The conference agreement clarifies the meaning of the term "foregone interest." Under the conference agreement, the term means, with respect to any period during which the loan is outstanding, the excess of (1) the amount of interest which would have been payable on the loan for the period if interest accrued at the applicable Federal rate and were payable annually on the last day of the calendar year, over (2) any interest payable on the loan properly allocable to such period.

Applicable Federal rate

The conference agreement follows the House bill and the Senate amendment.

Applicable Federal rates are to be announced on or before September 30, 1984, and are to apply as of January 1, 1985. Nei-

[9] This result is required because it would be anomalous to give effect for tax purposes to a loan made by a taxpayer to himself or herself.

[10] To the extent the benefit is not in lieu of a fee for services, such an arrangement nevertheless may have a significant effect on the tax liability of the lender or the borrower. If so, the loan may be treated under regulations as a loan subject to the provision.

[11] Term gift loans are treated as demand loans for income tax purposes because, in light of the underlying familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as being binding by the parties. In addition, an original issue discount analysis is required to determine the income tax consequences of a term loan. By treating term gift loans as demand loans for income tax purposes, such analysis is avoided.

ther the House bill nor the Senate amendment specify the rate that is to apply to days prior to January 1, 1985. The conference agreement provides that for periods prior to January 1, 1985, the applicable Federal rate is ten percent compounded semiannually.

Exceptions and limitations

The conference agreement provides specific de minimis rules. Generally, these rules are based on those contained in the Senate amendment.

De minimis exceptions

De minimis exception for gift loans between individuals.—As a general rule, no amount is treated as transferred by the lender to the borrower, or retransferred by the borrower to the lender, for any day during which the aggregate outstanding amount of loans does not exceed $10,000. For this purpose, the aggregate outstanding amount of loans includes all loans between the lender and the borrower regardless of the rate of interest.

This de minimis rule does not apply, however, if the loan is directly attributable to the purchase or carrying of income producing assets. Although a "directly attributable" test requires that there be some direct link between the loan and the borrower's purchase or continued ownership of income-producing assets, the conferees wish to emphasize that this is an anti-abuse provision, and should be interpreted in light of its purpose of preventing the avoidance of the assignment of income rules and the grantor trust rules.

The conference agreement makes it clear that, because a term gift loan is treated as a demand loan for income tax purposes, generally no amount is deemed retransferred by the borrower to the lender for any day on which the aggregate amount owed is $10,000 or less. Thus, if the balance of a term gift loan fluctuates, there may be income tax consequences for some days but not for other days.

De minimis exception for compensation related loans and corporation shareholder loans.—A de minimis exception is provided for loans between (1) an employer and an employee, or an independent contractor and a person for whom such independent contractor provides services, or (2) a corporation and a shareholder of such corporation. Under these rules, no amounts are treated as transferred by the lender to the borrower and retransferred by the borrower to the lender for any day during which the aggregate outstanding amount of loans between the borrower and the lender does not exceed $10,000. This *de minimis* rule does not apply, however, if a principal purpose of the interest arrangement is the avoidance of any Federal tax.

The conference agreement makes it clear that, for purposes of applying the exceptions and limitations, all loans between the same parties are aggregated. Further, in the case of non-gift term loans, the deemed transfers from the lender to the borrower are treated as occurring on the latter of the dates on which the loans are made or the first date on which the loans are subject to the provision. Thus, for example, if there are no other outstanding loans between an employer and an employee, and the employer makes $9,000 compensation-related term loan to an employee on April 1, and a $2,000 compensation-related term loan to the same employee on April 10, the parties are treated as if the employer made a $11,000 compensation-related term loan to the employee on April 10.

Finally, the conference agreement clarifies that in the event of a reduction in the outstanding balance of a non-gift term loan below $10,000, the provision continues to apply. Thus, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, foregone interest on the remaining outstanding balance.

Special rules for gift loans

The amount treated as retransferred by the borrower to the lender for any day on which the aggregate outstanding amount of loans between the lender and the borrower does not exceed $100,000 is limited to the borrower's net investment income for the year. If the borrower has outstanding two or more gift loans, net investment income is allocated among such loans in proportion to the respective amounts that would be treated as retransferred by the borrower without regard to this limitation.

In addition, the conference agreement provides that if a borrower has less than $1,000 of net investment income for the year, such borrower's net investment income for the year is deemed to be zero. Thus, if the aggregate outstanding amount of loans from the lender to the borrower does not exceed $100,000 on any day during a year, and the borrower has less than $1,000 of net investment income for the year, no amount is treated as retransferred by the borrower to the lender for such year.

The definition of net investment income in the conference agreement is generally the same as in the Senate amendment. However, the conference agreement makes it clear that United States Savings Bonds are deferred payment obligations.

It is anticipated that the Secretary will prescribe regulations to prevent the abuse of these rules through the deferral or other distortion of a borrower's net investment income. These regulations are to apply to situations in which a party can control the timing of the receipt of investment income (e.g. where the borrower can control the timing of dividends paid by a closely-held corporation) or has engaged in any activities a principal purpose of which is to defer receipt of net investment income. Further, it is anticipated that regulations will provide for determinations under these provisions in cases in which either the borrower or lender computes taxable income on the basis of a fiscal year.

These special rules for gift loans do not apply if a principal purpose of the interest arrangement is the avoidance of Federal taxes.

Other exceptions

The conference agreement is the same as the House bill and the Senate amendment.

Regulations

The conference agreement generally follows the House bill and the Senate amendment.

Under the conference agreement, authority is provided to issue regulations exempting from these provisions any class of transactions if the interest arrangements do not have a significant effect on the tax liability of the borrower or the lender. The conferees anticipate that, in appropriate circumstances, compensation-related loans, including employee-relocation loans, may be exempted by these regulations. The term "significant effect" has the same meaning for this purpose as it does for purposes of determining whether loans not otherwise covered by the provision should be subject to it under regulations.

Authority is also provided to issue regulations for the purpose of assuring that borrowers and lenders take consistent positions under this provision. In appropriate cases, these regulations may condition a deduction for imputed interest on adequate identification of the lender.

In addition, authority is provided to issue regulations concerning the tax consequences of a disposition by a lender or a borrower of his or her interest in a below-market loan, or the acquisition of an interest in such a loan.

Effective dates

In general, under the conference agreement, the provision applies to term loans made after June 6, 1984, and to amounts outstanding on demand loans after such date. Amounts outstanding on demand loans on June 6, 1984, will not be subject to the provision if repaid prior to 60 days after the date of enactment. No inference is intended with respect to the application of present law to any below-market loan outstanding prior to the effective date.

Compensation-related term loans that are otherwise treated as demand loans for purposes of determining the timing and amount of the deemed transfers under the provision are treated as term loans for purposes of this effective date provision. In addition, advances to continuing-care facilities by residents of such facilities made prior to June 6, 1984, are not subject to the provision. No inference is intended regarding the application of the provision to advances to continuing-care facilities made after that date.

3. Limitations with respect to property which is partially used for personal purposes and luxury automobiles

Present law

The portion of the cost of an asset attributable to business use is eligible for the investment tax credit (generally 6 percent on automobiles) and ACRS (automobiles are 3-year property), or, alternatively, for expensing (up to a specified dollar limit). Business use is any use in a trade or business (sec. 162) or in connection with the production of income (sec. 212).

A portion of the investment tax credit and expensing deduction may be recaptured if the portion of the asset attributable to business use declines after the first year it is placed in service. No such recapture rule applies to ACRS deductions.

a. Percentage of personal use presumption for automobiles

House bill

At least 50 percent of use is treated as personal unless the taxpayer establishes otherwise, effective for taxable years beginning after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the Senate amendment.

b. Limitation on investment tax credit and depreciation for automobiles

House bill

For purposes of tax credits, ACRS, and expensing, the basis of a passenger automobile is limited to $21,000, adjusted for inflation, effective for property placed in service after March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill, except that basis is limited to $15,000 and the provision is effective for property placed in service after March 15, 1984.

Conference agreement

The conference agreement generally follows the House bill, with modifications. The maximum investment tax credit that can be claimed with respect to any passenger automobile is $1,000, indexed for automobile price inflation and rounded to the nearest

$100. If the taxpayer elects a reduced investment credit in lieu of a basis adjustment for half the credit under section 48(q), then the credit is two-thirds of maximum credit that can be claimed. The maximum allowance for depreciation that can be claimed with respect to any passenger automobile is $4,000 in the year the automobile is placed in service by the taxpayer, and $6,000 in any subsequent year. Both figures are indexed for automobile price inflation and rounded to the nearest $100. In computing the allowable credit, the general rules for the credit are applied first; the limitation is then imposed. The credit as limited is then reduced to reflect any personal use. If business use is less than 100 percent, the taxpayer is entitled to claim the portion of the maximum investment tax credit and depreciation deductions allowable which corresponds to the taxpayer's business use percentage (as described below).

The limits do not apply to an automobile leased or held for leasing by any person regularly engaged in the business of leasing automobiles. Rather, the limits are applied to the lessee by denying a deduction for the percentage of the lease payments that is substantially equivalent to the effect as if these restrictions were placed on the lessor. This percentage is to be determined under tables prescribed by the Secretary. If the lessor passes through the credit to the lessee, the limit on the investment credit allowable applies to the lessee.

The limits are effective for property placed in service or leases entered into after June 18, 1984, except that property acquired pursuant to a binding contract in effect on or before June 18, 1984, that is placed in service before January 1, 1985, is not affected by these limits.

c. Personal use property

House bill

No provision.

Senate amendment

Under the Senate amendment, at least 90 percent of the use of an automobile (based on mileage) must be for business purposes for the taxpayer to claim ITC, ACRS, or expensing. If the 90 percent test is not met, the taxpayer must use standard mileage to determine his allowable deductions in lieu of ITC, ACRS, expensing, and actual operating expenses. An automobile kept at the taxpayer's residence more than 14 nights a year is automatically on standard mileage, unless the residence is the principal place of the taxpayer's principal business or the taxpayer is an outside salesman.

With respect to property used for transportation (except automobiles), entertainment and recreation property, computers, and other property listed in regulations, at least 90 percent of the use must be for business purposes in order for the property to be eligible for ITC, ACRS, and expensing. If the 90-percent test is not met, the taxpayer must use 12-year straight-line depreciation.

The taxpayer must meet the 90-percent test for both of the first two years to claim ITC, ACRS, and expensing, and if business use falls below 90 percent after the first two years, ITC, ACRS, and expensing are recaptured. Use by another person is not counted as for a business purpose unless (1) the use is directly connected with the taxpayer's trade or business, (2) the use gives rise to income to the other person, or (3) fair rent is paid to the taxpayer for the use.

The provision is effective for property placed in service after March 15, 1984.

Conference agreement

For automobiles and other transportation equipment, entertainment, recreation, or amusement property, computers, or other property specified in regulations, the investment credit and use of the accelerated percentages under ACRS are not allowed for property not used predominantly (i.e., more than 50 percent) on an annual basis in a trade or business. Use of this specified property for the production of income, but not in a trade or business, does not count in determining whether the 50-percent test is met. If the 50-percent test is otherwise met, however, use for the production of income may be considered in determining the amount of the investment credit and ACRS that may properly be claimed. For example, if a specified asset is used 30 percent in a trade or business and 30 percent for the production of income, the taxpayer may not claim the investment credit or ACRS and must instead compute depreciation under the rules described below. If, however, an asset is used 70 percent in a trade or business and 20 percent for the production of income, the taxpayer may claim the investment credit and ACRS based on 90 percent business use. As is required under present law, the taxpayer may properly claim the credit and deduction only with respect to the portion of the use of the asset that represents business use. Moreover, as is provided under present law, a taxpayer is entitled to no depreciation deduction with respect to an entertainment, recreation, or amusement facility.

If the taxpayer's automobile is used by another person, any use of the automobile by that other person is not treated, for purposes of this provision, as business use, if that use (A) is not directly connected with the business of the taxpayer, (B) does not give rise to income to the other person (which, in the case of an employee, must also be treated as wages for withholding purposes), or (C) does not result in a payment of fair market rent.

Provision of the use of listed property merely as compensation to 5-percent owners and related taxpayers or leasing to such individuals is not treated as use in a trade or business. However, for airplanes and helicopters, such compensation or leasing to such individuals can be considered business use, provided that business use without consideration of those activities is at least 25 percent of total use.

Listed property does not include any computer exclusively located at a regular business establishment (including a qualifying home office) of the employer or proprietor and owned by the employer or proprietor. However, present law rules permitting the credit and deduction only with respect to the business use of these computers would still apply.

If the 50-percent test is not met, the portion for which depreciation deductions are allowed must be depreciated on a straight-line basis (using a half-year convention (except for 15 year real property) and without regard to salvage value) using earnings and profits lives (see sec. 312(k)(3)(A)). With respect to 3-year property (such as automobiles), this is a 5-year period. With respect to 5-year property (such as computers or transportation equipment other than automobiles), it is a 12-year period. With respect to real property, it is a 35-year period.

Listed property which an individual owns in connection with his employment is eligible for the investment credit and ACRS deductions only if such property is required for the convenience of the employer and as a condition of employment. The conferees intend the terms "convenience of the employer" and "condition of employment" to have the same meaning with respect to this provision as it does with respect to the exclusion from gross income for lodging furnished to an employee. In order to satisfy the condition of employment requirement, the property must be required in order for an employee to properly perform the duties of his employment. This requirement is not satisfied merely by an employer's statement that the property is required as a condition of employment. The conferees intend that the principles of *Dole* v. *Commissioner*, 43 T.C. 697, *aff'd.*, 351 F.2d 308, (1st Cir. 1965) apply.

With respect to recapture of the investment credit, any property (or portion thereof) which ceases to be section 38 property during a taxable year, other than because of a disposition, is considered to be disposed of on the first day of the taxable year (Treas. reg. secs. 1.47-1(c), 1.47-2(e)). These regulations accomplish the objective of the provision in the Senate amendment denying the investment credit if business use falls below 90 percent in the first two years the property is in service. Accordingly, the 2-year rule of the Senate amendment has not been adopted. The conferees expect that these regulations will be strictly enforced. The conferees note that the Secretary can provide, as has been done in other areas, a rule that a *de minimis* reduction in the portion of property that continues to be section 38 property will not trigger any recapture.

For listed property, recapture rules for depreciation will apply. A reduction in the business use portion from above 50 percent to 50 percent or below will trigger recapture of the excess depreciation. Excess depreciation is the excess of depreciation actually claimed over depreciation that would have been claimed on the basis of earnings and profits lives on the straight-line method.

Reduction or denial, due to personal use by the lessee, of the investment tax credit, ACRS, and expensing will not apply to lessors. Personal use by the lessor will, however, cause a reduction in the available investment credit and depreciation. Lessees will be denied a deduction for a percentage of the lease payment equivalent to the value of the portion of the investment tax credit and depreciation and expensing deductions which would have been denied due to personal use. This percentage is to be prescribed in tables issued by the Secretary. These tables may be coordinated with the tables to be prescribed denying a deduction for a percentage of the lease payment attributable to the effect of the caps on the investment credit and depreciation.

Under ACRS, taxpayers may elect, in lieu of the prescribed accelerated percentages, an optional recovery method. The taxpayer may elect either percentages based on the straight line method for the regular recovery period or one of the two optional longer recovery periods. Generally, an election to use an optional recovery method must be made in the year the property is placed in service by the taxpayer. Additionally, except in the case of 15-year real property, a taxpayer who elects to use an optional recovery method must elect the same recovery method for all property of that class placed in service in the year for which the election is made. The mandatory use of the straight line method under this new provision is not intended to have a binding effect on all other recovery property of that class placed in service in the same year by the taxpayer. Thus, a taxpayer who owns a car that is subject to this provision which must be recovered over a 5-year recovery period has not made a binding election with respect to all other 3-year recovery property placed in service in the same taxable year.

In lieu of any investment tax credit and any depreciation or expensing deduction, the taxpayer may elect, as under present law, to compute his deduction for the busi-

ness use of his automobile at the standard mileage rate. This rate is currently 20.5 cents a mile for the first 15,000 miles of business use per year, up to a maximum of 60,000 miles. Beyond those limits, the rate is 11 cents per mile.

The conference agreement provides the Secretary with authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section. These regulations should, among other things, ensure that taxpayers do not attempt to evade the restrictions on the investment credit and depreciation by, for example, separating an automobile into its component parts.

The conferees also expect that the Secretary will issue regulations that provide explicit methods for allocating basis between business and personal use. With respect to automobiles, the regulations could provide that the proportion of business use is not to be greater than the proportion of total mileage which is driven for business purposes. The Secretary may also provide alternate means to determine the business use percentage for automobiles. For example, regulations could provide that if an automobile is used 5 days a week for business purposes and is available 2 days a week for personal purposes, in no event may the taxpayer consider more than five-sevenths of the use to be allocable to business purposes. An allocation based on different factors, such as time, may be more appropriate for other types of property as well.

Commuting is not business use, regardless of whether work is performed during the trip. Thus, for example, a business telephone call made on a telephone installed in an automobile while the taxpayer is commuting to work does not transform the character of the trip from commuting to business. This is also true for a business meeting held in a car while the taxpayer is commuting to work. Similarly, a business telephone call made on an otherwise personal trip does not transform the character of the trip from personal to business. In a likewise manner, the fact that an automobile is used to display material that advertises the owner's or user's trade or business does not convert an otherwise personal use into business use.

These provisions are effective for property placed in service after June 18, 1984, except that property acquired pursuant to a binding contract in effect on or before such date which is placed in service before January 1, 1985 (or January 1, 1987, in the case of real property) is not affected by these provisions.

The following examples illustrate the operation of this provision:

Example 1. On July 1, 1984, A purchases for $35,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in A's business. The amount of A's investment tax credit is limited to $1,000. A's unadjusted basis for ACRS purposes is $34,500 (i.e., $35,000 reduced by the one-half basis adjustment). A selects the use of the accelerated recovery percentages under ACRS. A's recovery deductions for the years during his recovery period (i.e., 1984 through 1986) are limited to $4,000, $6,000, and $6,000, respectively. A continues to use his car exclusively in his business during taxable years 1987 through 1990. For those years, A is limited to a recovery deduction of $6,000 per year. In 1990, A's recovery deduction is $500 (i.e., his remaining depreciable basis).

Example 2. On August 1, 1984, B corporation purchases for $25,000 and places in service a passenger automobile which is 3-year recovery property under section 168. C owns 100 percent of B corporation. The automobile is used 25 percent in B's business and 75 percent for C's personal use for years 1984 through 1989. Because business use does not exceed 50 percent, B may not claim the investment tax credit and must use either the straight-line method over 5 years or the longer recovery period of 12 years, which B may elect under section 168(b)(3). B uses the 5-year period. In 1984, B's recovery deduction is $625 (i.e., .25 (business use) x $25,000 x .10 (depreciation on a straight line basis with a half-year convention)). In 1985 through 1988, B's recovery deduction is $1,250 (i.e., .25 x $25,000 x .20). In 1989, B's recovery deduction is $625 (i.e., .25 x $25,000 x .10). No further recovery deductions are available to B. This is because the amount with respect to which recovery deductions are available is reduced each year by the amount that could have been deducted if business use had been 100 percent.

Example 3. On December 1, 1984, A purchases for $30,000 and places in service a passenger automobile which is 3-year recovery property under section 168. A owns 100 percent of his business. In 1984, A uses his car 40 percent in his business, 20 percent in an investment activity, and 40 percent for personal purposes. Because A does not use his car more than 50 percent in his business, A may not claim an investment tax credit with respect to the car. A's unadjusted basis is $30,000. Also, because A does not use the car more than 50 percent in his trade or business (i.e., in a "qualified business use"), the deduction allowed under section 168 must be determined by use of the straight-line method over a 5-year recovery period (or, if A so elects, over a 12-year period). A's business use percentage, for purposes of determining the allowable portion of the recovery deduction, is 60 percent for 1984 (that is, 40 percent trade or business use plus 20 percent investment activity use). Thus, A's allowable deduction for 1984 is $1,800 (that is, the allowable depreciation of $3,000 ($30,000 x 10% depreciation) (which is less than the $4,000 cap) times the 60 percent business use percentage).

Example 4. On July 1, 1984, A purchases for $18,000 and placed in service a passenger automobile which is 3-year recovery property under section 168. A's 1984 business use percentage is 80 percent. A elects to take a reduced investment tax credit in lieu of a basis adjustment. The amount of A's investment tax credit is limited to $536 (i.e., $1,000 x .67 (which is less than .4 x $18,000) times 80% business use). A selects the use of the accelerated recovery percentages under ACRS. A's unadjusted basis for ACRS purposes is $18,000. A's 1984 recovery deduction is $3,200 (i.e. $4,000 (which is less than $18,000 x .25) times 80% business use). In 1985, A's business use percentage is 80 percent. A's 1985 recovery deduction is $4,800 (i.e. $6,000 (which is less than $18,000 x .38) times 80% business use). In 1986, A's business use is 45 percent. As a result of the decline in business use percentage, A, for investment tax credit purposes, is treated as having disposed of the portion of the automobile converted to personal use and must recapture a portion of the investment tax credit claimed previously (pursuant to Treas. reg. secs. 1.47-1(c), 1.47-2(e)). A's investment credit recapture is $123.82 (i.e. $536 x .35 (which is .80 − .45) x .66 (the percentage specified in sec. 47(a)(5))). Since A's business use is not greater than 50 percent, A must recompute (for recapture purposes) his recovery deductions for the preceding recovery years using the straight line method over 5 years. A's recomputed recovery deductions for 1984 and 1985 are $1,440 (i.e., .10 x $18,000 x .80), and $2,880 (i.e., .20 x $18,000 x .80), respectively. A must recapture $3,680 (i.e., (3,200 + 4,800) − (1,440 + 2,880)) and include that amount in gross income as ordinary income for 1986. A's recovery deduction for 1986 is $1,620 (i.e. $18,000 x .20 (which is less than $6,000) times 45% business use). A's business use for 1987 and 1988 is 45 percent and his recovery deduction for each year is $1,620. In 1989, A's business use is 45 percent and his recovery deduction is $810 (i.e., $1,800 x .45). A may not recover any additional amounts, because had he used the automobile solely for business purposes, he would have recovered his entire unadjusted basis (i.e., $18,000) by 1989.

d. Recordkeeping

Present law

The taxpayer must substantiate any travel expenses by adequate records or other evidence corroborating his own statements. These records must show the amount, time, place, and business purpose of the travel expenses.

House bill

No provision.

Senate amendment

The Senate amendment extends present law substantiation requirements to all business use of an automobile and to the other property described above (i.e., property used for transportation, entertainment and recreation property, computers, and other property listed in regulations). The Senate amendment requires the maintenance of contemporaneous records.

The Senate amendment also requires that return preparers verify that adequate contemporaneous records have been kept supporting deductions before signing returns. The provision is effective with respect to property placed in service after March 15, 1984.

Conference agreement

The conference agreement follows the Senate amendment with modifications. Thus, taxpayers are required to substantiate by adequate contemporaneous records any investment tax credit or deduction with respect to the business use of listed property, traveling expenses (including meals and lodging while away from home as well as local travel) that are trade or business expenses or expenses for the production of income, for entertainment expenses, and for gifts. If the taxpayer does not have adequate contemporaneous records, no credit or deduction is allowed with respect to that item. If, however, these records are lost due to circumstances beyond the taxpayer's control, such as in a fire, flood, or earthquake, the conferees intend that taxpayers continue to have the ability, as they do under present law, to substantiate a deduction by reasonable reconstruction of expenditures (see Treas. reg. 1.274-5(c)(5)).

The conferees expect that these records will reflect with substantial accuracy the business use of the property. The records must indicate the business purpose of the expense or use, unless the business purpose is clear from the surrounding circumstances. With respect to automobiles, logs recording the date of the trip and the mileage driven for business purposes must be kept.

The requirement of the Senate amendment that return preparers verify that adequate records supporting all of these deductions have been kept before signing the return has been deleted. In place of that requirement, a return preparer must properly and fully advise the taxpayer of these contemporaneous recordkeeping requirements and obtain written confirmation from the taxpayer certifying that adequate contem-

poraneous records supporting these deductions and credits exist. If the return preparer does not obtain this written certification, the preparer may not sign the return. The conferees anticipate either that the content of this certification will be specified by the Secretary or that the Secretary will prescribe a form for this certification. The conferees expect that the Secretary will amend Form 2106 or any other appropriate form to require that the taxpayer directly indicate on his return whether the required records have been kept. This could be done, for example, by providing a box to check on the return.

The conference agreement also provides that any portion of an underpayment of tax attributable to a failure to comply with these contemporaneous recordkeeping requirements is treated as due to negligence in the absence of clear and convincing evidence to the contrary. Claiming a deduction or credit without the support of the required records is also potentially fraud. This is in addition to the loss of the credit and deduction which would occur under present law.

The conferees anticipate that the Secretary will draw the attention of taxpayers to these new recordkeeping requirements in the appropriate regularly issued Internal Revenue Service publications. To accomplish this, for example, the Service could describe these new recordkeeping requirements in the section of the instructions to the 1984 Form 1040 that highlights important tax law changes.

The compliance provisions are effective with respect to taxable years beginning after 1984.

4. Transfers of depreciable property between related parties

Present law

Transfers of depreciable property between related parties are denied capital gains and installment sales treatment. Related parties include (1) husband and wife, and (2) partnerships and corporations which are 80 percent controlled by one taxpayer.

House bill

For purposes of this rule, the House bill (1) treats a patent application as depreciable property, and (2) treats a person and a trust in which the person has a beneficial interest (other than a remote contingent interest) as related.

The provision is effective for transactions after March 1, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

5. Treatment of certain related party transactions

Present law

Present law denies a deduction for business expenses and interest by an accrual basis taxpayer owed to a related cash basis taxpayer if payment is not made within 2½ months after the close of the taxable year.

Present law does not apply to transactions between a partner and a partnership, and does not apply to transactions between related corporations.

House bill

The House bill provides that a deduction for expenses of an accrual basis taxpayer owed to a related cash basis taxpayer is allowed only when the amount is paid. The bill applies the new accrual rule to amounts accrued by a partnership to its partners and persons related to its partners (and vice versa). It also applies the present law rules denying losses between related parties as well as the new accrual rules to transactions between controlled corporations (using a 50-percent control test). It does not apply to sales to a controlled DISC.

The provision applies the accrual rules to taxable years beginning after December 31, 1983, unless pursuant to a binding contract in effect on September 29, 1983.

The expansion of the related party rules will apply to transactions after September 29, 1983, unless it is pursuant to a contract binding on that date. In the case of sales to a controlled foreign corporation, the provision will apply March 1, 1984.

Senate amendment

The Senate amendment generally is the same as the House bill, except (1) the partnership provision does not apply to certain cases involving resyndications of low-income housing, and (2) losses from sales and exchanges between controlled corporations will result in deferral (rather than denial) of losses until the related corporation disposes of the property outside the group in a recognition transaction. No DISC exception is provided.

The effective date generally is the same as the House bill except (1) the expansion of the related party rules will apply to taxable years beginning after December 31, 1983, and (2) no special rule applies to controlled foreign corporations.

Conference agreement

The provision generally follows the Senate amendment with the following modifications:

(1) There will be no attribution of partnership interests held by a subchapter C corporation to any shareholder owning less than 5 percent of the stock of the corporation.

(2) Except as provided in regulations, sales of inventory in the ordinary course of business between two corporations at least one of which is a foreign corporation will not be subject to the loss deferral rule. This exception will only apply if the sales are made for bona fide business purposes. The IRS may apply the loss deferral rule where sales are made for the purpose of accelerating losses. An abnormally large volume of sales near the end of the year would be an indication of a purpose to accelerate losses, absent evidence to the contrary.

(3) The operation of the loss deferral rule is clarified to provide that any loss sustained shall be deferred until the property is transferred outside the group, or until such other time as is provided by regulations. These rules will apply to taxpayers who have elected not to apply the deferral intercompany transactions rules, except to the extent regulations provide otherwise.

The Secretary may prescribe exceptions from these principles, for example, where necessary to properly reflect the net amount of income on a transaction. For example, it is intended that where any income is properly taken into account by the controlled group with respect to the face amount of a note receivable (for example, the income is accruable in accordance with the principles set forth in Rev. Rul. 71-365) at any time prior to the transfer of the property outside the group, any loss due to the discount in the note or receivable (to the extent of such income previously recognized) shall be allowed no later than the time that both the income has been taken into account and that loss has been sustained.

(4) Any loss sustained on the repayment of a loan to another member of the controlled group will not be disallowed if the loan is payable or denominated in a foreign currency and the loss is attributable to a reduction in value of the foreign currency.

(5) The DISC provision in the House bill is contained in the conference agreement.

(6) In the case of sales to a controlled foreign corporation the effective date will be March 1, 1984.

6. Losses on sales and exchanges of property used in a trade or business

Present law

Generally, gains and losses on the sale or exchange of business property plus the gains and losses on the involuntary conversion of business property and capital assets are treated as long-term capital gains and losses if there are net gains for the taxable year and they are treated as ordinary losses if there are net losses for the taxable year.

House bill

No provision.

Senate amendment

Under the Senate amendment, net losses from the sale or exchange of business assets will be treated as capital losses to the extent of net section 1231 gains for the prior three years and will be carried back to offset these gains. Also net gains will be treated as ordinary to the extent of net section 1231 losses for the prior three years.

The provision applies to taxable years beginning after December 31, 1984.

Conference agreement

Under the conference agreement, net section 1231 gains will be treated as ordinary income to the extent of unrecaptured net section 1231 losses of the taxpayer (or predecessor taxpayer) for the 5 most recent prior years beginning after December 31, 1981. Losses will be deemed recaptured in the chronological order they arose.

The provision applies to taxable years beginning after December 31, 1984.

7. Disallowance of certain expenses where taxpayer uses property similar to property owned by taxpayer

Present law

Deductions for personal expenses are disallowed. Deductions are allowed for expenses incurred in a trade or business or in connection with the production of income. In addition, an investment tax credit is allowed for depreciable property used in a trade or business or for the production of income.

House bill

No provision.

Senate amendment

The Senate amendment clarifies the application of present law where a taxpayer uses property owned by another person for personal purposes and such person (or a third person) uses similar property owned by the taxpayer for personal purposes, or, under regulations, where the taxpayer has an interest in a partnership or other entity, the principal purpose of which is to permit its owners to obtain personal use of property while claiming tax benefits with respect to similar property. If this provision applies, the taxpayer is treated as using the property with respect to which tax benefits are claimed for personal purposes, to the extent of the expenses attributable to the similar property that is actually used by the taxpayer for personal purposes.

The provision applies to the use of property after February 22, 1984.

Conference agreement

The conference agreement follows the House bill.

The conferees concluded that present law is adequate to prevent the abuse addressed by the Senate amendment.

8. Use of multicompany structure to reduce tax on coal operations

Present law

Present law (sec. 631(c)) provides that, subject to certain special limits, royalties received on the disposition of coal or iron ore qualify for capital gain treatment. For capital gain treatment to apply, the coal or iron ore must have been held for more than one year before mining. Capital gain treatment does not apply to income realized by an owner as a co-adventurer, partner, or principal in the mining of the coal or iron ore. In the case of iron ore (but not coal), capital gain treatment is also not applicable to a disposal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the ore. If capital gain treatment is allowed for coal or iron ore royalties, the royalty owner is not entitled to percentage depletion with respect to the coal or iron ore disposed of.

Under present law, it is possible to reduce the overall tax on coal mining operations by having a separate land-holding company acquire coal reserves and lease them for a retained arm's-length royalty to the company which actually conducts mining operations. Under such an arrangement, the royalties are deductible by the operating company, and the amount of the royalties received by the land company (after subtracting cost depletion and certain expenses) qualify for capital gain treatment. If the benefits of capital gain treatment exceed the loss from foregoing percentage depletion on the coal in question, the overall tax on the operation will be reduced. The Code specifically prohibits this result in the case of iron ore by denying capital gains treatment for dispositions to related persons.

House bill

No provision.

Senate amendment

Section 631(c) is amended to specify that capital gain treatment does not apply to any disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the coal.

The provision is effective for coal disposed of (i.e., mined) after September 30, 1985.

Conference agreement

The conference agreement follows the Senate amendment, except that the amendment does not apply to coal sold under a fixed contract in effect on June 15, 1984, and at all times thereafter, before for such sale, under which the price for such coal cannot be adjusted to reflect to any extent the increased liabilities of the selling royalty owner for income tax by reason of the amendment. This exception for fixed contracts terminates on January 1, 1990. For purposes of this effective date rule, if an operator sells coal under both fixed contracts and other contracts, unless the contract otherwise provide, the royalty subject to the new rules will be treated as paid first out of the proceeds from the fixed contracts.

9. Public utility dividend reinvestment plans

Present law

Under present law, shareholders may exclude from income up to $750 ($1,500 in the case of a joint return) of stock distributions from public utility corporations under qualified dividend reinvestment plans. This provision expires for distributions made after 1985.

House bill

No provision.

Senate amendment

The Senate amendment repeals this provision effective for distributions made after December 31, 1984.

Conference agreement

The conference agreement does not contain the Senate amendment.

10. Modification of income averaging

Present law

Income averaging is presently available to taxpayers with "averageable income." Averageable income is current year taxable income in excess of 120 percent of average taxable income in the four preceding years. In effect, income averaging widens the tax brackets by a factor of five with respect to averageable income.

House bill

The House bill increases the 120-percent threshold to 140 percent and provides that only the three preceding years are to be taken into account. The bill modifies income averaging so that it, in effect, widens the tax brackets by a factor of four, not five, with respect to averageable income.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The Conference agreement follows the House bill and the Senate amendment.

11. Taxation of the Federal Home Loan Mortgage Corporation

Present law

Tax exemption of the Federal Home Loan Mortgage Corporation ("Freddie Mac")

Under a non-Code provision, the Federal Home Loan Mortgage Corporation ("Freddie Mac") is exempt from all Federal, State, and local taxation. Real property held by Freddie Mac remains subject to State and local tax.

Net operating loss carrybacks

Corporations are generally allowed to carry net operating losses back 3 years and forward 15 years. Under a special rule, the Federal National Mortgage Association (Fannie Mae) is allowed to carry net operating losses arising in 1982 or later back 10 years and forward 5 years, other than losses resulting from mortgage dispositions. Losses resulting from mortgage dispositions are subject to the general corporate rules (i.e., a 3-year carryback and 15-year carryforward).

Dividends received deduction

Corporations are allowed a deducation for a portion (generally, 85 percent) of dividends received from a domestic corporation. This deduction is not allowed for dividends received from a tax-exempt entity. Thus, dividends received by savings institutions from a Federal Home Loan Bank (which is tax-exempt under a non-Code provision) do not qualify for a dividends received deduction.

For dividends received by thrift institutions (including savings and loans and mutual savings banks), present law reduces the amount of the otherwise allowable dividends received deduction by 40 percent.

House bill

No provision.

Senate amendment

Repeal of Freddie Mac tax exemption

The Senate amendment repeals the Federal tax exemption for Freddie Mac, effective January 1, 1985. The State or local tax treatment of Freddie Mac is not affected.

Net operating loss carrybacks

The Senate amendment provides Freddie Mac with treatment equivalent to that provided under present law to Fannie Mae, i.e., a 10-year carryback and 5-year carryforward of net operating losses (except losses resulting from mortgage dispositions).

Dividends received deduction

The Senate amendment allows a dividends received deduction for dividends received from a Home Loan Bank which are allocable to dividends paid by Freddie Mac out of current earnings profits or earnings and profits accumulated after December 31, 1984. For dividends paid out of current earnings and profits of a Home Loan Bank, the amount of any dividend which qualifies for a deduction is that amount which bears the same ratio to the total dividend as the ratio of (a) dividends received by the Home Loan Bank from Freddie Mac during the Home Loan Bank's current taxable year, to (b) the total earnings and profits of the Home Loan Bank for the year.

If the amount of the dividends paid by a Home Loan Bank to its shareholders exceeds the bank's earnings and profits for the current taxable year, then, under the Senate amendment, a deduction is allowed for that portion of any dividend paid out of accumulated earnings and profits of Freddie Mac which is equivalent to the ratio of (a) the amount of dividends received by the Home Loan Bank from Freddie Mac out of Freddie Mac earnings and profits for taxable years ending after December 31, 1984, which have not been accounted for under the rules described in the preceding paragraph, to (b) the sum of (i) the retained earnings of the Home Loan Bank as of January 1, 1985, and (ii) the accumulated earnings and profits of the Home Loan Bank at the time the dividend is paid which are attributable to periods after December 31, 1984. For purposes of his rule, the Home Loan Banks are permitted to treat retained earnings for financial accounting purposes as of January 1, 1985, as accumulated earnings and profits for years before 1985. No deduction is allowed for dividends paid by Home Loan Banks allocable to dividends paid by Freddie Mac out of earnings and profits it accumulated before January 1, 1985 (ie., prior to the date of taxability).

Effective date and transition rules

Under the Senate amendment, the repeal of the Freddie Mac tax exemption is effective on January 1, 1985. Additionally, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985.

The Senate amendment includes special basis rules designed to ensure that, to the extent possible, pre-1985 appreciation or decline in the value of Freddie Mac assets will not be taken into account for tax purposes. Under these rules, for purposes of determining gain, the basis of any asset held on January 1, 1985, is to be the higher of (1) the regular adjusted basis of the asset in the hands of Freddie Mac, or (2) the fair market value of the asset on January 1, 1985. For purposes of determining loss, the basis of any asset held on January 1, 1985, is to be the lower of these two figures. Where the amount realized on the disposition of an asset is greater than the lower of these figures, but less than the higher figure, no gain or loss is to be recognized by Freddie Mac on the disposition.

The Senate amendment provides specifically that, for purposes of the basis rules above, rights to income retained by Freddie Mac under participation certificates (PCs) and similar interests in mortgages (including guaranteed mortgage certificates and collateralized mortgage obligations) which Freddie Mac sold prior to January 1, 1985, are not to be considered to have a built-in

income component on January 1, 1985, which could be treated as an asset held by Freddie Mac as of the date of taxability. Under a special rule, if Freddie Mac realizes gain on the sale of its interests in a PC or similar interest in mortgages between March 15, 1984, and January 1, 1985, such income is to be recognized on January 1, 1985 (and therefore subject to tax).

Conference agreement

The conference agreement follows the Senate amendment with the following modifications.

Net operating loss carrybacks

The conference agreement follows the Senate amendment in providing Freddie Mac with treatment equivalent to that provided to Fannie Mae under present law, i.e., a 10-year carryback and 5-year carryforward of net operating losses (other than losses from mortgage dispositions). However, the conference agreement provides that no net operating loss, capital loss, or excess credit of Freddie Mac for any taxable year beginning after December 31, 1984, shall be allowed as a carryback to any taxable year beginning before January 1, 1985. This adjustment prevents Freddie Mac from being required to carry back losses or credits to years in which the corporation was not taxable (and in which the losses or credits are therefore without value to Freddie Mac), and allows such losses or credits to instead be carried forward to later taxable years.

Dividends received deduction

The conference agreement clarifies that, in determining the amount of the deduction for dividends paid out of accumulated earnings and profits of a Home Loan Bank, the total accumulated earnings and profits of the Home Loan Bank at the time the dividend is paid are to be taken into account. Thus, a deduction is to be allowed for that portion of such a dividend which bears the same ratio to the total dividend as the ratio of (a) the amount of dividends received by the Home Loan Bank from Freddie Mac which are out of Freddie Mac earnings and profits for taxable years ending after December 31, 1984, and which have not been taken into account in determining the deduction for dividends paid out of current earnings and profits of the Home Loan Bank, to (b) the total accumulated earnings and profits of the Home Loan Bank at the time the dividend is paid. For purposes of this rule, the retained earnings and profits of the Home Loan Bank as of January 1, 1985, are to be treated as its accumulated earnings and profits as of that date.

Effective date and transition rules

Basis of Freddie Mac assets

The conference agreement follows the rules of the Senate amendment regarding the basis of Freddie Mac assets held by the corporation on January 1, 1985. However, the conference agreement provides an exception to these general rules in the case of tangible depreciable property held by Freddie Mac on January 1, 1985. For such property, the adjusted basis, for purposes of both gain or loss, is to be equal to the lesser of (1) the regular adjusted basis of the property in the hands of Freddie Mac, or (2) the fair market value of the property as of January 1, 1985. This rule is primarily intended to prevent Freddie Mac from claiming deductions based on pre-1985 depreciation of tangible property (e.g., buildings or office equipment) held by the corporation as of the date of taxability.

Treatment of participation certificates (PCs)

The conference agreement follows the Senate amendment with regard to the treatment of income rights under mortgage pool participation certificates (PCs) or other similar interests in mortgages sold prior to January 1, 1985, with certain technical adjustments. Under the conference agreement, Freddie Mac is to be treated as having no basis in its income rights with respect to PCs or similar interests in mortgages, under the basis provisions of the conference agreement, where the PC, similar interest, or any related security was sold or issued by Freddie Mac prior to January 1, 1985. The conferees intend that this provision will apply in the case of collateralized mortgage obligations (CMOs) sold or issued by Freddie Mac prior to January 1, 1985. Thus, income received by Freddie Mac which is attributable to PCs, CMOs, or similar obligations sold prior to January 1, 1985, is to be taxable in the year received, regardless of whether such income is attributable to services performed by Freddie Mac prior to January 1, 1985, to guarantees provided by Freddie Mac, or to a built-in income or profit component which may be considered to exist as of January 1, 1985. Additionally, Freddie Mac is not to be entitled to a deduction for depreciation or amortization with respect to its income rights in these obligations and is to have no basis in such income rights, under the basis provisions of the conference agreement, for purposes of determining gain or loss on the sale or disposition of such income rights.

The conference agreement follows the special rule of the Senate amendment under which gain realized by Freddie Mac on the sale of its income rights in PCs or similar interests in mortgages after March 15, 1984, and before January 1, 1985, is recognized on January 1, 1985.

Treatment of certain replacement obligations

The conference agreement adds a special rule under which Freddie Mac is denied a deduction for interest accruing after December 31, 1984, on any replacement obligation. For this purpose, a replacement obligation means any obligation created after March 15, 1984, which the Treasury Department determines to replace any equity or debt interest of a Federal Home Loan Bank (or of any other person) in Freddie Mac which existed on March 15, 1984. This provision is intended to prevent any rearrangement of the existing capital structure of Freddie Mac (e.g., replacement of equity or low-interest debt with high-interest debt) from resulting in an unintended tax benefit. The provision does not apply to any obligation with respect to which Freddie Mac establishes that there is no tax avoidance effect.

12. Interest on debt used to purchase or carry tax-exempt obligations of related parties

Present law

Present law (sec. 265(2)) disallows a deduction for interest on debt used to purchase or carry tax-exempt obligations. The application of this rule to related parties is unclear.

House bill

No provision.

Senate amendment

The Senate amendment disallows a deduction under section 265(2) for interest on debt which is used to purchase or carry tax-exempt obligations owned by (1) the taxpayer's spouse or (2) an 80-percent owned entity with respect to the taxpayer.

This provision is effective for term obligations incurred after the date of enactment and demand obligations outstanding 60 days after enactment.

Conference agreement

The conference agreement provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of tax provisions which deal with (1) the linking of borrowing to investment, or (2) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. The conferees specifically intend that this provision will be applied (but will not be limited to) the disallowance of interest deductions under section 265(2).

The conferees intend that, for purposes of section 265(2), related persons will include related persons as defined under section 1239, i.e., (1) a husband and wife, and (2) a person and certain 80-percent entities with respect to such person. Additionally, in appropriate instances, related persons for purposes of section 265(2) will include a person and any minor children of such person.

The conferees intend that this provision will not alter the present law rule which disallows an interest deduction under section 265(2) only if the purpose of borrowing is to purchase or carry tax-exempt obligations.[13] In particular, the conferees are aware that certain corporations engaged in banking, writing insurance, or issuing travelers checks, hold large investment portfolios, including tax-exempt securities, that are required to be held to satisfy obligations to or for their customers in the ordinary course of business. Often these corporations do not have significant amounts of interest-bearing debt. In addition, these corporations are often affiliates of other corporations which have large amounts of interest-bearing debt. The conferees intend that this provision will not cause interest on borrowings by an affiliated company to be disallowed in any case where such interest would not be disallowed under present law if the operations of the corporations were carried on as separate divisions of a single corporation.

The Code, as amended by the conference agreement, contains certain provisions other than sec. 265(2) which apply specific rules in cases in which indebtedness is linked to certain kinds of investments. The Code, as amended by the conference agreement, also contains many provisions (e.g., sec. 243) applying specific rules in cases in which a taxpayer reduces his risk of loss with respect to certain kinds of investments. Under the conference agreement, the Treasury regulations regarding related parties, pass-through entities, or other intermediaries are to be applied to all of these provisions. No inference is intended that any other Code provision may be circumvented by the use of related parties, pass-through entities, or other intermediaries. Nor is any inference intended that any particular provision under present law or as amended by the conference agreement (e.g., sec. 265(2) or sec. 246A), by its own terms, is not applicable in the case of related parties, pass-through entities, or other intermediaries.

The provision regarding related parties, pass-through entities, and other intermediaries is generally effective on the date of enactment. However, for purposes of section 265(2) only, this provision is to be effective with respect to (1) term obligations incurred after the date of enactment, and (2) demand obligations outstanding 60 days after the date of enactment.

[13] See, e.g., *Leslie* v. *Commissioner*, 413 F. 2d 636 (2d Cir. 1969); *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F. 2d 420 (7th Cir. 1968); Rev. Proc. 72-18, 72-1 C.B. 740.

II. LIFE INSURANCE TAX PROVISIONS

A. Tax Treatment of Life Insurance Companies

1. Definition of a life insurance company

Present law

A company is taxed as a life insurance company if (1) it is an insurance company; (2) it is engaged in the business of issuing life insurance and annuity contracts (either separately or in combination with accident and health insurance), or noncancellable accident and health insurance contracts; and (3) more than 50 percent of its total reserves are life insurance reserves or unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident or health policies not included in life insurance reserves. Life insurance reserves and total reserves do not include deficiency reserves.

Under present law, there is no statutory definition of an insurance company. Treasury regulations, however, provide that an insurance company is a company "whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." (Treas. Reg. sec. 1.801-3(a)).

House bill

The House bill generally adopts the present-law test for determining whether an insurance company is a life insurance company and, for this purpose, continues to look to properly computed statutory reserves. However, for purposes of qualifying as a life insurance company, the House bill adopts a statutory definition of an insurance company. Specifically, for purposes of qualifying as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The House bill adopts the same definition of a life insurance reserve as under present law. In doing so, the treatment of noncancellable accident and health insurance contracts in the 1959 Act as being comparable to life insurance contracts because of their long-term rate commitments is continued. Also, generally, the bill adopts the present-law definition of total reserves.

Senate amendment

The Senate amendment is generally the same as the House bill with two modifications. First, because of a general change in State law, as well as new rules for computing tax reserves, the present-law provision that excludes deficiency reserves from the definition of life insurance reserves and total reserves is eliminated. Rather, the new rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increase in reserves deduction.

Second, an insurance company may make a permanent election to treat individual noncancellable (or guaranteed renewable) accident and health contracts as cancellable for purposes of determining the qualification fraction. Thus, a company with large amounts of individual noncancellable accident and health business may elect to be taxed as a property and casualty insurance company, forfeiting the special and small life insurance company deductions.

Conference agreement

The conference agreement follows the Senate amendment, with the modification that the election to treat noncancellable accident and health contracts as cancellable must be made on the return filed for the first taxable year beginning after 1983.

2. Computation of life insurance company taxable income

Present law

A life insurance company currently is subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company is taxed currently on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeds its taxable investment income, 50 percent of such excess (Phase II). The other 50 percent of the gain from operations is accounted for as part of a policy holders' surplus account and, subject to certain limitations, is taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Thus, although life insurance companies are taxed at the normal corporate rates under present law, special accounting rules are provided for computing taxable income. Consistent with the taxation of other taxpayers, net capital gain that is taxable to the company may be subject to an alternative tax.

a. Life insurance company taxable income

House bill

Under the House bill, a life insurance company is to be taxed at corporate rates, under a single-phase system, on its life insurance company taxable income (LICTI), plus any distribution from a policyholders' surplus account. LICTI is life insurance gross income reduced by life insurance deductions which include generally available business deductions (with modifications) and special life insurance deductions. As under present law, net capital gain that is taxable to the company may be subject to an alternative tax. A stock life insurance company is to be taxed, at full corporate rates, on any distributions from a pre-1984 policyholders' surplus account.

Senate amendment

The Senate amendment is generally the same as the House bill with the exception of the specific differences described below.

Conference agreement

The conference agreement follows the House bill and the Senate amendment with the specific differences between the two resolved as described below.

b. Deduction for intercorporate dividends

House bill

With respect to the deduction for intercorporate dividends received by a life insurance company, in general, the House bill continues a present-law rule for prorating the deduction between the company and the policyholders as the items of investment income are allocated between the company and the policyholders. However, "100-percent dividends" (i.e., dividends that would be allowed a 100-percent deduction under sections 243 or 244, and certain dividends received by foreign corporations that would be 100-percent dividends but for the foreign recipient) are not subject to proration except to the extent they are funded with tax-exempt interest or with dividends that would not qualify as 100-percent dividends in the hands of the taxpayer.

Senate amendment

The Senate amendment is the same as the House bill except for a provision that allows 100-percent dividend treatment for dividends received from life subsidiaries and certain nonlife insurance subsidiaries if certain conditions are met. One-hundred percent dividends from a life insurance subsidiary will not be prorated if all the affiliated life insurance companies apply proration on a consolidated basis. Dividends from nonlife insurance subsidiaries (e.g., property and casualty insurance companies) will not be prorated if the subsidiary's surplus does not exceed 30 percent of assets and if its tax-advantaged investments (e.g., tax-exempt bonds or common stocks) do not exceed 60 percent of assets. One-hundred percent dividends from reinsurance subsidiaries may be excluded from the general proration rule under regulations. Dividends paid out of pre-1984 earnings by subsidiaries falling under these special rules for exclusion from or application of proration will not be taken into account in computing statement gains from operations under the ownership differential provision (new sec. 809). The special rules for exclusion from proration will terminate and not apply after 1986.

Conference agreement

The conference agreement follows the House bill. Thus, 100-percent dividends received by a life insurance company are not subject to proration except to the extent they are funded either with tax-exempt interest or with dividends that would not qualify as 100-percent dividends in the hands of the taxpayer. The conferees wish to clarify that in determining how much of a dividend has been paid out of tax-exempt interest, or dividends other than 100-percent dividends, or out of other taxable income items, a comparison should be made between the amount that previously undistributed tax-exempt interest and dividends other than 100-percent dividends have contributed to a company's current and post-1983 accumulated earnings and profits and all such earnings and profits immediately prior to the distribution. The conferees believe that this interpretation of the dividends-received proration provision is consistent with the definition of a dividend as a distribution out of earnings and profits (and not out of other amounts). Any other interpretation either would require the establishment of a unique set of earnings and profits accounting provisions, or would result potentially in year-to-year distortions because of annual variations in the proration formula.

c. The special life insurance company deduction

House bill

A life insurance company is allowed a deduction for any taxable year of 25 percent of its "tentative life insurance company taxable income" (tentative LICTI) over the amount of the company's small life insurance company deduction. Generally, a company's tentative LICTI is its life insurance company taxable income determined without regard to (1) the special life insurance company deductions, and small life insurance company deductions, and (2) any items (income or loss) attributable to any noninsurance business.

Under this provision, the special life insurance company deduction applies only with respect to income resulting from a company's insurance business. For these purposes, noninsurance business means any business which is not an insurance business. Generally, insurance business refers to the business activity of issuing insurance and annuity contracts and the resinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to the contracts issued or reinsured by the taxpayer. Any business that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as insurance business.

The House bill limits the amount of the special life insurance company deduction by treating all life insurance companies that

are members of the same controlled group as one company whether such companies join in the filing of a consolidate return or file separate returns. Thus, the gain or loss of any life insurance company member will be reflected in the computation of the affiliated group's tentative life insurance company income, even if that particular member is not allowed to join in the consolidated return because it has not been a member of the affiliated group for the required time or is a foreign corporation. The bill gives Treasury authority to prescribe proper adjustments to eliminate a double reduction of tentative LICTI under such circumstances.

Senate amendment

The Senate amendment is generally the same as the House bill, except that the special deduction is 20 percent of tentative LICTI.

The Senate amendment modifies the computation of tentative LICTI if a company has both insurance and noninsurance business. Noninsurance business means any activity that is not an insurance business; however, an activity is treated as insurance business if it has been traditionally carried on by insurance companies and is carried on for investment purposes, but only if the activity (except for investment in real estate) does not constitute the active conduct of a trade or business. In addition, the performance of administrative services in connection with any plans providing life insurance, pension, or accident and health benefits is treated as insurance business. Also, for purposes of computing LICTI, any gain or loss from the noninsurance business of a life insurance company is treated as if it were the gain or loss of a noninusrance member that joined in the filing of a consolidated return with that life insurance company. Thus, a company's noninsurance losses will be subject to the 35-percent limitation of section 1503(c).

The Senate amendment has the same general rule as the House bill for computing tentative LICTI of a controlled group. However, the Senate amendment provides broader regulatory authority for Treasury to prescribe proper adjustments to be made in the application of the general provision for computing tentative LICTI of a controlled group in order to eliminate any excessive detriment or benefit (from year to year) arising from the operation of that provision.

Also, in lieu of the general rule for computing tentative LICTI of a controlled group, the Senate amendment permits a common parent to elect to compute the special life insurance company deduction separately for each "affiliated group" (as defined by sec. 1504) within the controlled group and for companies that are not members of an affiliated group. Where this election is made, a limitation is imposed on an affiliated group's ability to utilize life company members' losses against nonlife company members' income.

Conference agreement

The conference agreement generally follows the Senate amendment.

In following the Senate amendment with regard to the distinction made between insurance business and noninsurance business, the conferees believe that the distinction drawn between passive investment activities and an active conduct of a trade or business will be more administrable and provide more guidance and certainty for the industry as it further refines the "traditional investment" standard of the House bill. The general insurance-noninsurance distinction that is made for purposes of computing the amount of the special deduction will prevent a company from obtaining a tax rate on income from noninsurance activities that is lower (through the operation of the special deduction) than would be applied if the activities were carried on in a separate nonlife insurance company. At the same time, the conferees recognize that a life insurance company should not be allowed a greater advantage by carrying on, within the company, noninsurance activities that result in losses than would result if those same activities were carried on in a separate company. Thus, the conference agreement adopts the provision that a loss from noninsurnace activities will be treated as a gain or loss of a noninsurance subsidiary of the life insurance company that joined in the filing of a consolidated return with that life insurance company. This results from the application of the general principles of life-nonlife consolidation (sec. 1503(c)) for purposes of combining income and losses from insurance and noninsurance business activities in computing the LICTI of a life insurance company.

For example, noninsurance losses taken into account for purposes of computing LICTI (after the special deduction and small life insurance company deduction) for a taxable year will be limited to 35 percent of the lesser of the noninsurance loss or LICTI (without regard to the noninsurance loss). It is anticipated that regulations under section 1503(c) will develop rules for the treatment of such noninsurance income or losses within a life-nonlife consolidated group that are consistent with the treatment of such items for purposes of computing LICTI of a single life insurance company.

Whether an activity will be treated as insurance business or noninsurance business depends on the nature of the activity itself, regardless of whether the assets and income related to the activity are financially supportive of the insurance business operation. Thus, for example, even though a company might choose to invest premium receipts in an oil or gas joint venture and use the investment return therefrom to meet policy obligations, gain or loss arising from the joint venture will be treated as a noninsurance gain or loss if the company's participation in the joint venture constitutes the conduct of a trade or business. However, the conference agreement provides that certain existing investments in oil and gas through will be treated as insurance business for purposes of computing tentative LICTI. On the other hand, participation in an oil and gas venture solely as a limited partner will ordinarily be treated as a passive investment activity, income and expenses of which will be treated as part of the insurance business. By the same token, the ownership of stock will always be treated as insurance business because it is essentially a passive investment activity, even when the stock ownership results in the life insurance company having control of another company.

This characterization of an activity as insurance or noninsurance business, based on whether it is a passive investment or an active trade or business, is to apply only with respect to the determination of the amount of the special life insurance company deduction (and small life insurance company deduction) and the computation of LICTI, and is not intended to be used for purposes of determining whether a company is a life insurance company for tax purposes. Qualification as a life insurance company will be determined under rules similar to those of present law.

d. The small life insurance company deduction

House bill

Under the House bill, small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction also is based on tentative LICTI, and applies before the special life insurance company deduction. The amount of the deduction is 60 percent of so much of tentative LICTI for such taxable year as does not exceed $3 million, reduced by 15 percent of the excess of tentative LICTI over $3 million.

As in the case of the special life insurance company deduction, the small life insurance company deduction is computed by treating all life insurance companies that are members of the same controlled group as one company whether those companies join in the filing of a consolidated return or file separate returns.

The small life insurance company deduction is only allowable to companies with gross assets of less than $500 million. The asset qualification for the small company deduction is determined on the basis of a controlled group as defined in section 1563.

Senate amendment

The Senate amendment is the same as the House bill, except that for 1984, only the assets of controlled group members that can be classified as financial intermediaries (e.g., insurance companies, banks, savings and loans, finance companies, securities brokers, and similar institutions), will be aggregated for purposes of the $500 million asset test if certain requirements are met. Also, the modifications to the definition of tentative LICTI described above (item d.) apply for purposes of the small life insurance company deduction.

Conference agreement

The conference agreement follows the Senate amendment.

e. The alternative life insurance company deduction

House bill

No provision.

Senate amendment

In lieu of both the special life insurance company deduction and the small life insurance company deduction, a company can elect (subject to certain special rules), for 1984 through 1987, to claim the alternative life insurance company deduction. The amount of the alternative deduction for any year is determined in part as a percentage of the combined special and small life insurance company deductions and in part a percentage of the qualified first-year premium amount. The amount of the alternative deduction will converge over five years to the sole use of the special and small life insurance company deductions. After 1987, there will be no alternative deduction.

The qualified first-year premium amount means 20 percent of premiums for certain newly issued ordinary life and individual accident and health insurance contracts. Also, the amount of qualified premiums must be reduced by the amount of premiums for reinsurance ceded.

Conference agreement

The conference agreement follows the House bill.

3. Policyholders' surplus accounts

Present law

Present law permits stock life insurance companies to defer the tax on 50 percent of their gain from operations in excess of their taxable investment income. The deferred income is added to a policyholder's surplus account, along with amounts deducted for nonparticipating contracts and group life and accident and health insurance contracts. Amounts in the policyholders' surplus account are taxed only when distributed by the company to its shareholders. To

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determine whether amounts have been distributed, a company must maintain a shareholder's surplus account which generally includes the company's previously taxed income and certain nontaxable items that would be available for distribution to shareholders. Distributions to shareholders are treated as being first out of the shareholders' surplus account, then out of the policyholders' surplus account and finally out of other accounts.

House bill

In general, the House bill eliminates any further deferral with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholders' surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders' surplus account under rules comparable to those provided under the 1959 Act, but which reflect the basic changes in the tax structure under the bill.

Specifically, for each taxable year, the excess of the sum of the following amounts over the taxes paid for the year will be added to the shareholders' surplus account: (1) LICTI (determined without regard to any distributions from the policyholders' surplus account); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the deduction allowed the company for intercorporate dividends received; and (5) excluded tax-exempt interest.

Senate amendment

The Senate amendment is the same as the House bill, except it also contains a special provision to relieve a company from tax on a distribution from a policyholders' surplus account due to a reduction of premium volume brought about by a reinsurance transaction ordered by the Federal Reserve Board.

Conference agreement

The conference agreement follows the House bill.

The conferees understand that the rules governing distributions from the policyholders' surplus account have been altered somewhat to reflect the general structure and goals of the new bill. However, the shareholders' surplus account will continue to be maintained as an account of certain positive additions representing items that can be characterized generally as previously taxed or nontaxable amounts that would be available for distribution to shareholders before requiring a distribution from the policyholders' surplus account. Thus, for these purposes, the item of LICTI added to the shareholders' surplus account can never be less than zero. Also, the conference agreement makes it clear that when there are distributions from the policyholders' surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of amounts in the policyholders' surplus account for the benefit of shareholders) is taxed in addition to LICTI and not as part of the LICTI computation. Thus, distributions from the policyholders' surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

4. Computation of reserve deductions

Present law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. A life insurance company's tax reserves are based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflects an increase in its statutory reserves over its statutory reserves for the prior year. Reserves computed for statutory purposes on a preliminary term basis may be revalued to a net level premium basis using either an exact revaluation method or an approximate revaluation method.

House bill

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. In computing the net increase or net decrease in reserves, the House bill specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

Computation of reserves.—For purposes of determining life insurance company taxable income, the House bill provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on an aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualifying supplemental benefit or qualifying substandard risk.

The House bill requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioner's standard tables for mortality or morbidity.

Reserve method.—With respect to the reserve method to be used, the House bill prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued. For noncancellable accident and health insurance contracts, a 2-year full preliminary term method is required. Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract.

There is a special rule for any company domiciled in a State which, in determining minimum reserves for an annuity contract for State purposes, does not reduce the reserves for surrender charges. The bill provides that if a State has continuously pursued this practice since September 27, 1983, then any life insurance company domiciled in that State may adjust its Federally prescribed reserves by taking into account the reasonable surrender charge.

There is also a special rule which allows a company to use the net level premium reserve method for tax purposes for noncancellable accident and health insurance contracts, if the company was using that method for statutory reserves on such contracts as of December 31, 1982, and continues to do so for annual statement purposes for such noncancellable accident and health contracts.

Senate amendment

The Senate amendment is generally the same as the House bill, except that it does not include the special reserve rule for annuity contracts if the State of domicile requires that reserves be computed without reduction for surrender charges. It also does not include the special rule that allows companies to use the net level method for noncancellable accident and health insurance contracts under certain circumstances.

In addition, the Senate amendment specifies that the reserve methods prescribed for tax reserves do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under present law or whether the NAIC prescribed method would otherwise require a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).

Finally, the amendment differs from the House bill in that it provides a special rule for contracts issued before January 1, 1989 under plans of insurance in existence on March 15, 1984, for purposes of computing tax reserves with respect to riders for term life insurance and annuity benefits. Term life insurance and annuity benefits included in insurance contracts will be treated as qualified supplemental benefits, for purposes of allowing the tax reserve to be computed for such benefits as though each benefit were a separate contract. However, such benefits will not be treated as qualified supplemental benefits for purposes of using the statutory reserve as the tax reserve for such benefits.

Conference agreement

The conference agreement generally follows the Senate amendment, but also includes the special rule that allows a company which computed all its noncancellable accident and health contract reserves on a net level basis for State purposes to continue to do so for tax purposes also. The conferees wish to clarify that a company can use the net level reserve method for tax purposes for noncancellable accident and health contracts sold under a particular plan of insurance, if the company computed all its reserves for such contracts on that method for statutory purposes as of December 31, 1983 (as evidenced by its 1983 annual statement, as originally filed) and continues to do so for all such reserves on both new and existing business. If the company was not using a net level reserve method as of December 31, 1983, with respect to contracts sold under a particular plan of insurance, the company must use the generally prescribed reserve method (2-year full preliminary term method) for all contracts under the plan. Likewise, the generally prescribed method must be used for noncancellable accident and health insurance contracts sold under any new plans of insurance.

In adopting the Senate amendment with respect to the computation of annuity reserves, the conferees understand that the practices of the various States differ on

whether surrender charges should be taken into account (and reduce the amount of the reserve) and that the matter is currently being considered by the NAIC for a recommendation. In light of these events, the conferees intend that, in the case of annuity reserves, if the NAIC in 1984 clarifies what surrender charge factors are to be disregarded (and not to reduce the amount of the reserve) under the CARVM, then this clarification is to be considered in effect on the date of issuance of such contracts. The conferees recognize that giving retroactive effect to a NAIC recommendation in this instance is an exception to the general rule that reserves must be computed for tax purposes under the method prescribed by the NAIC (or the prevailing State interpretation thereof) in effect on the date of issuance of the contract.

Also, the conference agreement adopts a special rule for purposes of identifying the prevailing interest rate with respect to life insurance reserves on noncancellable accident and health insurance contracts (e.g., the reserve in addition to the unearned premiums and unpaid losses on such contracts). Until States specifically prescribe an interest rate for these reserves, the conference agreement provides, that, because of the analogous character of these reserves to reserves on ordinary life policies, the prevailing interest rate for reserves on life policies will be used.

Finally, the conference agreement adopts a transitional rule for recomputation of reserves for group contracts if the issuance date (or the date benefits were guaranteed) cannot be determined. In such a case, the issuance date must be determined on the basis prescribed by Treasury. It is anticipated that Treasury will develop some method for approximating the date of issuance that generally reflects the pattern of growth in the type of group business.

5. Variable contracts

Present law

In general, either a variable annuity [1] or a variable life insurance contract is a contract under which any amounts or premiums received are invested in a separate asset account of the insurance company, and the amounts paid in or paid out reflect the investment return and the market value of such separate account. Under a variable annuity, either the cash surrender value before the annuity starting date or annuity payments made after the annuity starting date (or both) reflects the investment activity of the separate account; under a variable life insurance contract, the cash surrender value and the amount of death benefit fluctuates with the investment activity of the separate account.

Generally, income on an annuity contract is taxed only once, at the policyholder level when the income is distributed. This is accomplished by means of a deduction at the company level for amounts credited to policyholders under annuity contracts. However, under present law, income on a nonqualified variable annuity (i.e., one that is not purchased as part of a qualified pension plan) may be taxed at the company level as well as at the policyholder level. Under separate accounting provisions of present law, amounts credited to the holder of a nonqualified variable annuity based on appreciation in the value of the separate asset account are not deductible by the company. Thus, under present law, the company pays a tax at a capital gains rate on the sale of an appreciated asset, without an offsetting deduction for the income credited to the contractholder. When the income is distributed, it is taxable as ordinary income to the contractholder. The result is that amounts credited to a variable annuity that reflect the appreciation in the value of assets in the separate accoiunt are taxed once at the company level at the capital gains rate and once to the contractholder as ordinary income. This consequence was recognized as appropriate in 1959 and again in 1962,[2] although it was eliminated for qualified pension contracts in 1962.

The special provisions described above do not cover the newer variable life insurance contracts. In the case of such accounts, there is no company level tax on amounts credited to contractholders that reflect the appreciation of the assets in the underlying separate account. Further, the company is allowed an ordinary deduction for such appreciation, whether realized or unrealized, when it is credited to the variable life insurance contract (and is reflected in reserves or the cash surrender value) and is taxed at the capital gains rate on the appreciation income when it is realized upon sale of the asset.

House bill

The House bill continues to provide special rules for variable annuities and contracts with reserves based on segregated asset accounts and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year. This adjustment in computing the annual increase or decrease in reserves for variable contracts results in the capital gain or loss being recognized and taxes at both the company level and the policyholder level, since no adjustment is made in either the company's basis or the policyholder's investment in the contract.

The House bill also continues the separate accounting requirements under present law for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to variable contracts. Likewise, the equity base of the separate account will be determined under the separate accounting requirement and aggregated with the company's average equity base for its general account business.

Senate amendment

The Senate amendment is the same as the House bill with respect to the separate accountng requirements for segregated accounts and variable contracts. However, the company's basis in the assets underlying all variable contracts will be adjusted for appreciation or depreciation, to the extent the reserves are so adjusted. Thus, the corporate level capital gains tax is eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under present law.

The Senate amendment also permits the Treasury to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. If the segregated asset account does not meet the prescribed diversification standards, then a variable contract based on the account will not be treated as an annuity, endowment or life insurance contract for purposes of subchapter L (relating to taxation of insurance companies), section 72, and section 7702(a) (relating to the definition of a life insurance contract). There is an exception from the general investment diversification provisions for a segregated asset account used for variable life insurance contracts, if the account invests only in securities issued by the United States Treasury. Also, a company can use an independent investment advisor with respect to the segregated asset accounts underlying any of its variable contracts.

Conference agreement

The conference agreement generally follows the Senate amendment, but further defines the range of the diversification requirement within which Treasury has authority to set standards. Specifically, the conference agreement provides that any fund that is at least as diversified as the requirements of a regulated investment company under section 851(b) will be considered to be adequately diversified without further showing, if the fund has no more than 55 percent of its assets held in cash, cash items, Government securities, or securities of other regulated investment companies. The exception that allowed variable life insurance to be based on a fund fully invested in securities issued by the Treasury continues to be provided. In addition, the conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available.

In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment would be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (e.g., stocks, bonds, or certificates of deposits of a single issuer); (2) that invest in one or a relatively small number of publicly available mutual funds; (3) that invest in one or a relatively small number of specific properties (whether real or personal); or (4) that invest in a nondiversified pool of mortgage type investments. This new diversification authority is not intended to allow the imposition of any requirement that the investment fund reflect a diverse range of investment goals (e.g., short-term/long-term, or fixed income/equity securities need not be mixed in a single fund). This diversification requirement will not apply to funds underlying pension plan contracts defined under new section 818. The conference agreement also clarifies that a variable contract will cease to be treated as an annuity, endowment or life insurance contract when and if the underlying fund fails to be adequately diversified.

In addition, Treasury will have regulatory authority (under an amendment to sec. 514) to subject to tax the assets of a segregated asset account if the account is used to circumvent the acquisition indebtedness rules.

[1] The term variable annuity is used generally to refer to a contract which reflects the investment activity of a company and also a contract that reflects the investment return and market value of a segregated asset account within a company, although the latter may be referred to more specifically as "a contract with reserves based on a segregated asset account." See present-law sec. 801(g).

[2] S. Rep. 291, 86th Cong., 1st Sess. 36 (1959); and S. Rep. 2109, 87th Cong., 2d Sess. 7-8 (1962).

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6. Policyholder dividends

Present law

In general, under present law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language has been expanded in regulations so that the term policyholder dividends generally refers to amounts returned to policyholders that are not fixed in the contract and depend on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term does not include excess interest even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of management.

Under present law, policyholder dividends are accounted for on a reserve basis, and a company is allowed to deduct additions to its policyholder dividend reserves for dividends that are payable during the year following the taxable year.

House bill

The House bill adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) when the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds.

As under present law, the House bill allows a deduction for dividends or similar distributions to policyholders. The bill departs from present law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of the increases in the reserves for policyholder dividends that are payable during the year following the taxable year. Under the fresh start transitional rule, this change from a reserve to an accrual method is not to be treated as a change in a method of accounting. Thus, no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

7. Reduction of certain deductions of mutual companies

Present law

Under present law, policyholder dividends paid by mutual and stock life insurance companies are deductible at the company level. Special rules apply, however, to limit the amount of this deduction. Under the 1959 Act, the policyholder dividend deduction is limited to the excess of gain from operations over taxable investment income, plus $250,000. TEFRA adopted, for 1982 and 1983, a more generous limit on policyholder dividends, allowing either (1) an amount computed under the 1959 Act rule with the $250,000 statutory amount increased to $1 million, phasing down to zero as the sum of the company's policyholder dividends and other special deductions increased from more than $4 million to $8 million, or (2) an amount equal to the statutory amount (as modified), plus 100 percent of dividends on nonpension business, plus 77½ percent of nonpension policyholder dividends for mutual companies (85 percent for stocks).

House bill

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, the amount of the deduction for mutual companies is reduced by the "differential earnings amount." If the differential earnings amount exceeds the allowable deduction, then such excess will reduce the closing balance of the company's reserves. This reduction reflects recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners. Thus, the bill recognizes an ownership differential between policyholders of mutual and stock life insurance companies.

The "differential earnings amount" is computed by multiplying the company's average equity base for the taxable year by the "differential earnings rate" for the taxable year. The differential earnings rate is the excess of the "imputed earnings rate" over the "average mutual earnings rate". The "imputed earnings rate" is set in the Code, and subsequently adjusted in accordance with future changes in the average earnings rate of the 50 largest stock life insurance companies.

The House bill provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds a percentage of assets that is approximately 130 percent of the arithmetic average equity base to asset ratio of the 50 largest mutual life insurance companies, (as determined by the Secretary using the most recent data available). A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. However, in no event can the amount of any excess not taken into account exceed $50 million in 1984. The amount of any excess equity not taken into account in applying the differential earnings rate, as well as the $50 million cap, will decrease ratably each year, until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate.

Senate amendment

The Senate amendment is the same as the House bill except in three instances. First, the amendment contains a special transition rule for determining the average equity base of a life subsidiary of a mutual life insurance company issuing excess interest life insurance contracts. Second, a special rule is provided for certain mutual life insurance companies that are successor companies to fraternal benefit societies. Third, the amendment has the same transition rule for high surplus mutual life insurance companies except it does not have a $50 million cap on the amount of excess surplus that can be taken into account.

Conference agreement

The conference agreement follows the House bill and the Senate amendment with respect to the general rules for the ownership differential. In order to simplify the administration of the ownership differential provisions for the initial years covered by the bill, the conference agreement substitutes a fixed differential earnings rate of 7.8 percent to be used for purposes of filing returns for the 1984 tax year and for estimated taxes for 1985. Likewise, in order to eliminate distortions in the computation of the average earning rate of the 50 largest stock companies, the Secretary will have the authority to omit aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being or is insolvent). The conference agreement also clarifies that Treasury has authority under section 6001 to require the relevant stock or mutual life insurance companies to submit information returns from which Treasury will be able to ascertain data necessary for it to implement the ownership differential provisions, even with respect to tax years ending before 1984.

In determining the average equity base to which the differential earnings rate is to apply, both the House bill and the Senate amendment provide that voluntary reserves are to be treated as part of equity. The conferees wish to clarify that this reference to voluntary reserves is not limited to reserves for potential or unaccrued liabilities relating to insurance contracts. It is anticipated that Treasury regulations will provide guidance for classifying reserves as voluntary. For example, a reserve for Federal taxes may be in whole or in part a voluntary reserve. If the reserve is for a Federal income tax liability that might arise in the future if certain items are identified on audit, such a reserve will be treated as a voluntary reserve because liability for those amounts is contingent on detection of the tax issue, assertion of a deficiency, and resolution of the issue. If the reserve is for taxes accrued and payable on the due date of the return for the year, it will not constitute a voluntary reserve. In cases that are less clearcut, such as when the reserve is for deficiencies that have been asserted after audit, the Secretary will have authority to give further guidance on whether the reserve is voluntary.

The conference agreement adopts the Senate amendment for a transitional rule for certain mutual life insurance companies with life subsidiaries issuing excess interest life insurance contracts. In doing so, the conferees wish to clarify that this special provision is limited to the sale of such contracts under plans to insurance in existence on July 1, 1983, and that for these narrow purposes any change in the contract that requires approval by the State insurance department or that changes the form and timing of amounts credited will be considered a change in the plan of insurance. Thus, a company cannot change a traditional participating policy with policyholder dividends payable on the policy anniversary to an excess interest contract with excess interest guaranteed for a period in advance in order to qualify for the special transition rule for excess interest life insurance contracts.

The conference agreement adopts the Senate amendment with respect to mutual successors to fraternal benefit societies and extends the rule to apply to mutual life insurance companies that assumed the surplus of such an organization in March 1961, as well as in 1950.

The conference agreement follows the Senate amendment with respect to the transitional rule for high surplus mutual life insurance companies. Also, it clarifies that the amount of excess equity taken into account by any mutual life insurance company for any year (before being phased down ratably over the 5-year period of the transitional rule) cannot exceed the amount of the excess equity determined for 1984. The conference agreement simplifies the administration of the high surplus transitional rule by adopting fixed percentages to be used in lieu of computing 130 percent of the average equity to asset ratio of the 50 largest mutual life insurance companies to determine the excess equity threshold. These are: 14.5 percent for taxable years beginning in 1984; 14.0 percent for taxable years begin-

ning in 1985 and 1986; and 13.5 percent for taxable years beginning in 1987 and 1988.

For purposes of determining whether a company is a high surplus company and the amount fo excess equity, the assets taken into account in the equity to asset ratio include all assets (e.g., certain nonadmitted assets) taken into account in determining its equity base and for purposes of the rules for the treatment of stock companies owned by mutual life insurance companies. Thus, all the assets of any life insurance subsidiary whose equity is included in the equity of the parent mutual company, as well as any assets of separate asset accounts, are included in assets for purposes of applying the high surplus transitional rule. Payables and receivables between the parent and life subsidiaries should be ignored, while the same items between the parent and a nonlife subsidiary should be taken into account. Also, the rule against double counting should be observed generally in this area. Thus, for example, if a company purchases bonds at the end of the year and carries a suspense account for the amount of the consideration to be transferred, the value of the bonds should be included in assets and the amount of the suspense account should not.

8. Operations loss deduction

Present law

Generally, operations losses may be carried back to each of the 3 taxable years preceding the loss year and may be carried over to each of the 15 taxable years following the loss year. For a life insurance company that qualifies as a new company in the loss year, the 3-year carryback may be added, instead, to the 15-year carryover.

House bill

The operations loss deduction provided in the House bill is substantially the same as that in section 812 in present law and new section 810 is treated as a continuation of present-law section 812. Modifications are made that will conform the definition of an operations loss deduction to the new method for determining life insurance company taxable income. In both the bill and present-law section 812, the operations loss deduction is consistent with the general treatment for a net operating loss in section 172.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

9. Accounting provisions

Present law

Generally, under present law, all computations entering into the determination of life insurance company taxable income are to be made under an accrual method of accounting or, to the extent permitted under regulations, under a combination of an accrual method with any other recognized method other than the cash receipts and disbursements method. Except as provided in the general rule, all such computations are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

When two or more related parties (within the meaning of sec. 1239) are parties to a reinsurance agreement, present law gives the Secretary authority to allocate or recharacterize any items necessary to reflect the proper source and character of the taxable income of each related party.

Also, there was a temporary rule (adopted under TEFRA) for computing reserves on contracts where interest is guaranteed beyond the end of the taxable year; any interest which is computed at a rate which is in excess of the lowest rate assumed in the contract and is guaranteed beyond the end of the taxable year is taken into account in computing reserves as if such interest were guaranteed only up to the end of the taxable year.

Finally, under present law there are specific rules for the amortization of premium and accrual of discount on bonds and for life insurance companies with short taxable years.

House bill

The House bill retains the general rule in present law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the bill makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules.

In the case of reinsurance agreements, the House bill expands the reallocation authority granted Treasury. As under present law, in the case of a reinsurance agreement between two or more related persons, the Treasury can allocate among the parties and recharacterize income, deductions, assets, reserves, credits, and any other items related to the reinsurance agreement in order to reflect the proper source and character of the items for each party. Under the bill, however, related parties are defined as they are in section 482. Also, Treasury can use its recharacterization authority for a reinsurance agreement between unrelated parties where one of the parties to the agreement (with respect to any contract covered by the agreement), in effect, is an agent of, or conduit for, another party to such agreement. Treasury's new allocation and recharacterization authority will apply to any contract issued before September 27, 1983, which is reinsured before such date under a reinsurance agreement entered into before such date.

Finally, the House bill includes, as a permanent provision, the accounting rule adopted as a temporary provision in TEFRA for computing reserves for contracts that guarantee excess interest beyond the end of the taxable year. Under the bill, the provision is modified to reflect the new Federally prescribed reserve rules.

With respect to the special rules for amortization of premium and accrual of discount on bonds, and short taxable years for life insurance companies, the House bill makes no change from present law.

Senate amendment

The Senate amendment is the same as the House bill except that it further clarifies Treasury's new allocation and recharacterization authority so that it specifically applies to reinsurance agreements between unrelated parties if one of the parties to the agreement is an agent for another party to the agreement or is a conduit between related persons. The Senate amendment also has a different effective date for the new authority; it will apply to any risk reinsured after September 27, 1983, whether or not the reinsurance agreement was entered into before such date.

Conference agreement

The conference agreement generally follows the Senate amendment, but further extends Treasury's authority to examine reinsurance transactions by adopting an additional provision covering transactions between unrelated parties. Thus, under the conference agreement there are two rules which permit the Secretary to make adjustments in reinsurance transactions to prevent tax avoidance or evasion.

The first provision is a modified form of the provision in the Senate amendment permitting reallocations in related party reinsurance transactions to reflect the proper source and character of income. Under the conference agreement, if 2 or more related insurance companies enter into a reinsurance contract, the Secretary may allocate between or among such companies income, deductions, assets, reserves, credits and other items related to the agreement or may recharacterize such items. The Secretary also may make any other adjustment or recharacterization for one or both parties (if the transaction has unrelated parties acting as agents or conduits for another) necessary for these purposes. This authority is generally similar to that provided under section 482 for the Secretary to make correlative adjustments between related parties, except that the authority extends to a broader class of items and may be exercised whenever it is necessary to reflect the proper character and source of item.

Under the second provision of the conference agreement, if the Secretary determines that a reinsurance contract between unrelated insurance companies has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. This unrelated party reinsurance rule differs from the general related party reallocation authority in that before making adjustments under this second rule the Secretary must determine that there is a "significant tax avoidance effect" to the reinsurance agreement as opposed to meeting the lower standard of "necessary to effect the proper source and character of the taxable income." Any transaction which would be within the scope of the unrelated party rule but for the fact that the parties are related, would be within the scope of the related party reinsurance rule. On the other hand, a transaction which would not give rise to adjustments if entered into by unrelated parties might result in adjustments as among related parties.

The operative standards for both of the reinsurance adjustment provisions are objective tests of (1) whether adjustments are necessary to more properly reflect income or (2) whether the transaction has a significant tax avoidance effect. The motivations of the parties is wholly irrelevant in making this determination. The fact that a transaction has a business purpose or was not entered into with tax avoidance or evasion as a principal purpose or is entered into at arm's length will not foreclose Treasury from examining a reinsurance transaction under either the provision dealing with related parties or the new provision in the conference agreement dealing with unrelated parties.

In the case of a reinsurance transaction between unrelated parties, the determination of a significant tax avoidance effect for one party to a reinsurance contract, for example, together with any adjustments deemed proper by the Secretary (including deemed termination of the contract), will not require that any correlative adjustments be made to the other party to the contract. Also, the adjustment authority under either reinsurance provision can be exercised with respect to any transaction characterized as reinsurance or insurance by the parties. The exercise of such authority will not preclude the Treasury from also questioning whether the transaction consti-

tutes insurance or reinsurance for other purposes.

In general, whether a reinsurance contract has a tax avoidance effect with respect to any party should be determined by reference to the effect (with respect to one or both parties) in the current year or any other year, after taking into account the time value of money. A tax avoidance effect may arise, for example, when the reinsurance contract artificially reduces a company's equity, changes the source or character of any item, defers taxation of income items, eliminates the "SRLY taint" of a previous net operating loss, artificially transfers tax benefits between taxpayers in different tax brackets, or effectively extends a carryover period. A tax avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties. There is no significant tax avoidance effect for a reinsurer, however, merely because a tax reduction arises from a loss on the reinsurance contract for a particular year, if the loss experienced was no greater than if the reinsurer had written the allocable portion of the reinsured business directly.

In making the determination whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, the Secretary should examine the economic substance of the transaction, taking into account factors such as those described below. These factors may suggest that a significant tax avoidance effect exists for either or both of the parties, but none alone will be determinative.

First, the duration or age of the business reinsured should be taken into account because it bears directly on the issue of whether significant economic risk is transferred between the parties. For example, the coinsurance of new contracts may carry a risk of lapse as well as the mortality risk of the underlying contracts; thus, there may be a significant economic risk that the reinsurer will not realize its share of the potential profits of the underlying contracts. On the other hand, the reinsurance of an old block of business, for which the risk of lapse is minimal, may not result in a significant economic risk being transferred between the parties in proportion to the tax benefits enjoyed.

Second, the character of the business reinsured should be taken into account in determining whether the tax benefits of any party are disproportionate to the risk transferred. For example, coinsurance of yearly renewable term life insurance will generally not have significant tax avoidance effect for the parties to the transaction because it does not involve the transfer of long-term reserves as under the coinsurance of ordinary life insurance.

Third, the structure for determining the potential profits of each of the parties and any experience rating should be considered by Treasury. If the experience rating formula results in the reinsurer receiving only an annual risk premium, plus a fixed fee, the transaction might be viewed as economically equivalent to yearly renewable term reinsurance combined with a financing arrangement between the ceding company and the reinsurer. However, if the experience rating formula results in the reinsurer assuming a risk of loss beyond the annual mortality risk, as well as enjoying a share of the profits commensurate with its loss exposure, such a factor may indicate that tax benefits arising from the assumption of reserve liabilities by the reinsurer are not disproportionate to the risk transferred between the parties.

Fourth, the duration of the reinsurance agreement between the parties should be considered. The fact that there has been a longstanding agreement for automatic reinsurance of certain types of policies would tend to indicate that there is no significant tax avoidance effect when a coincidental tax benefit is enjoyed by a ceding company because income arising from the reinsurance transaction offsets an expiring loss carryover. On the other hand, even a longstanding agreement may be ignored if the experience rating formula in effect allows the parties to tailor income, expense, and profit allocation on an individual contract basis.

Fifth, the parties' rights to terminate the reinsurance agreement and the consequences of a termination should also be taken into account. For example, a contract may contain payback provisions to protect a reinsurer against termination of the reinsurance agreement after a large upfront ceding commission has been paid, but before the reinsurer has been able to enjoy the future profit stream. Such a provision may be a reasonable business practice and should not automatically be viewed as creating a tax avoidance effect. On the other hand, a payback provision which allows a reinsurer to recover all its losses in any case, through adjustments in future premiums or specific termination provisions, would indicate that the transaction is merely a financing arrangement.

Sixth, the relative tax positions of the parties is a factor that should be considered. The essential tax benefit or avoidance effect from a reinsurance transaction arises because income and deductions will have differing economic value depending on the tax bracket of the insurance company. For example, under the new life insurance provisions, bracket shifting is possible between small and large companies, as well as between profit and loss companies or between life and nonlife insurance companies.

Seventh, the general financial situations of the parties may be relevant. For example, surplus relief insurance for an otherwise insolvent insurance company tends to indicate that the transaction may not have a significant tax avoidance effect.

Taking into account the factors described above, and until Treasury regulations can be issued, the conferees believe there are certain kinds of reinsurance transactions which generally will not require Treasury to exercise its reallocation authority. First, yearly renewable term reinsurance will not require adjustments for the parties, to the extent it requires only the payment of a premium for the annual risk and no sharing of expenses. Second, coinsurance of annual renewable term life insurance will generally not require adjustments, because it requires the transfer of an annual risk premium and a sharing of expenses, but does not involve the transfer of long-term reserves. Third, a coinsurance contract covering new business of the ceding company and which allocates expenses and income items between the ceding company and the reinsurer in the same proportion as the allocation of the risk reinsured generally will not require adjustment by Treasury. The same will be true with respect to the reinsurer for the coinsurance contract entered into to cover existing business, if the initial ceding commission is reasonable in reflecting the proper allocable share of past expenses of the ceding company and any premium that might be paid by the reinsurer to the ceding company that reflects anticipated profitability of the reinsured business. The conferees anticipate that the Treasury will provide more guidance in regulations under these provisions. To the extent that future regulations in these areas are inconsistent with the above-described specific examples of situations that will not require Treasury to exercise its adjustment authority, the conferees intend that those regulations have effect only prospectively.

The provision for related party reinsurance is effective with respect to risks reinsured on or after September 27, 1983. The provision for unrelated party reinsurance is effective with respect to risks reinsured after December 31, 1984. For these purposes, a risk is not considered reinsured prior to the time it arises under the contracts covered by the reinsurance agreement. The conference agreement also clarifies that both the reinsurance provisions will apply to reinsurance transactions between insurance companies taxable under subchapter L.

10. Definition of company's share and policyholders' share

Present law

Under present law, all items of investment yield (i.e., gross investment income, including tax-exempt interest and dividends received, less certain investment expenses) are allocated between the policyholders and the company. Amounts allocated to policyholders are not included in taxable investment income or gain from operations. Generally, this allocation is accomplished by means of a proration formula which, in general, compares amounts credited to policyholders to investment yield. The practical effect of the proration formula is to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.

House bill

The general concept that items of investment yield should be allocated between policyholders and the company has been retained from present law.

Specifically, under the House bill the policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. The company's share of net investment income is the excess of net investment income over the sum of (1) the deductible portion of policyholder dividends and (2) all amounts in the nature of interest paid or credited to policyholders as customers pursuant to insurance or annuity contracts (including all pension plan contracts).

Under the House bill, net investment income is defined as the excess of gross investment income over investment expenses. Gross investment income is generally the same as under present law, and includes tax-exempt interest. However, gross investment income does not include dividends, received from a subsidiary which are eligible for the 100 percent dividends received deduction (or which would have been eligible for the 100 percent dividends received deduction if the recipient were not a foreign corporation) except to the extent such dividends are paid, directly or indirectly, out of tax-exempt income. Investment expenses are defined as the sum of the direct investment expenses plus an allocable share of the general expenses. General expenses of the life insurance company must be allocated to gross investment income in the same proportion as gross investment income for the taxable year bears to the gross receipts for the taxable year. For purposes of this formula, general expenses are indirect expenses not directly allocable to investment income or underwriting income.

Senate amendment

The Senate amendment is generally the same as the House bill but has a proration fraction that will be simpler to compute. Under the amendment, net investment income is defined as 90 percent of gross investment income. Also, the company's share of net investment income is the excess of net investment income over the sum of: (1) required interest for reserves; (2) any excess interest; (3) any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract for employees not yet retired or to a deferred annuity contract before the annuity starting date; and (4) a fraction of the deductible portion of policyholder dividends (not including any amounts previously included under (1), (2) or (3) or any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

Conference agreement

The conference agreement follows the Senate amendment.

11. Foreign tax credit

Present law

Life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid or accrued to a foreign country ("foreign tax credit").

The Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. To calculate U.S. taxable income and foreign taxable income, which is necessary to compute the limitation, all deductions must be allocated against gross income, and apportioned against gross U.S. income or gross foreign income. Expenses that are properly allocated or apportioned to a class of U.S. (or foreign) source income reduce gross income in that category (sec. 861(b), 862(b), and 863; Reg. sec. 1.861-8). Expenses that cannot definitely be allocated to a class of gross income are generally deducted ratably from all classes of gross income.

House bill

Under a general rule, the House bill provides that in calculating U.S. source income and foreign source income, three items will be treated under regulations as items which cannot definitely be allocated to an item or class of gross income, but will be allocated ratably among all classes of gross income. These items are policyholder dividends (determined under new section 808(c)), reserve adjustments (under subsections (a) and (b) of new section 807), and death benefits and other amounts described in new section 805(a)(1).

Also, taxpayers will be able to elect to treat the expenses that are the subject of the general rule of the bill as properly apportioned or allocated among items of gross income in the manner and to the extent prescribed in regulations. The election will apply for all taxable years of the taxpayer to which the bill applies. It must be made on or before September 15, 1984. Once made, it will be irrevocable, except with the consent of the Commissioner.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment, but changes the date by which the foreign tax credit election must be made to September 15, 1985, so that the election may be made on the return for the first year to which the new rules apply.

12. Foreign life insurance companies' minimum surplus

Present law

A foreign corporation carrying on an insurance business within the United States, that would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. A special rule may alter the U.S. tax on foreign life insurance companies doing business in the United States when they hold a relatively small surplus attributable to the U.S. business in the United States. If the foreign insurance company's surplus held in the United States is less than a specified minimum amount, then certain deductions of the company are decreased to reflect imputed earnings on any deficiency in surplus compared to the specified minimum surplus.

House bill

The House bill generally retains the Secretary's ratio adjustment, with modifications. A foreign company taxable as a life insurance company must compare its surplus held in the United States to a required surplus computed under the new statute. If the required surplus exceeds the actual surplus, the company must increase its income by the product of that excess and its current investment yield.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

13. Contiguous country branches of U.S. life insurance companies

Present law

U.S. corporations are taxable on worldwide income, including foreign income (although the foreign tax credit may offset U.S. tax on foreign income). In general, foreign corporations (even those wholly owned by U.S. persons) are not subject to U.S. tax on foreign income. Foreign branch operations of U.S. taxpayers generally are subject to tax currently. Generally, a U.S. mutual life insurance company may elect to exempt the income of its branches that operate in Canada or Mexico so long as the foreign branch does not repatriate its income to the United States. Repatriation of contiguous country branch income results in an increase in life insurance company taxable income. In this respect, the treatment of contiguous country branches corresponds generally to the treatment of foreign subsidiaries of U.S. parent companies.

House bill

The House bill retains the contiguous country branch rule of present law, with technical modifications.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

14. Rules relating to capital gains and losses

Present law

With respect to property used in a trade or business and held for more than 12 months, present law provides, in general, that if the gains from the sale or exchange of such property exceed such losses, then the net gain is treated as not being from the sale or exchange of a long-term capital asset. If the losses exceed the gains, then the net loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

In the case of life insurance companies, a special rule applies which modifies the general rule by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Further, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business is treated as including only property used in carrying on an insurance business.

In both cases, the term "property used in carrying on an insurance business" means only those assets used in the operation of the insurance trade or business.

Under present law, the amount of gain that is recognized on the sale or other disposition of certain property acquired before December 31, 1958 is limited. In the case of property acquired after December 31, 1958, having a substituted basis (within the meaning of sec. 1016(b)), the limitation on the gain recognized shall apply if the property or properties were held only by life insurance companies during the relevant periods. The term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221 relating to stock in trade or inventory-type property.

House bill

The House bill continues the present-law treatment relating to capital gains and losses and gains and losses on property used in the trade or business for life insurance companies and continues the current distinction between indemnity and assumption reinsurance arrangements.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

15. Technical and conforming amendments

House bill

The House bill contains 27 technical changes to the provisions of the Internal Revenue Code of 1954 outside of Part I of subchapter L to conform the existing provisions of the 1954 Code to the new single phase tax system adopted for life insurance companies under the bill.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

16. General effective date

House bill

Generally, the life insurance company taxation provisions apply to taxable years beginning after December 31, 1983.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

17. Transitional rules

a. Reserves computed on a new basis

House bill

As of the beginning of the first taxable year after December 31, 1983, the reserve for any contract shall be recomputed as if the amendments made in the House bill had applied to such contract when it was issued. This provision applies to reserves held by any company taxable under subchapter L of the Code (relating to the taxation of insurance companies).

Any change in accounting (e.g., in computing the policyholder dividends deduction) or any change in the method of computing reserves which is required by the House bill will not be treated as a change in the method of accounting or in the method of computing reserves, and will not give rise to income or loss. This "fresh start" provision will apply only to life insurance companies and solely to changes made between any company's first taxable year beginning after December 31, 1983, and the preceding taxable year.

Senate amendment

The Senate amendment is generally the same as the House bill, except it clarifies how a nonlife insurance company should recompute life insurance reserves and extends the "fresh start" benefits to any insurance company required to recompute reserves under the new provisions.

The Senate amendment provides that a company with less than $500 million in assets may elect not to recompute its reserves for existing business and may use instead statutory reserves for such business for tax purposes. If a company has made this election, and also qualifies for the full small company deduction, it may also elect to compute tax reserves for contracts issued after 1983 and before 1989 according to a formula that adjusts statutory reserves depending on the difference between the prevailing interest rate and the assumed interest rate.

Conference agreement

The conference agreement follows the Senate amendment, with the modification that the election not to recompute life insurance reserves for existing business is limited to companies with less than $100 million in assets.

b. Allocation of the "fresh start" in certain cases

House bill

No provision.

Senate amendment

The Senate amendment allocates the "fresh start" benefit between the ceding company and the reinsurer with respect to reserves subject to a coinsurance agreement entered into during 1982 or 1983. Generally, the "fresh start" benefit is allocated by income recognition or deductions upon termination of the reinsurance agreement, making the amounts under the allocation reflect the duration of the agreement between the parties after 1983.

Conference agreement

The conference agreement follows the Senate amendment with certain technical clarifications.

c. Denial of "fresh start" in certain cases

House bill

The "fresh start" rule is not applicable to any recomputation of reserves transferred pursuant to a reinsurance agreement entered into, modified or terminated after January 1, September 27, 1983, and before January 1, 1984. The bill also provides that if expenses have been transferred between insurance companies pursuant to a reinsurance agreement that is entered into, modified, or terminated after September 27, 1983 (and before January 1, 1984), any income attributable to those expenses and taken into account in a later year cannot be taken into account for purposes of determining the amount of the special life insurance company deduction and the small life insurance company deduction. Also, the "fresh start" rule does not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Senate amendment

The Senate amendment does not deny the benefits available under the "fresh start," per se, but shifts the tax effects of certain events occurring between the announcement of the "fresh start" proposal and the effective date of the bill. Specifically, the Senate amendment provides that, for purposes of computing life insurance company taxable income, a reinsurance agreement entered into or a modification to a reinsurance agreement (to the extent of the modification) made after September 27, 1983 (and before January 1, 1984), will not be taken into account until January 1, 1984. Likewise, any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984, will not be taken into account until January 1, 1984.

For these purposes, the phrase "any reserve strengthening" includes the computation of reserves on contracts issued in 1983, under plans of insurance in existence on September 27, 1983, on a more conservative basis than was the customary practice of the company for similar contracts, or to the strengthening of reserves for tax purposes, generally, on existing business. Reserve strengthening for tax purposes resulting from a proper election under section 818(c) of present law will be eligible for a fresh start if more than 95 percent of the section 818(c) amount arises from risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

Conference agreement

The conference agreement follows the House bill with respect to the denial of the "fresh start" for reserves transferred pursuant to the entering into or the modification of a reinsurance agreement entered into after September 27, 1983, and before January 1, 1984, as well as for reserve strengthening claimed after September 27, 1983, for a taxable year ending before January 1, 1984. It does not deny a "fresh start" for reserves transferred because of a termination of the reinsurance agreement during the proscribed period. The conference agreement follows the Senate amendment with respect to the statutory definition of reserve strengthening and the exception therefrom for certain proper elections under section 818(c) of present law.

For situations in which there is a denial of the "fresh start," the conference report provides specific rules for how the amount arising from the recomputation of reserves will be taken into account. Generally, the amount will be taken into account ratably over 10 years, unless a 10-year spread would not have been applicable under the 1958 Act. Thus, any decrease in reserves attributable to the section 818(c) revaluation that is not allowed under the required reserve recomputation of the bill will be taken into account in the first taxable year beginning after December 31, 1983. Also, any amount included in income as a decrease in reserves, and any income attributable to expenses transferred in connection with a proscribed transfer of reserves, will not be taken into account for purposes of determining the amount of the special and small life insurance company deductions.

Finally, the conference agreement follows the substance of the Senate amendment with respect to the denial of the deductions for nonparticipating contracts and accident and health insurance and group life insurance contracts, if those deductions arose from the entering into or the modification of a reinsurance agreement during the proscribed period. Rather than denying such deductions by treating the proscribed reinsurance activities as occurring in the 1984 tax year, the conference agreement denies the deductions for the 1983 tax year.

18. Special rules

House bill

If, prior to January 1, 1984, an election is made to treat income from an installment obligation as investment income, any income from such obligation will be treated as attributable to a noninsurance business.

The House bill provides that, in certain specific cases, involving the acquisition of one or more insurance companies (after 1979 and before April 1, 1983), if certain tests are met, then the tentative LICTI of the corporation holding the assets for taxable years 1984 and 1985 will be increased by the deduction allowable for the amortization of the cost of insurance contracts acquired in the acquisition and for any portion of any operations loss deduction attributable to such amortization.

Finally, the House bill provides that any company that has been operating for a 10-year period ending on December 31, 1983, as a hybrid company (i.e., as a mutual life insurance company with shareholders), will be treated as part stock and part mutual life insurance company.

Senate amendment

The Senate amendment is the same as the House bill with respect to the treatment of installment contracts. It is the same as the House bill with respect to the treatment of amortization of expenses for certain acquisitions of insurance companies between 1979 and April 1, 1983, but the provision is limited in its application to certain acquiring life insurance companies domiciled in Texas, Alabama and Oklahoma, and the benefit is extended to all taxable years after December 31, 1983. The Senate amendment treats a hybrid life insurance company as a stock life insurance company.

Finally, the Senate amendment has a special provision to treat the ownership of certain stock as noninsurance business for purposes of computing tentative LICTI if the stock was acquired through debt financing.

Conference agreement

The conference agreement follows the House bill and Senate amendment with respect to the treatment of installment contracts.

It follows the Senate amendment with respect to the treatment of amortization of expenses for certain life insurance company acquisitions between 1979 and April 1, 1983, but with the modification that to be eligible to use the special rule a company must be domiciled or have its principal place of business in Alabama, Arkansas, Oklahoma, or Texas.

The conference agreement adopts a similar rule for a company with certain losses on guaranteed interest contracts used in pension business by allowing a deduction of those losses after the computation of the special and small life insurance company deductions. The losses arise in situations in which a company has guaranteed a long-

term interest rate and intended to meet the obligation by matching the interest rate guarantee with investments in discounted bonds, relying on both the current income of the bond and the amount of the discount to be realized at capital gain rates. To the extent the guaranteed interest rate exceeds the current income of the discounted bond, the company is allowed a deduction after the special and small life insurance company deductions at a full 46 percent tax rate in order to maintain the economics of the transactions with respect to existing guarantees. The rule is narrowly drawn because of special reliance on present-law tax rules (i.e., the pricing reflected in expected tax savings) in structuring the transaction. Moreover, the amount of tax benefit that can be enjoyed because of this rule is limited to $4.5 million in 1984, $4.5 million in 1985, $3.0 million in 1986, $2.0 million in 1987, and zero for 1988 and thereafter.

Also, the conference agreement follows the substance of the Senate amendment with respect to the treatment of certain ownership of stock acquired through debt financing, requiring that the income and deductions related to such stock ownership also be taken into account after computation of the special and small life insurance company deductions (without any loss limitations).

Finally, the conference agreement adopts the Senate amendment with respect to hybrid life insurance companies.

19. Waiver of estimated tax penalty

Present law

Corporate taxpayers are required to pay tax quarterly on an estimated basis. In the case of an underpayment of estimated tax, an additional amount is due, determined at the deficiency interest rate on the amount of the underpayment for the period of underpayment.

House bill

The House bill is the same as present law.

Senate amendment

Any penalty for underpayment of estimated tax by an insurance company, for any 1984 period, is waived to the extent the underpayment is due to changes from present-law tax provisions that are made retroactive by the effective date of the bill.

Conference agreement

The conference agreement follows the Senate amendment.

B. Taxation of Life Insurance Products

1. Definition of a life insurance contract

Present law

Generally, there is no statutory definition of life insurance under present law, except for purposes of tax-free exchanges. Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, but it is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

In TEFRA, Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life) qualified as life insurance contracts for purposes of the exclusion of death benefits from income. Violation of the guidelines at any time during the contract causes the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

House bill

The House bill adopts a definition of a life insurance contract for purposes of the Internal Revenue Code. This provision extends to all life insurance contracts rules that are similar to, but narrower than, those contained in the temporary provisions of TEFRA.

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes (e.g., the cash value accumulation test must be met (at all times) by the terms of the contract). For purposes of applying the definitional tests, computational rules and adjustment rules are specifically provided.

If a contract fails to meet either of the alternative tests, the contract will be treated as a combination of term life insurance and a currently taxable fund.

The provision is effective for contracts issued after December 31, 1983. Contracts issued during 1984, will qualify (1) if they meet the present-law flexible premium contract tests (whether or not they are flexible premium contracts); (2) if not flexible premium contracts, they would meet the new definition by substituting 3 percent for 4 percent in the cash value test and treating the maturity date as the latest permitted in the contract (but not less than 20 years after date of issue or age 95, if earlier); or (3) if they meet a statutory description of irreplaceable life. The House bill also has a transition rule or grandfather for certain 20-pay contracts issued under existing plans of insurance (as of September 28, 1983), which allows "3 percent" to be substituted for "4 percent" for purposes of meeting the cash value accumulation test.

Senate amendment

The Senate amendment is generally the same as the House bill, except for certain technical clarifications in the computational rules, and for differences in the treatment of failing contracts and in the effective date provisions.

Contracts that fail are treated as a combination of term life insurance and an annuity as of the date of failure; upon failure, an excise tax of 10 percent of the net surrender value of the contract is imposed on the company.

The definition is effective for contracts issued after December 31, 1984, except increasing death benefit policies (1) issued under post-March 14, 1984, plans of insurance, or (2) having premium funding more rapid than 10-year level premiums, for which the definition is effective January 1, 1984. A special rule allows the sale of certain single premium increasing death policies until June 1, 1984, where face amount is $5,000 or less, and there is no more than 1 policy sold per customer. There is an extension of the flexible premium contracts provision for 1 year.

The Senate amendment has the same provision for grandfathered contracts under existing plans of insurance as in the House bill.

Conference agreement

The conference agreement generally follows the House bill and the Senate amendment, with the technical clarifications in the computational rules of the Senate amendment. It follows the House bill with respect to the consequences of failing to meet the definition of life insurance.

With respect to the effective date, the conference agreement follows the Senate amendment, adopting a general effective date that makes the new definitional provisions applicable to contracts issued after December 31, 1984. The new provisions will be effective for a contract issued after June 30, 1984, if the contract has an increasing death benefit and premium funding more rapid than 10-year level premium payments, unless the contract meets one of the three transition rules described in the House bill. Thus, present law applies through 1984 (with sec. 101(f) extended for the same period), except in the case of the above described increasing death benefit contracts.

There is an additional transition rule for certain increasing death benefit policies, which makes the new definitional provisions applicable only for a contract issued after September 30, 1984, if the contract would meet the new definition by substituting "3 percent" for "4 percent" in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges), and if (with the same "3 percent" for "4 percent" substitution) the cash surrender value of the contract does not at any time exceed the net single premium which would have to be paid at such time to fund future benefits at the then current level of benefits.

Finally, the conference agreement provides a transition rule for 20-pay qualified contracts that permits certain existing plans of insurance to be modified to permit the crediting of excess interest or similar amounts annually and not monthly, without forfeiting the grandfather provision.

2. Treatment of certain annuity contracts

Present law

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contract holder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder or as a payment under an annuity for life or at least 5 years. No income is recognized to the recipient of an annuity on the death of the contractholder. However, since the recipient has the same investment in the contract as the deceased contractholder, the recipient is subject to income tax on the income accumulated in the contract prior to death when it is distributed from the contract.

House bill

The House bill generally retains the present-law provisions for annuity contracts. However, the 5-percent penalty on premature distributions will apply to any amount distributed to the taxpayer, without regard to whether the distribution is allocable to an investment made within 10 years, unless the taxpayer owner has attained age 59½.

In the event that the owner of any annuity contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract shall be treated as paid to the contractholder immediately before death.

These provisions apply to contracts issued after the day which is six months after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill except in the event of the annuity owner's death before the annuity starting date. Under the Senate amendment, if the owner of any annuity contract dies before the annuity starting date, specific distribution rules will apply, depending on the decedent's beneficiary with respect to the contract. First, if there is a nonspousal beneficiary, the income in the annuity contract generally will have to be distributed within 5 years after the death of the owner. Second, if the decedent's spouse is the beneficiary, the annuity contract may be continued (together with deferral of tax on the accrued and future income under the contract) until distribution to or the death of the spouse. Third, if the beneficiary is a dependent minor child, the contract can be continued until the child reaches age 26. Fourth, if the beneficiary is a dependent handicapped individual, the contract can be continued until that individual reaches age 26, and then an annuity for the beneficiary can be commenced covering any period (including the life of the handicapped individual).

Conference agreement

The conference agreement follows generally the Senate amendment, but with some modifications to the rules for the treatment of annuity contracts in the event of the contractholder's death. These modified rules generally conform to those applicable to qualified pension plans and IRAs.

To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as the method of distribution in effect. If the contractholder dies before the annuity starting date, generally, the entire interest must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within 1 year after that date. If there is a spousal beneficiary upon the contractholder's death, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder.

As under both the House bill and the Senate amendment, the new provisions will be effective for contracts issued more than 6 months after enactment. For these purposes, an annuity contract issued in exchange for another will be considered a new contract subject to the new penalty and distribution-at-death rules. The grandfather provisions granted in TEFRA for amounts invested in or credited to investments in annuity contracts prior to August 13, 1982, continue in effect for purposes of applying the distribution of income-first rules applicable to annuity contracts.

The conference agreement also adopts a technical correction to the TEFRA annuity provisions which allows any investment in a multiple premium annuity contract (issued prior to the effective date of the new penalty provisions) to be treated as having been made on January 1 of the year of investment. This technical correction is intended to simplify the accounting requirements of the 10-year-aging rule in TEFRA for the penalty on early distributions from annuity contracts.

3. Policyholder loans

Present law

Under present law, no deduction is allowed for interest on policyholder loans made pursuant to a plan which contemplates systematic borrowing, or for interest on a loan incurred to purchase or carry a single premium life insurance contract. These rules do not apply if (1) 4 out of the first 7 annual premiums due are paid without borrowing, (2) the total interest subject to limitation is less than $100, (3) borrowing is incurred because of unforeseen substantial income loss or increased financial obligations, or (4) borrowing is incurred in a trade or business.

House bill

In addition to present law, the House bill provides an overall limitation for deduction of interest on policyholder loans. The amount of the limitation is equal to the deficiency interest rate times: (1) $250,000, for individuals; (2) $500,000, for joint returns; and (3) $500,000, for each qualified individual insured in a trade or business. A qualified individual is one who has whole life coverage of at least 10 percent of the amount of coverage on the individual with the greatest coverage. Generally, unused limitations may be carried over.

The new provision applies only to policies issued after September 27, 1983.

Senate amendment

The Senate amendment does not alter present law.

Conference agreement

The conference agreement follows the Senate amendment.

4. Certain exchanges of insurance policies

Present law

Under present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date or for an annuity contract; or (3) an annuity contract for an annuity contract. For purposes of this exchange rule, an endowment contract or life insurance contract with a life insurance is defined, in part, as a contract with a life insurance company (as defined for tax purposes).

House bill

The House bill does not alter present law.

Senate amendment

The Senate amendment changes the definition of an endowment contract and a life insurance contract to include contracts issued by any insurance company taxable under subchapter L of the Code, rather than just by life insurance companies. The amendment will be effective as if included in the Internal Revenue Code of 1954.

Conference agreement

The conference agreement follows the Senate amendment.

5. Group-term life insurance purchased for employees

Present law

The cost of group term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. This rule does not apply to former employees because of retirement or disability. An employer may provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (based on the uniform cost table).

House bill

The House bill effects three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also will apply to retired as well as active employees. Second, the nondiscrimination rules will be applied to plans covering retired employees. Third, under the House bill, if a plan fails to qualify for the exclusion because it is discriminatory, then the employees and retirees will have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury.

The provisions are effective for taxable years beginning after December 31, 1983. However, the new provisions do not apply to individuals covered by plans of group-term insurance in existence on September 27, 1983 (or comparable successor plans) to the extent of their coverage guaranteed for retirement on that date.

Senate amendment

The Senate amendment is generally the same as the House bill with a specific clarification that the cost of the group-term life insurance coverage will be included in the income of a retired employee for the year in which the coverage is received, whether or not the benefit of retirement coverage vests upon retirement.

However, the Senate amendments make the provisions applicable to taxable years that begin after December 31, 1983, but not to any group-term life insurance plan in existence on January 1, 1984 or to any group-term life insurance plan of the employer (or successor employer) which is a comparable successor to an existing plan, with respect to an individual who retires under the plan and who attained age 55 on or before January 1, 1984. The provision for nonapplication of the new provisions will not itself apply to any plan which is discriminatory after March 15, 1987, with respect to any individual retiring after that date.

Conference agreement

The conference agreement generally follows the Senate amendment. By adopting the Senate amendment, including the clarification of when the group-term life insurance benefit for a retired employee is included in income, the conferees do not intend to affect in any way the determination of whether the form of the benefit received by an employee upon retirement constitutes group-term life insurance for purposes of section 79.

However, the conference agreement does modify the nonapplicability provision for existing plans. That is, the new provisions will not apply to any group-term life insurance plan in existence on January 1, 1984 (or to any comparable successor plan), but only with respect to those individuals who retire under the plan, who were employed during 1983 by the employer having the plan, and who attained age 55 on or before January 1, 1984. The new provisions do not apply to any employees who retired before January 1, 1984. Also, the nonapplication provision will not apply to any plan that is

discriminatory after December 31, 1986, with respect to any individual retiring after that date.

C. Studies

Present law

No specific provision.

House bill

The bill requires that certain studies and reports be made on revenue, segment balance and other issues arising under the new life insurance tax provisions. These reports are to be made by Treasury in consultation with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation.

The final report is to be submitted by January 1, 1989, to the House Committee on Ways and Means and the Senate Committee on Finance. Interim reports are to be submitted to the committees not later than July 1, 1986, 1987, and 1988.

Senate amendment

The Senate amendment is the same as the House bill, except that consultation is not required.

Conference agreement

The conference agreement follows the House bill. The conferees wish to emphasize that in preparing this report, the Treasury should give specific attention to the revenue impact of allowing consolidated returns to be filed by life insurance companies with nonlife or noninsurance companies. Likewise, the conferees intend that the general authority granted to Treasury to gather information to study the revenue effect and assess the tax policy adopted under the insurance provisions be used to gather information on the volume and use of policyholder loans so that the committees will have useful information for future legislative work in that area.

III. CHARITABLE DEDUCTION RULES; PRIVATE FOUNDATION PROVISIONS; EXEMPT ORGANIZATIONS

A. General

Charitable Deduction Rules

1. Public charities

Present law

Contributions of cash or ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's contribution base for the year (adjusted gross income, with certain modifications). Contributions in excess of this limitation, or of the 30-percent limitation applicable to gifts by individuals of capital-gain property to such charities, may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (Code sec. 170).

House bill

No provision.

Senate amendment

The Senate amendment increases to 60 percent the present-law 50-percent limitation on the deductibility by individuals of certain charitable contributions, and extends to 15 years the present-law five-year carryover period for certain excess contributions.

This provision applies to contributions made after December 31, 1984. Carryovers of excess pre-1985 contributions to post-1984 years remain subject to the present-law carryover period and deduction limitations.

Conference agreement

The conference agreement does not include the Senate amendment.

2. Nonoperating (grant making) foundations

Present law

In general, all contributions to private nonoperating foundations are deductible up to 20 percent of the donor's contribution base for the year, with no carryover of excess contribution amounts.

The amount deductible for contributions of appreciated capital-gain property to nonoperating foundations equals the donor's basis in the property plus 60 percent of the appreciation (i.e., 60 percent of the excess of fair market value over the donor's basis). Contributions of such property to public charities or operating foundations are deductible at full fair market value (subject to a special rule for unrelated-use tangible personal property).

House bill

The House bill increases the percentage limitation on deductibility of contributions of cash or ordinary-income property to nonoperating foundations (and of certain other charitable contributions) to 30 percent of the donor's contribution base, effective for contributions made after 1984. The bill retains the 20-percent limitation for all gifts of capital-gain property except such gifts to public charities or private operating foundations. Thus, gifts of capital-gain property to private nonoperating foundations (including gifts of certain appreciated stock which are deductible under the bill at fair market value) remain subject to the 20-percent limitation. Also, excess post-1984 contributions are eligible for a five-year carryover.

The House bill generally allows a deduction at full fair market value for contributions, made after 1984 and before 1995, to nonoperating foundations of up to 10 percent of the stock of a corporation for which (as of the contribution date) market quotations for the stock are readily available on an established securities market.

Senate amendment

Under the Senate amendment, the income tax treatment of contributions by individuals to private nonoperating foundations is the same as that of contributions by individuals to public charities or operating foundations, effective for contributions made after the date of enactment.

Conference agreement

The conference agreement follows the House bill, with modifications to the effective date. The percentage limitation and carryover provisions of the bill apply to contributions in taxable years ending after the date of enactment. The provision on deductibility of contributions of certain stock applies to such contributions made after the date of enactment and before January 1, 1995.

3. Expansion of circumstances in which a deduction may be claimed for qualified conservation contributions

Present law

Subject to certain limitations as to amount and type of property interest, present law provides a deduction for contributions of property to charitable organizations, to the United States, or to a State or local government. Charitable deductions are provided for income, gift, and estate tax purposes (Code secs. 170, 2055, and 2522).

Gifts of less than the donor's entire interest in property are subject to special restrictions. An exception to these restrictions is provided in the case of qualified conservation contributions. One of the requirements for a qualified conservation contribution to be tax-deductible is that surface mining be precluded on the land with respect to which the contribution is made.

House bill

No provision.

Senate amendment

The Senate amendment provides that deductions are allowable for qualified conservation contributions of property even though surface mining is not precluded if two conditions are satisfied. First, the surface and mineral estates in the property must have been separated at all times after June 12, 1976. Second, the probability of surface mining occurring on the property must be so remote as to be negligible.

This provision is effective for contributions made after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

4. Collection of amounts for U.S. Olympic Committee

Present law

There is no procedure under present law for collecting amounts for nongovernmental organizations through Federal tax returns.

House bill

No provision.

Senate amendment

Individuals may forego $1 of their income tax refund ($2 on a joint return), or may pay an additional $1 in tax ($2 on a joint return), to be transferred, less collection costs, by the Treasury to the U.S. Olympic Committee. No charitable deduction is allowed in either situation. A U.S. Olympic Trust Fund is established to administer the funds.

This provision is effective for returns filed for 1984 through 1988.

Conference agreement

The conference agreement does not include the Senate amendment.

5. Charitable expense deduction for use of passenger automobile

Present law

In determining the amount of charitable contribution deduction attributable to use of a car in providing services to a charity, a taxpayer may deduct actual "out-of-pocket" expenses (Treas. Reg. sec. 1.170A-1(g)). Alternatively, the taxpayer may use a standard mileage rate; at present, this rate is set by the IRS at nine cents a mile (Rev. Proc. 82-61, 1982-2 C.B. 849). Under either computation method, the taxpayer may also deduct parking fees and tolls, but may not deduct general repair or maintenance expenses, depreciation, insurance, registration fees, etc.

House bill

No provision.

Senate amendment

The standard mileage rate used in determining the amount of a taxpayer's charitable contribution deduction for the use of a passenger automobile in performing donated services, if the actual expense method is not used, is increased to 12 cents a mile. (As with the present mileage rate, the taxpayer may also deduct parking fees and tolls, but may not also deduct general repair or maintenance expenses, depreciation, insurance, registration fees, etc.) The deduction is allowable, as in the case of other types of charitable contributions, only if verified pursuant to Treasury regulations (sec. 170(a)(1)).

The provision is effective for taxable years beginning after 1984.

Conference agreement

The conference agreement follows the Senate amendment.

B. Private Foundation Provisions

1. Exemption for certain operating foundations from excise tax on investment income

Present law

Private foundations are subject to a two-percent excise tax on their net investment income for the taxable year (Code sec. 4940).

House bill

The House bill provides that a private operating foundation (such as a museum or library) which previously had been publicly supported for at least 10 years (or qualified as an operating foundation on January 1, 1983), which has a governing body broadly representative of the general public (with at least 75 percent consisting of persons unrelated to the foundation), and none of whose officers otherwise are disqualified persons, is exempt from the two-percent excise tax on net investment income, effective for taxable years beginning after 1984, and that post-1984 grants to such foundation are not subject to the expenditure responsibility rules.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

2. Reduction in excise tax on investment income if charitable payout increases

Present law

Private foundations are subject to a two-percent excise tax on their net investment income for the taxable year (Code sec. 4940).

House bill

Under the House bill, the excise tax on investment income is reduced to one percent for the year if the foundation's payout for charitable purposes (computed on a five-year average) is increased by an equivalent amount, effective for taxable years beginning after 1984.

No provision.

Conference agreement

The conference agreement follows the House bill.

3. Limitation on grant administrative expenses as qualifying distributions

Present law

A private nonoperating foundation generally must make charitable payouts ("qualifying distributions") at least equal to five percent of the fair market value of its net investment assets (Code sec. 4942). Administrative expenses incurred in making grants to other charities or in directly carrying on charitable activities count, without limitation, toward satifying the payout requirement, and hence may reduce the amounts which the foundation actually distributes to charitable beneficiaries.

House bill

The House bill provides that the amount of administrative expenses incurred by a foundation in making qualified grants or contributions can be counted toward satisfying the charitable payout requirement only up to 15 percent of the amount of qualified grants or contributions made by the foundation, computed on the basis of a five-year average.

The limitation does not apply to administrative expenses incurred by a foundation directly for the active conduct by the foundation of exempt activities of the foundation. The term "directly for the active conduct" of exempt activities has the same meaning as in section 4942(j)(3)(A) and the Treasury regulations thereunder, but disregarding the special allocation rule in Treas. Reg. sec. 53.4942(b)-1(b)(1) which states that for purposes of the definition of operating foundations under section 4942(j), all reasonable administrative expenses necessary to conduct a foundation's exempt activities, regardless of whether incurred directly for the active conduct of such exempt activities, are treated as qualifying distributions expended directly for the active conduct of such exempt activities.

The grant administrative expense provision is effective for taxable years beginning after 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill, with modifications. The conferees believe that a reasonable limitation should be placed on the extent to which grant administrative expenses may be counted in satisfaction of the payout requirement, in order to ensure that more foundation expenditures actually reach charitable beneficiaries. Under the conference agreement, foundations must actually pay out amounts equal to 4.35 percent of its payout base (net investment assets) as grants or contributions, program-related investments (sec. 4944(c)), expenditures directly for the active conduct by the foundation of exempt activities of the foundation, or qualified administrative expenses incurred directly in making such direct operating expenditures or program-related investments.

Under the conference agreement, (1) the limitation on the amount of grant administrative expenses which may be counted as qualifying distributions is expressed as 0.65 percent of net investment assets (i.e., of the minimum investment return base as computed under sec. 4942(e)), computed on the basis of a three-year average; (2) a conforming change is made in the transitional rule applicable with respect to pre-1985 base period years; (3) it is clarified that qualified administrative expenses incurred directly in making such program-related investments (within the meaning of sec. 4944(c)) are not subject to the limitation; and (4) the limitation will not apply to taxable years beginning after December 31, 1990. Also, the general definition of qualifying distributions in section 4942(g)(1)(A) is amended by substituting "(including that portion of reasonable and necessary administrative expenses)" in place of "(including administrative expenses)".

In addition, the IRS is authorized and directed by the Congress to modify the foundation information return (Form 990-PF) as soon as practicable to require additional and more detailed information on expenditures by nonoperating and operating foundations, both by categories of expenditures (such as grants, direct operating expenditures, program-related investments, other investments, administrative expenses, etc.) and by types of administrative expenses (e.g., separate line items within each of such categories for salaries, rent, legal fees, accounting fees, consulting fees, utilities, traveling expenses, etc.). The revised form is to require the foundation to attach a statement of the accounting principles and practices by which it allocates administrative expenses among those which will satisfy the definition of qualifying distributions as modified by the bill (sec. 4942(g)(1)(A)) and other categories of administrative expenses.

The Treasury is to submit a study to the tax-writing committees by January 1, 1988 concerning administrative expenses incurred by nonoperating and operating foundations, on the basis of the revised forms. To the extent practicable, the study is to examine (a) the amount of qualifying distributions which actually reach charitable beneficiaries; (2) the administrative costs of such payouts; (3) the effect of the revised general definition (sec. 4942(g)(1)(A)) of those administrative expenses which are eligible to be qualifying distributions, subject to the new limitation; and (4) the additional information provided by the revised form concerning categories and types of administrative expenses, and the basis for allocating such expenses among categories of foundation expenditures. This study is intended to provide more detailed information concerning foundation administrative expenditures than is now available.

Also, the conferees clarified that the mere fact that a State attorney general, or other State government or official, has approved the amount of director fees or other expenditures by a foundation does not establish that such amounts or expenditures are reasonable or not excessive reasonable for purposes of any of the private foundation tax provisions.

Under section 170, contributions by individuals to private nonoperating foundations receive certain favorable treatment if the foundation makes qualifying distributions (which are treated as corpus distributions) equal to 100 percent of the amount of contributions received in the year within 2½ months after the close of that year (secs. 170(b)(1)(D), 170(e)(1)(B)). For purposes solely of determining qualifying distributions under these deduction rules relating to "conduit" foundations, the Treasury is authorized to prescribe by regulations that the grant administrative expense limitation is to be expressed as 15 percent of the amount of such pass-through contributions, and to prescribe in the regulations any necessary or desirable conforming and coordinating rules with respect to the section 4942 limitation which is expressed as a percentage of the foundation's net investment assets.

4. Technical amendments to charitable payout rules

Present law

In 1981, Code section 4942 was amended to define the required minimum payout as five percent of the value of the foundation's net investment assets (rather than the higher of that figure or net income). The 1981 amendment failed to add back to the newly defined payout amount the previously applicable modifications set forth in section 4942(f)(2)(C), relating to (i) repayment to the foundation of amounts previously treated as qualifying distributions (e.g., scholarship loans); (ii) amounts received on disposition of assets previously treated as qualifying distributions; and (iii) amounts previously set aside for a charitable project but not so used.

House bill

The House bill adds to the required minimum payout the amounts specified in Code section 4942(f)(2)(C) (certain loan repayments, proceeds from assets dispositions, and unused set-asides), effective for post-1984 taxable years. Also, the bill corrects certain cross-references, effective on enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference amendment follows the House bill and the Senate amendment.

5. Abatement of first-tier taxes in certain cases

Present law

Any violation of the private foundation rules (secs. 4941–4945) generally results in automatic imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation).

House bill

The House bill provides the IRS with discretionary authority to abate the automatic first-tier penalty taxes (other than the sec. 4941 tax on self-dealing) if the foundation establishes that the violation was due to reasonable cause and not to willful neglect, and corrects the violation. This provision applies to taxable events occurring after 1984.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

6. Modification to limitations on foundation support of voter registration drives

Present law

A foundation may support a section 501(c)(3) organization conducting a voter registration drive only if the tax-exempt organization conducting the drive meets certain support and expenditure requirements, and if the voter registration activities are nonpartisan, are not confined to one specific election period, and are conducted in at least five States (Code sec. 4945(f)).

House bill

Under the House bill, the five-State requirement is dropped, effective January 1, 1984; all other requirements of present law are retained (e.g., that the voter registration drive is nonpartisan and not confined to one election period).

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision.

7. Definition of disqualified persons

Present law

All lineal descendants (and their spouses) of a substantial contributor to a foundation themselves constitute "disqualified persons" (Code sec. 4946(d)). Status as a disqualified person is important because holdings of disqualified persons are aggregated with those of the foundation for purposes of the business holdings limitations, and because a disqualified person in precluded from engaging in certain business transactions with the foundation.

House bill

Under the House bill, lineal descendants more distant than great-grandchildren will not be treated as disqualified persons, effective January 1, 1985.

Senate amendment

Under the Senate amendment, lineal descendants more distant than grandchildren will not be treated as disqualified persons, effective January 1, 1985.

Conference agreement

The conference agreement follows the House bill.

8. Public disclosure requirements

Present law

A private foundation must publish annually a newspaper notice of availability of its annual return (Code sec. 6104). The notice must state the address of the foundation's principal office, but need not state its telephone number.

House bill

The House bill provides, effective January 1, 1985, that the annual newspaper notice required under Code section 6104 must contain the telephone number for the foundation's principal office.

Also, the IRS is directed to enforce fully the present-law rules relating to foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

9. Reliance on IRS classifications of donees

Present law

Treasury regulations and IRS rulings specify circumstances under which donor private foundations may rely on IRS classifications of donee organizations as public charities, so that the grantor need not exercise expenditure responsibility over grants to such donees.

House bill

There is no statutory provision in the House bill relating to reliance on IRS classifications of donees. However, the committee report directs Treasury to extend the advance ruling period during which qualifying new organizations are considered public charities to five years, and to amend its regulations to permit greater reliance on IRS classifications concerning new organizations in the first five years of their existence.

Senate amendment

The Senate amendment provides that a private foundation making a grant to a charitable organization may rely in specified circumstances on an IRS determination of the organization's public charity or operating foundation status, effective for grants made after 1984.

Conference agreement

The conference agreement follows the House directions to Treasury to extend the advance ruling period, and to amend its regulations to permit greater reliance on IRS classifications concerning new organizations in the first five years of their existence and in any other circumstances in which Treasury concludes that greater reliance is appropriate.

10. Expenditure responsibility rules

Present law

In the case of grants to organizations other than public charities, a private foundation must exercise "expenditure responsibility" over the grant (Code sec. 4945(d)). To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the IRS on the grants. Treasury regulations set forth guidelines under which donor foundations may satisfy the section 4945 rules.

House bill

There is no statutory provision in the House bill on expenditure responsibility rules. However, the committee report directs the Treasury Department to review its expenditure responsibility regulations for purposes of modifying any requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify the required grantor reports to the IRS.

Senate amendment

The Senate amendment is the same as the approach under the House bill.

Conference agreement

The conference committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, because the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects (which may operate to deter grants by some foundations to newly formed, community-based foundations), the conference agreement follows the approach under the House bill and the Senate amendment in directing the Treasury to review its expenditure responsibility regulations for purposes of modifying any requirements which are found to be unduly burdensome or unnecessary. As part of its review, the Treasury is to modify the required grantor reports to the IRS. The Treasury is to report to the tax-writing committees on its review and modifications.

11. Divestiture of post-1969 holdings acquired by gift or bequest

Present law

If a private foundation acquires, by gift or bequest after May 26, 1969, business holdings exceeding permitted limitations (generally, 20 percent), the foundation must reduce its holdings to the permitted level within five years (Code sec. 4943(c)(6)).

House bill

The House bill authorizes the IRS to allow an additional five-year period for disposition of an unusually large gift or bequest (after 1969) of either diverse or complex business holdings, on a showing by the foundation of diligent efforts to divest during the initial period but that divestiture had not been possible because of the size and complexity or diversity of the holdings. This provision applies with respect to business holdings as to which the initial five-year divestiture period ends after October 31, 1983.

Senate amendment

The Senate amendment generally is the same as the House bill. However, the Senate amendment adds as justifications for failure to divest within the initial period a Federal or State court order, or Federal or State law, which effectively precluded divestiture; also, the additional period is extended beyond five years if such a court order is then in effect. The Senate amendment requires that the divestiture plan be submitted to the relevant State attorney general.

Conference agreement

The conference agreement follows the House bill, with a modification adding the requirement in the Senate amendment that the divestiture plan must be submitted to the relevant State attorney general.

12. Divestiture of grandfathered business holdings of foundations

Present law

The Tax Reform Act of 1969 in effect generally limited the combined ownership of a business corporation by a private foundation and disqualified persons to not more than 20 percent of the voting stock (Code sec. 4943). Under transitional rules for divestiture of then existing holdings, the 1969

Act provided that if on May 26, 1969, a foundation (together with disqualified persons) had business holdings exceeding the limitations, the existing holdings generally could be retained, subject to gradual reduction over several phases.

Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation—

Ownership on 5/26/69:	Deadline to reach 50% combined holdings:
More than 95% by foundation alone.	May 26, 1989.
More than 75% combined holdings.	May 26, 1984.
More than 50% combined holdings.	May 26, 1979.

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do not own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock during the third (and final) phase.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

House bill

No provision.

Senate amendment

Under the Senate amendment, holdings acquired prior to May 27, 1969 in a business enterprise are exempt from the section 4943 divestiture rules if—

(1) the management of the foundation and the management of the business enterprise are sufficiently unrelated,

(2) no disqualified person who was not a foundation manager on March 12, 1984 can become a foundation manager after that date,

(3) no disqualified person receives compensation (other than reasonable director fees) from both the foundation and the business enterprise,

(4) the foundation continues to meet the charitable payout rules of present law, and

(5) the foundation and any disqualified persons comply with the section 4943 rules applicable to any holdings in the enterprise acquired after May 26, 1969.

This provision is effective on enactment.

Conference agreement

The conference agreement does not include the Senate amendment.

13. Exception to "downward ratchet" rule

Present law

Grandfathered excess business holdings are subject to reduction by operation of the "downward ratchet" rule (Code sec. 4943(c)(4)(A)(ii)). This rule, in effect, provides that if there is any reduction in the holdings of a private foundation or in combined private foundation/disqualified person holdings, then these holdings can never go up again to the former grandfathered or otherwise permitted level over 20 percent (35 percent, if applicable).

House bill

The House bill provides an exception to the downward ratchet rule under which certain reductions of less than two percent in a foundation's holdings are disregarded when resulting from certain issuances of stock (or stock issuances coupled with subsequent redemptions). This provision is effective for decreases and subsequent increases occurring after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

14. Eligibility for 20-year first phase

Present law

The 20-year first phase divestiture period for grandfathered holdings applies where the foundation itself held more than 95 percent of the stock of the business enterprise, but not where the 95-percent requirement can be met only by aggregating foundation/disqualified person holdings.

House bill

The House bill modifies the divestiture rules of present law to provide that the 20-year first phase period to reduce grandfathered excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969. This provision is effective on the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill, but clarifies that the provision is effective as if included in the Tax Reform Act of 1969.

Conference agreement

The conference agreement follows the House bill and the Senate amendment (with the effective date clarification in the Senate amendment).

15. Modification of second and third divestiture phases

Present law

During the second and third phases of the divestiture rules for grandfathered excess business holdings, private foundations have a lower limit (i.e., 25 percent of voting stock) for direct holdings if disqualified persons own more than two percent of the business enterprise. If disqualified persons first acquire more than two percent during those phases, present law does not permit any time for the private foundation to reduce its holdings to the lower limit and avoid excise taxes.

House bill

The House bill provides that if a private foundation's maximum business holdings must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than two percent of the business enterprise during either the second or third phase of the divestiture rules, the private foundation is given five years to dispose of the excess over 25 percent. This provision applies to acquisitions made after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

16. Technical correction in description of Herndon Foundation

Present law

The Tax Reform Act of 1969 permitted the Herndon Foundation to retain more than 50 percent of certain business enterprises.

House bill

The House bill makes a technical correction to clarify that the Herndon Foundation is permitted to continue to hold a majority of the stock of certain business enterprises. This provision applies as if included in section 101(*l*)(4) of the Tax Reform Act of 1969.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

17. Treatment of ESOP as disqualified person for section 4943 rules applicable to grandfathered buildings

Present law

The owner of more than 20 percent of a corporation which is a substantial contributor to a private foundation constitutes a disqualified person (Code sec. 4946(a)(1)(C)), and the stock it owns is therefore aggregated with that of the foundation for purposes of the section 4943 business holdings limitations.

House bill

No provision.

Senate amendment

An employee stock ownership plan described in Code sec. 4975(e)(7) is excepted from the definition of disqualified person, only for section 4943 purposes, with respect to grandfathered business holdings acquired pursuant to a pre-1969 will. This provision is effective for taxable years beginning after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

18. Exception to self-dealing rules for certain stock transactions

Present law

Present law in effect prohibits certain transactions between a private foundation and substantial contributors (or other disqualified persons), including the sale of property between a private foundation and a disqualified person and the lending of money or other extension of credit between a private foundation and a disqualified person (Code sec. 4941). Excise taxes are imposed for violations of these rules.

House bill

The House bill exempts from the self-dealing taxes certain 1978 transactions. Under the bill, Code section 4941 is not to apply in the case of the 1978 sale of stock of Murphy Motor Freight Lines, Inc. by the Wasie Foundation to Murphy Motor Freight Lines, Inc. and the related financing by the Wasie Foundation if the total consideration received (i.e., the sum of the cash and the value of the notes) equaled or exceeded the fair market value of the stock to Wasie Foundation. The provision applies retroactively for 1978 and subsequent years.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

19. Termination of status as substantial contributor

Present law

The term substantial contributor means a person whose contributions to a private

foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000. Once a person becomes a substantial contributor, that person retains that status forever (Code sec. 507(d)(2)).

House bill

The House bill provides rules under which a person's status as a substantial contributor terminates in certain circumstances after 10 years with no connection to the foundation, effective for post-1984 taxable years.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

C. Exempt Organizations

1. Acquisition indebtedness of certain educational institutions and organizations managing property for tax-exempt organizations; tax exemption for such organizations

Present law

Under present law, tax-exempt organizations (including qualified pension trusts and IRAs) generally are subject to tax on income from a trade or business unrelated to the organization's exempt purposes. Exclusions are provided for certain types of passive income.

Income that is subject to tax includes income from debt-financed property. An exception is provided to this rule for property acquired or improved by a qualified pension trust if the acquisition satisfies certain restrictions.

Present law provides that a company that holds title to property for a tax-exempt organization is entitled to tax exemption. However, present law is unclear as to whether a title-holding company may have more than one parent.

House bill

No provision.

Senate amendment

Unrelated business income tax on debt-financed property

The special exception to the debt-financed property rules is extended to certain educational institutions (and certain affiliated support organizations) and to certain tax-exempt title-holding companies that are granted tax-exempt status by the Senate amendment. However, in order for any organization (including a qualified pension trust) to qualify for the exception, two additional restrictions must be met. First, if the real property is acquired by a partnership, the exception does not apply to any partner unless each partner is an organization eligible for the exception. Second, no part of the financing of the acquisition can be provided by the seller.

The provision is effective with respect to indebtedness incurred after the date of enactment.

Title-holding companies

The Senate amendment provides tax exemption to a title-holding corporation that has more than one parent (and to trusts established for the same purposes), only if no individual who provides investment advice to the title-holding company is an officer, member of the board of directors, etc., of the company. Organizations eligible to invest in a title-holding company include (1) a qualified pension plan, (2) a governmental pension plan, (3) the United States, or any State or political subdivision, or (4) any charitable organization described in sec. 501(c)(3).

The provision is effective for taxable years beginning after December 31, 1984.

Conference agreement

Unrelated business income tax on debt-financed property

The conference agreement generally follows the Senate amendment with one exception. Under the conference agreement, an organization that is a partner in a partnership that holds real property can qualify for the exception to the tax on unrelated business income on debt-financed real property as long as (1) all of the partners of the partnership are organizations qualifying for the exception, or (2) each allocation to a partner of the partnership that is a qualified organization is a qualified allocation. For purposes of (1), an organization is not treated as a qualified organization if any of such organization's income is unrelated business taxable income determined without regard to sec. 514(c)(9).

Under the conference agreement, an allocation generally is a qualified allocation if it meets the rules relating to partnerships under the tax-exempt leasing provisions. Thus, a qualified allocation is an allocation under which (1) the qualified organization is allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property), (2) such share remains the same during the entire period that the organization is a partner, and (3) such allocation has a substantial economic effect, as defined under the rules applicable to partnership allocations generally (sec. 704(b)(2)).

The conference agreement authorizes the Treasury to prescribe regulations dealing with the effect of guaranteed payments (as defined in sec. 707(c)) under this rule. Under those regulations, priority cash distributions to partners that constitute guaranteed payments should not disqualify an otherwise qualified allocation so long as the priority cash distributions are reasonable in amount (e.g., equal to the most appropriate Federal rate) and are made to all partners in proportion to their capital in the partnership. On the other hand, the conferees expect that the regulations will prevent partnerships from avoiding the qualified allocation rules by making disproportionately large guaranteed payments to its tax-exempt partners for the use of their capital.

Under the conference agreement, a qualified organization includes a qualified pension trust (sec. 401) and certain educational organizations (and their support organizations).

The conference agreement provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of the unrelated debt-financed income provisions, including regulations to prevent the circumvention of these provisions through the use of segregated asset accounts. The conferees intend that such regulations shall be applied only with respect to transactions entered into after the date on which any regulations relating to this provision are issued.

The conferees intend that the rules of present law relating to the transfer of property with liabilities that exceed the transferor's basis in the property shall be applied to the transfers of property to a tax-exempt organization, particularly where such transfers are designed to avoid ordinary income recapture on the property.

Title-holding companies

The conference agreement does not contain the Senate amendment.

Effective dates

The conference agreement is generally effective with respect to indebtedness incurred after the date of enactment. Certain partnership transition rules are provided under the conference agreement.

2. Exemption for certain local organizations of police and firefighters

Present law

Under present law, certain local police and firefighter organizations in Minnesota that provide pension and other benefits to members have received IRS determinations providing exemption from Federal income tax.

House bill

No provision.

Senate amendment

The Senate amendment provides income tax exemption to an organization (other than a qualified pension plan) for police and firefighter organizations that provide benefits in lieu of government-funded benefits and that meet the requirements applicable to qualified pension plans maintained by a State or local government.

The provision is effective for taxable years beginning after August 23, 1981.

Conference agreement

The conference agreement does not include the Senate amendment. However, the conferees understand that the Internal Revenue Service will issue a revenue ruling that clarifies that the affected organizations are exempt from tax.

3. UBIT exemption for renting of membership lists by Federally chartered corporations

Present law

The U.S. Court of Claims held in a 1981 case that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of mailing lists is subject to the unrelated business income tax (UBIT). The court found that in renting its donor lists, the DAV operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that these rental activities were regularly carried on; and that the rental activities were not substantially related to accomplishment of exempt purposes (apart from the organization's need for or use of funds derived from renting the mailing lists). Similarly, the IRS has ruled that amounts received by an exempt charitable organization from the regular sale of its membership or mailing lists to business firms and charities are subject to the UBIT.

House bill

No provision.

Senate amendment

The Senate amendment provides an exemption from the UBIT for amounts received by certain Federally chartered corporations (named in 36 U.S. Code sec. 1101) for renting or exchanging lists of their donors or members with organizations contributions to which are eligible for charitable deductions, effective for taxable years ending after the date of enactment. The 60 some organizations benefitting from the provision include various veterans, scouting, scientific, and literary groups.

Conference agreement

The conference agreement does not include the Senate amendment.

4. Exemption from UBIT for certain gambling income

Present law

An exemption from the unrelated business income tax (UBIT) is provided for certain bingo games conducted by tax-exempt organizations (Code sec. 513(f)).

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House bill

The House bill extends the bingo exemption to certain games of chance which, under State law, can be conducted only by nonprofit organizations, effective for games of chance conducted after June 30, 1981.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

5. Tax treatment of certain nonprofit child care organizations

Present law

Nonprofit organizations which are organized and operated exclusively for charitable, educational, or other specified purposes, and which meet certain other requirements, are exempt from Federal income tax, and contributions to such organizations are deductible for income, gift, and estate tax purposes. The IRS has recognized that nonprofit day care centers may be eligible for tax exemption and tax-deductible contributions where enrollment is based on financial need of the family and the need of the child for the program, or where the center provides preschool age children of working parents with an educational program through a professional staff of qualified teachers.

House bill

Under the House bill, nonprofit organizations which provide care of children (away from their homes) are deemed to have a qualifying tax-exempt purpose if both (1) substantially all of the child care provided by the organization is for the purpose of enabling individuals (the parents) to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is effective for taxable years beginning after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment. The provision is not intended to affect the meaning of the terms "educational" or "charitable" for any purpose other than considering the child care organizations described in the provision as having educational purposes.

6. Church audits

a. Commencement of church tax inquiry

Present law

No special requirements are imposed before commencing an investigation or inquiry regarding church tax liabilities. Special requirements are imposed before the IRS may examine church books of account as defined under present law.

House bill

No provision.

Senate amendment

Under the Senate amendment, an investigation of church tax liabilities may be commenced only if the IRS regional commissioner reasonably believes, on the basis of facts and circumstances recorded in writing (1) that the church does not qualify for tax exemption as a church, or (2) that the church is engaged in taxable activities. Additionally, before commencing the investigation, the IRS is required to provide notice containing specified information to the church. This notice must contain (1) a list of Code provisions authorizing the investigation, (2) a general explanation of the church's administrative and constitutional rights in connection with the audit, and (3) an explanation of the concerns which gave rise to the investigation and the general subject matter of the investigation.

Conference agreement

Requirement of reasonable belief before commencing church tax inquiry

The conference agreement provides that the IRS may begin a church tax inquiry only if the IRS regional commissioner (or higher official) reasonably believes, on the basis of facts and circumstances recorded in writing, that the organization (1) may not qualify for tax exemption as a church, or (2) may be carrying on an unrelated trade or business (within the meaning of section 513 of the Code) or be otherwise engaged in taxable activities. A church tax inquiry is defined as any inquiry to a church (other than an examination) which serves as a basis for determining whether the organization qualifies for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters which do not primarily concern the tax status or liability of the church itself (as specified in the conference agreement).

The conferees intend that the facts and circumstances which form the basis for a reasonable belief under this provision will be derived from information lawfully obtained by the IRS. Information obtained from informants used by the IRS for this purpose must not be known to be unreliable.

Notice requirement upon commencement of inquiry

Under the conference agreement, upon beginning a church tax inquiry, the IRS is required to provide written notice to the church of the beginning of the inquiry. This notice is to include (1) an explanation of the concerns which gave rise to the inquiry and the general subject matter of the inquiry, (2) a general explanation of the provisions of the Internal Revenue Code which authorize the inquiry or which may otherwise be involved in the inquiry, and (3) a general explanation of applicable administrative and constitutional provisions with respect to the inquiry, including the right to a conference with the IRS before an examination of church records.

The explanation of the concerns and general subject matter of the inquiry (item (1) above) should be sufficiently specific to allow the church to understand the particular area of church activities or behavior which is at issue in the inquiry. For example, for an inquiry regarding unrelated business income, the notice should indicate the general activities of the church which may result in unrelated income (e.g., use of a particular property or facility for other than tax-exempt purposes). For an inquiry regarding tax-exempt status, the notice should indicate those general aspects of the church's operations or activities which have given rise to questions regarding its tax-exempt status. The IRS is not to be precluded from expanding its inquiry beyond the concerns expressed in the notice as a result of facts and circumstances which subsequently come to its attention (including, where appropriate, an expansion of an unrelated income inquiry to include questions of tax-exempt status, or vice-versa).

The notice requirement is not to be interpreted to require the IRS to share particular items of evidence with the church, or to identify its sources of information regarding church activities, where providing such information would be damaging to the inquiry or to the sources of IRS information. For example, in an inquiry regarding unrelated business income, the IRS might indicate that its inquiry was prompted by a local newspaper advertisement regarding a church-owned business; however, the IRS would not be required to reveal the existence or identity of any so-called "informers" within a church (including present or former employees).

The general explanation of applicable administrative and constitutional provisions (item 3) should make reference to the various stages of the church audit procedures contained in the conference agreement (including the right to a pre-examination conference) and the principle of separation of church and state under the First Amendment. The explanation is not required to explain the possible legal or constitutional ramifications of any particular church audit.

For purposes of this and the remaining church audit procedures, a church includes (1) any organization claiming to be a church or (2) a convention or association of churches. For purposes of these procedures, a church does not include church-supported schools or other organizations incorporated separately from the church.

b. Notice before examining church records

Present law

Under section 7605(c) of the Code and the regulations thereunder, the IRS may examine church books of account (generally, accounting and bookkeeping records) only if (1) the IRS regional commissioner believes that an examination is necessary, and (2) the IRS notifies the church at least 30 days prior to examination.

House bill

No provision.

Senate amendment

The Senate amendment broadens the present law rule to require a pre-examination notice containing specified information to be sent to the church. This notice is in addition to the notice of commencement of an investigation and must be provided not less than 15 days after the prior notice. As part of this second notice, the IRS must offer the church a pre-examination meeting to seek to resolve outstanding issues and an opportunity to request, under the Freedom of Information Act, copies of any materials in the possession of the IRS which are relevant to the investigation of the church. The church is to have 15 days (i.e., a minimum of 30 days after the notice of commencement of investigation) in which to request a pre-examination meeting, during which period the IRS is prohibited from examining church records. The IRS is also prohibited from examining church records until a meeting (if requested by the church) is held, or until any any Freedom of Information Act request by the church is granted or a final administrative denial of the request is made.

Concurrently with the notice of examination to the church, the IRS regional counsel must be notified of the proposed examination and has 15 days in which to file a nonbinding objection to the examination.

Conference agreement

Additional notice and offer of IRS conference

Under the conference agreement, the IRS may examine church records or religious activities only if, at least 15 days prior to the examination, the IRS provides written notice to the church and to the IRS regional counsel of the proposed examination.

This notice is in addition to the notice of commencement of inquiry previously provided to the church.

The notice of examination is required to include (1) a copy of the church tax inquiry notice previously provided to the church, (2) a description of the church records and activities which the IRS seeks to examine, and (3) a copy of all documents which were collected or prepared by the IRS for use in the examination, and which are required to be disclosed under the Freedom of Information Act (5 U.S.C. sec 552) as supplemented by section 6103 of the Code (relating to disclosure and confidentiality of tax return information). The conferees intend that the documents to be supplied under this provision will be limited to documents specifically concerning the church whose records are to be examined and will not include documents relating to other inquiries or examinations or to IRS practices and procedures in general. The conferees further specifically intend that disclosure to the church will be subject to the restrictions of present law regarding the disclosure of the existence or identity of informers. The description of materials to be examined in the notice of examination and the documents disclosed by the IRS to the church do not restrict the ability of the IRS to examine the church records or religious activities which are properly within the scope of the examination.

The conference agreement further requires the IRS regional commissioner, as part of the notice of examination, to offer the church an opportunity to meet with an IRS official to discuss the concerns which gave rise to the inquiry and the general subject matter of the inquiry. The organization may request such a meeting at any time prior to the examination. If the church requests a meeting, the IRS is required to schedule a meeting within a reasonable time and may proceed to examine church records only following the meeting. The conferees intend that the holding of one meeting with the church will be sufficient to satisfy the requirements of this provision. The conferees further intend that churches will not be able to utilize the meeting requirement in order to unreasonably delay an examination.

The purpose of a meeting between the church and the IRS is to discuss the relevant issues that may arise as part of the inquiry, in an effort to resolve the issues of tax exemption or liability without the necessity of an examination of church records. The conferees therefore intend that the church and the IRS will make a reasonable effort to resolve outstanding issues at the meeting. To avoid misunderstandings, the conferees intend that the IRS will remind the church at the meeting, in general terms, of the stages of the church audit procedures and the church's rights under such procedures. However, the IRS will not be required to reveal information at the meeting of a type properly excludable from a written notice (including information regarding the identity of third-party witnesses or evidence provided by such witnesses).

The notice of examination may be sent to a church not less than 15 days after the notice of commencement of a church tax inquiry. Thus, at least 30 days must pass between the first notice and the actual examination of church records. For example, if notice of commencement of an inquiry is sent to a church on day 1, notice of proposed examination may be sent to the church no earlier than day 15, and no examination of church records may be made prior to day 30. If an organization does not request a meeting prior to day 30, the IRS may proceed to examine church records. However, if the IRS does not send a notice of examination within 90 days after sending the notice of inquiry, the inquiry would be terminated. The conferees intend that this 90-day period be suspended during any period for which the two-year period for duration of a church audit (item (d) below) would be suspended; however, the 90-day period is not to be suspended because of the church's failure to comply with requests for information made prior to the notice of examination. If the inquiry is terminated under this provision, any further inquiry regarding the same or similar issues within a 5-year period would then require approval of the IRS Assistant Commissioner for Employee Plans and Exempt Organizations, as specified in the conference agreement.

Notification of regional counsel

At the same time as notice of an examination is provided to a church, the IRS is required to provide a copy of the same notice to the appropriate IRS regional counsel. The regional counsel is then allowed 15 days from issuance of the notice in which to file an advisory objection to the examination. (This is concurrent with the 15-day period during which the IRS is prohibited from examining church records pending a request for a conference.) The committee intends that the regional commissioner will take any objection by the regional counsel into account when determining whether to proceed with the examination.

c. Definition of protected church records

Present law

Church books of account may be examined only to the extent necessary to determine the amount (if any) of the tax liabilities of a church or its contributors or employees. Under IRS guidelines, books of account include accounting and bookkeeping records kept in the regular course of church business. The present law notice requirements are also limited to examinations of church books of account.

Third-party records (e.g., records held by a bank) are not subject to special scope or notice requirements. However, under general third-party summons rules (sec. 7609), the church must be notified before the IRS examines such records.

Present law provides that, when an organization claims to be a church, the religious activities of the organization may be examined only to the extent necessary to determine whether the organization actually is a church.

House bill

No provision.

Senate amendment

Under the Senate amendment, all regularly kept church corporate and financial records, including (but not limited to) corporate minute books, contributor or membership lists in the possession of the church, and church books of account, may be examined only to the extent necessary to determine tax. The special notice requirements under the amendment (items (a) and (b) above) apply to examinations of any such records. The scope and notice rules do not apply to records previously filed with a public official.

As under present law, third-party records are not specially protected. However, the Senate amendment prohibits the IRS from revoking a church's tax exemption or imposing tax on a church, on the basis of third-party records, without following the proper church audit procedures.

Conference agreement

The conference agreement provides that the IRS may examine church records only to the extent necessary to determine the liability for, and the amount of, any Federal tax. The conferees intend that, as under present law, this may include examinations (1) to determine the initial or continuing qualification of the organization whose records re being examined as a tax-exempt entity under section 501(c)(3); (2) to determine whether the organization qualifies to receive tax-deductible contributions (sec. 170(c); or (3) to determine the amount of tax, if any, which is to be imposed on the organization.

Church records include all regularly kept church corporate and financial records, including (but not limited to) corporate minute books, contributor or membership lists, and any materials which qualify as church books of account under present law. The conferees further intend that church records will include private correspondence between a church and its members that is in the possession of the church. Church records protected by the conference agreement do not include records previously filed with a public official or, as under present law, newspapers or newsletters distributed generally to the church members.

Records held by third parties (e.g., cancelled checks or other records in the possession of a bank) are not considered church records for purposes of the conference agreement. Thus, subject to the general Code provisions regarding third party summonses, the IRS is permitted access to such records without regard to the requirements of the church audit procedures (sec. 7609). As under present law, either the IRS or a third party recordkeeper generally is required, however, to inform a church of any IRS requests for materials.

The conference agreement provides that the IRS may not determine that a church is not entitled to an exemption or assess tax for unrelated business income against a church solely on the basis of third party records, without complying with the church audit procedures. This limitation does not apply to assessments of tax other than for unrelated business income (e.g., for social security or other employment taxes). The conferees further intend that the IRS will be prohibited from using information obtained from third party bank records to avoid the purposes of the church audit procedures.

The conference agreement provides that, as under present law, the IRS may examine the religious activities of an organization claiming to be a church (including a convention or association of churches) only to the extent necessary to determine if the organization actually is a church. The conference agreement clarifies that this includes a determination of the organization's qualification as a church for any period.

d. Time limitation on church audit

Present law

There is no specific limitation under present law on the duration of a church audit.

House bill

No provision.

Senate amendment

The Senate amendment generally requires the IRS to complete an investigation of church tax liabilities, and to make a final determination in such an investigation, within two years after notifying the church of the commencement of the investigation. The running of this period is suspended for any period during which (1) a judicial proceeding initiated by the church or its agents challenging the IRS investigation, examination, or proceeding is pending or being appealed, (2) a judicial proceeding brought by the IRS to compel compliance with a rea-

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sonable request for an examination of church records or religious activities is pending or being appealed, or (3) the IRS is unable to take action by reason of a stay of a suit involving access to third-party records (sec. 7609). The two-year period is also suspended, under the Senate amendment, for certain periods relating to the filing of a Freedom of Information Act by the church seeking access to documents in the possession at the IRS. Additionally, the committee report provides that the two-year period is to be suspended for any period in which the IRS is unable to make a determination because of the refusal of the church or its agents to comply with reasonable and lawful requests for information or materials necessary for the conduct of the investigation.

The Senate amendment allows the two-year period to be extended by mutual agreement of the church and the IRS.

Conference agreement

The conference agreement requires the IRS to complete any church inquiry or examination, and to make a final determination with respect thereto, not later than two years after the date on which the notice of examination is supplied to the church. The running of this two-year period is suspended for any period during which (1) a judicial proceeding brought by the church or its agents against the IRS with respect to the church tax inquiry or examination is pending or being appealed, (2) a judicial proceeding brought by the IRS against the church (or any official thereof) to compel compliance with any reasonable IRS request for examination of church records or religious activities is pending or being appealed, or (3) the IRS is unable to take actions with respect to the church tax inquiry or examination by reason of an order issued in a suit involving access to third-party records under section 7609. The two-year period is also suspended for any period in excess of 20 days (but not in excess of 6 months) in which the church or its agents fail to comply with any reasonable IRS request for church records or other information.

The conference agreement allows the two-year period to be extended by mutual agreement of the church and the IRS.

e. Period for assessment or collection of tax

Present law

The IRS is generally required to assess tax, or proceed for collection without assessment, within three years after a return is filed. No limitation period applies if no return is filed or in the case of a false or fraudulent return or willful tax evasion.

Where a limitation period is applicable, the period may be extended by mutual agreement of a taxpayer and the IRS.

House bill

No provision.

Senate amendment

The Senate amendment applies a three-year limitation period for assessment or collection of church tax liabilities whether or not a return has been filed. No limitation applies in cases of fraud, willful tax evasion, or knowing failure to file a return which should have been filed.

Under the Senate amendment, the three-year limitation period is suspended during periods for which the two-year limit on duration of a church audit (item (d) above) is suspended. As under present law, the three-year period may be extended by mutual agreement of a church and the IRS.

Conference agreement

Under the conference agreement, for examinations regarding revocation of tax-exempt status, where no return is filed, the IRS is to be limited initially to an examination of church records which are relevant to a determination of tax status or liability for the three most recent taxable years preceding the date on which the notice of examination (i.e., second notice) is sent to the church. If the church is proven not to be exempt for any of these years, the IRS may examine relevant records and assess tax (or proceed without assessment), as part of the same audit, for a total of 6 years preceding the notice of examination date.

For examinations relating to unrelated business taxable income, where no return is filed, the IRS may assess or collect tax for the 6 most recent years preceding the date on which the notice of examination is sent, with no additional limit on the period of church records which may be examined.

For examinations involving issues other than revocation of exempt status or unrelated business income (e.g., examinations relating to social security or other employment taxes), no limitation period is to apply if no return has been filed.

The special limitation periods for church tax liabilities are not to be construed to increase an otherwise applicable limitation period. Thus, as under present law, a three-year limitation period would apply where a church filed a tax return before an examination was held and did not substantially understate income. No limitation period is to apply in any case of fraud, willful tax evasion, or knowing failure to file a return which should have been filed.

As under present law, the applicable limitation period may be extended by mutual agreement of the church and the IRS.

f. Declaratory judgment actions regarding tax-exempt status

Present law

Organizations (including churches) may bring a declaratory judgment action in any case involving a determination of tax-exempt status under section 501(c)(3). The action may be brought in the Tax Court, the Claims Court, or the United States District Court for the District of Columbia. The court may generally issue a declaratory judgment only after (1) a final adverse determination by the IRS, or (2) failure by the IRS to make a determination within 270 days of a request for such.

Service of process.—Where an action is brought under section 7428 in the Tax Court or the Claims Court, trial subpoenas may be served on a nationwide basis. However, if the suit is brought in the United States District Court for the District of Columbia, a trial subpoena may generally be served only within a limited distance of the place of trial.

House bill

No provision.

Senate amendment

Under the Senate amendment, an organization is entitled to bring a declaratory judgment action under section 7428 once the IRS issues a revenue agent's final report ("30-day letter") proposing to revoke a church's tax-exempt status.

Conference agreement

The conference agreement follows the Senate amendment.

Additionally, the conference agreement further provides for nationwide service of trial subpoenas in declaratory judgment actions brought under section 7428 in the United States District Court for the District of Columbia.

g. Regional counsel approval of final IRS determinations

Present law

There is no statutory provision requiring approval of IRS determinations in church audits by a particular IRS official.

House bill

No provision.

Senate amendment

The Senate amendment requires the IRS regional counsel to approve, in writing, the issuance of an adverse determination letter or deficiency notice to a church.

Conference agreement

The conference agreement requires the IRS regional counsel to approve, in writing, (1) the determination of whether an organization has tax-exempt status as a church (sec. 501(a), (2) the determination of whether such an organization is a church which is entitled to receive tax-deductible contributions (sec. 170(c)), or (3) the issuance of a notice of tax deficiency to a church following a church tax examination (in cases where deficiency procedures are inapplicable, the assessment of any underpayment of tax by the church following a church tax examination). The conference agreement further requires the regional counsel to state in writing that the IRS has substantially complied with the church audit procedures as provided by the conference agreement.

h. Prevention of repeated examinations

Present law

There is no special provision regarding approval of a second examination of a church. However, the IRS must provide special notice before inspecting any taxpayer's records twice for the same tax year.

House bill

No provision.

Senate amendment

The Senate amendment requires the appropriate IRS assistant commissioner to approve, in writing, any second investigation or examination of a church, unless the first investigation or examination resulted in (1) revocation of tax exemption or an assessment of tax, or (2) a request by the IRS for any significant changes in church operational practices (including the adequacy or sufficiency of records maintained to reflect income). The committee report indicates that this provision is to apply only to second audits involving the same or similar issues as the prior audit.

Conference agreement

The conference agreement follows the Senate amendment, but specifies that (1) the requirement of assistant commissioner approval does not apply where the second audit (i.e., church tax inquiry or examination) does not involve the same or similar issues as the preceding inquiry or examination, and (2) the requirement applies only to second audits beginning within 5 years of the date on which the notice of examination was sent to the church during the prior audit (if no notice of examination was sent, the date of the notice of commencement of inquiry). This 5-year period is to be suspended for periods during which the two-year period for completion of an audit is suspended as described under the conference agreement (unless the prior audit was actually concluded within 2 years of the notice of examination). Finally, the conference agreement clarifies that the approval of any second audit to which the provision applies is to be made by the IRS Assistant Commissioner for Employee Plans and Exempt Organizations.

The conferees intend that, in determining whether a second audit involves similar issues to a prior audit, the substantive factual issues involved in the two audits, rather than legal classifications, will govern. Specifically, the conferees intend that unrelated business income from different sources will be considered different issues for purposes of this provision.

i. Scope of church audit procedures

Present law

The Internal Revenue Code applies special procedural requirements (described above) which are primarily intended to protect churches in examinations concerning unrelated business income. Treasury regulations generally extend these rules to examinations concerning tax-exempt status of an organization claiming to be a church.

House bill

No provision.

Senate amendment

The Senate amendment applies expanded statutory procedures (described above) to investigations of church tax status and liabilities. The committee report specifies that these procedures do not apply to investigations of individuals' tax liability (e.g., liabilities of individual contributors to a church) and do not prevent routine inquiries to a church (e.g., regarding employment taxes, income tax withholding, or similar matters). However, further legislative history indicates that the procedures are intended to apply at any point at which the tax status of a church becomes the issue in an investigation.

Conference agreement

The conference agreement specifies that the church examination procedures described above do not apply to (1) any inquiry or examination of any person other than a church, (2) any termination assessment (sec. 6851) or jeopardy assessment (sec. 6861), or (3) any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. Additionally, the conference agreement clarifies that these procedures do not apply to criminal investigations.

The conferees intend that inquires or examinations which relate primarily to the tax status or liability of persons other than the church (including the tax status or liability of a contributor or contributors to the church), rather than the tax status or liability of the church itself, will not be subject to the church audit procedures. These may include, but are not be limited to, (1) inquiries or examinations regarding the inurement of church funds to a particular individual or individuals or to another organization, which may result in the denial of all or part of such individual's or organization's deduction for charitable contributions to the church, (2) inquiries or examinations regarding the assignment of income or services or excessive contributions to a church, and (3) inquiries or examinations regarding a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church. The IRS may inquire of a church regarding these matters without being considered to have commenced a church tax inquiry and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements applicable to church tax examinations, subject to the general rules regarding examinations of taxpayer books and records.

The conferees intend that inquiries or examinations conducted outside the church audit procedures will be limited to the determination of facts and circumstances specifically relating to the tax liabilities of the individuals or other organizations in question. For example, in an inurement case, the IRS could request information or examine church records regarding amounts of money, property, or services transferred to the individual or individuals in question (including wages, loans, or non-contractual transfers), the use of church funds for personal expenses, or other similar matters, outside of the church audit procedures. In an assignment of income case, the IRS could request information or examine church records relevant to an individual's assignment of particular income, donation of property, or transfer of a business to a church. However, the IRS could not examine a contributor or membership list in the possession of the church, without following the church audit procedures, for the purpose of determining the overall financial structure of the church, merely because such structure was relevant to the church's qualification as a tax-exempt entity and therefore indirectly relevant to the validity of contributors' deductions in general. The conferees further intend that the IRS will not make use of inquiries or examinations regarding individuals' or other organizations' tax liabilities to avoid the intended purpose of the church audit procedures. The failure of a church to respond to repeated inquiries regarding individuals' or other organizations' tax liabilities will be considered a reasonable basis for commencement of a church tax inquiry.

The conferees further intend that routine IRS inquiries to a church will not be considered to commence a church tax inquiry and therefore will not trigger application of the church audit procedures. Routine questions for the purpose include (but are not limited to) questions regarding (1) the filing or failure to file any tax return or information return by the church, (2) compliance with income tax or FICA tax withholding responsibilities by the church, (3) any supplemental information needed to complete the mechanical processing of any incomplete or incorrect return filed by the church, (4) information necessary to process applications for exempt status, letter ruling requests, or employment tax exemption requests by the church, and information identifying a church that is used by the IRS to update its Cumulative List of Tax Exempt Organizations and other computer files, and (5) confirmation that a specific business is or is not owned or operated by a church. Repeated failure by a church or its agents to reply to such routine inquiries will be considered reasonable basis for commencement of a church tax inquiry under the applicable church audit procedures. The IRS may further request a church to provide information necessary to locate third-party records (e.g., bank records), including information regarding the church's chartered name, state and year of incorporation, and location of checking and savings accounts, without following the church audit procedures; failure to provide this type of information is to be a factor, but not a conclusive factor, in determining if there is reasonable cause for commencing a church tax inquiry.

The conference agreement specifies that the church audit procedures do not apply to any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. The conferees are aware that, in recent years, increasing numbers of tax protesters and other taxpayers have utilized the form of religious organizations in an effort to avoid tax. In Fiscal Year 1983, the IRS closed 6,612 examinations involving alleged church tax avoidance schemes, assessing $23,803,200 in taxes and penalties (an average assessment of $3,600 per return) and leaving a calendar year-end inventory of 15,296 church tax avoidance cases (in addition to approximately 200 criminal investigations). In the first 6 months of Fiscal 1984 alone (October 1, 1983–March 31, 1984), the IRS assessed $25,620,178 in taxes and penalties in 5,498 cases relating to church tax avoidance schemes.[1] The conferees specifically intend that nothing in the church audit procedures will inhibit IRS inquiries, examinations, or criminal investigations of tax protestor or other tax avoidance schemes posing as religious organizations, including (but not limited to) tax avoidance schemes posing as mail-order ministries or storefront churches, whether such schemes are limited to one particular taxpayer or encompass a group of taxpayers.

j. Remedy for IRS violation of audit procedures

Present law

The violation of statutory procedures may generally be raised as a defense (but not an absolute defense) in a proceeding to gain access to statutorily protected records.

House bill

No provision.

Senate amendment

The Senate amendment specifies that IRS failure to follow the proper church audit procedures is a defense (but not an absolute defense) in a proceeding to gain access to church records. The committee report states that, once this defense is raised, the IRS has the burden to prove it has followed the property statutory procedures. However, the IRS is permitted to correct any procedural violations before continuing an investigation.

Conference agreement

The conference agreement provides that the exclusive remedy for any IRS violation of the church audit procedures described above is as follows: failure of the IRS to substantially comply with (1) the requirement that two notices be sent to the church, (2) the requirement that the regional commissioner approve the commencement of a church tax inquiry, or (3) that an offer of an IRS conference with the church be made (and a conference held if requested), will result in a stay of proceedings in a summons proceeding to gain access to church records (but not in dismissal of such proceeding) until these requirements are satisfied. The two-year limitation on duration of a church audit is not to be suspended during stays of summons proceedings resulting from violations described above; however, the IRS may correct such violations without regard to the otherwise applicable time limits prescribed under the church examination procedures. The conferees intend that, in determining whether a stay is necessary, a court will consider the good faith of the IRS and the effect of any violation of the proper examination procedures.

Aside from the exclusive remedy described above, there is to be no judicial remedy for IRS violation of any of the church examination procedures provided by the conference agreement. IRS failure to comply with any of these requirements may not be raised as a defense or an affirmative ground for relief in any judicial proceeding including, but not limited to, a summons proceeding to gain access to church records; a declaratory judgment proceeding involving a determination of tax-exempt status (sec. 7428); or a proceeding to collect unpaid tax. Additionally,

[1] Information provided to Treasury Department by IRS Employee Plans/Exempt Organizations Operations Division, June 19, 1984.

failure to substantially comply with the requirements that two notices be sent, that the assistant commissioner approve an inquiry, and that a conference be offered (and the conference held if requested) may not be raised as a defense or as an affirmative grounds for relief in a summons proceeding or any other judicial proceeding other than as specifically set forth above. The conferees specifically intend that a church or its representatives will not be able to litigate the issue of the reasonableness of the assistant commissioner's belief in approving the commencement of a church tax inquiry (i.e., that the church may not be tax-exempt or may be engaged in taxable activities) in a summons proceeding or any other judicial proceeding. These provisions are not, however, intended to derogate from a church's right to raise any substantive or procedural argument which would be available to taxpayers generally in the appropriate proceeding.

k. Effective date

Present law

No provision.

House bill

No provision.

Senate amendment

Under the Senate amendment, the church audit procedures are effective for investigations, examinations, or other proceedings commencing after the date of enactment.

Conference agreement

The church audit procedures contained in the conference agreement are effective for inquiries and examinations commencing after December 31, 1984.

IV. SIMPLIFICATION

A. Individual Estimated Tax

Present law

Under present law, a penalty is imposed on the underpayment of the individual estimated tax. The amount of underpayment is based on difference between payments (including withholding) made and 80 percent of tax shown on the return. No penalty is imposed if payment equals an amount based on: (1) the tax shown on the preceding year's return; (2) 80 percent of the current year's tax computed on income to date placed on an annualized basis; (3) 90 percent of the tax on income to date; or (4) tax on the prior year's facts and current year's rates and exemptions. The penalty may not be waived by the IRS. Estimated payments of the alternative minimum tax are not required.

The IRS had ruled (Rev. Rul. 83-111, 1983-2 C.B. 245) that overpayments may not be credited to estimated tax payments earlier than the date election to credit payment is made. This ruling has been revoked by Rev. Rul. 84-58, 1984-16 I.R.B. 8.

House bill

Under the House bill, the underpayment will be based on the lesser of (1) 80 percent of tax shown on the return, (2) 100 percent of tax shown on the preceding year's return, or (3) 80 percent of the current year's tax computed on income to date placed on an annualized basis. Exceptions (3) and (4) described under present law are repealed.

The penalty may be waived as the result of casualty, disaster or circumstances where imposition of tax would be inequitable. Estimated tax payments of the alternative minimum tax will be required.

The House bill overrules Revenue Ruling 83-111.

The provision is generally effective for taxable years beginning after December 31, 1984.

Senate amendment

Under the Senate amendment, the underpayment may be waived as in the House bill. Also the penalty may be waived for reasonable cause during the first 2 years after the taxpayer retires upon reaching age 62 or becomes disabled.

Estimated tax payments of the alternative minimum tax will be required.

The provision is effective for taxable years beginning after December 31, 1984.

Conference agreement

The conference agreement follows the House bill, with the Senate amendment relating to penalty waivers. The penalty waiver provision will be effective for taxable years beginning after December 31, 1983.

If the taxpayer designates that the overpayment of tax shown on his return is to be credited against his estimated tax, but the overpayment is offset for either past-due child support or non-tax Federal debt under section 6402(c) or (d), and the taxpayer is not notified of the offset prior to the due date of the estimated tax, the conferees intend that the Secretary consider these circumstances as warranting a waiver of the estimated tax penalty.

B. Domestic Relations Tax Reform

1. Treatment of transfer of property between spouses or incident to divorce

Present law

Under present law, gain is generally recognized on transfers of property in exchange for the release of marital claims (*United States* v. *Davis*, 370 U.S. 65 (1962)).

House bill

The House bill provides that transfers of property between spouses or incident to divorce will generally be non-taxable, carryover basis transactions.

The provision applies to transfers after date of enactment (other than transfers pursuant to instruments in effect on that date where the parties do not elect to have the provisions apply). The parties may elect to have the provision apply to transfers after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

2. Alimony

Present law

Alimony paid under divorce or separation instruments is deductible by the payor and includible in the income of the payee. Alimony must be in discharge of a legal obligation because of family or marital relationship; the payment may not discharge a principal sum, with an exception for certain payments which exceed 10 years.

There is no requirement to furnish the name or social security number of payee.

House bill

The House bill repeals the present law requirements to qualify as alimony. The bill's new requirements are as follows: (1) payment must be in cash; (2) payor and payee who are divorced or legally separated may not be members of the same household at time of payment; (3) payment must be terminable at death of payee spouse; and (4) the parties must not designate the payment as not being alimony.

The deduction for payments made during the first year which exceed average payments made during the second and third year by more than $15,000 will be recaptured. Also recapture will occur where second-year payments exceed third-year payments by more than $15,000. No recapture will occur where either party dies or where payee spouse remarries by the end of the third year. Recapture does not apply to temporary support decrees.

Payee must furnish payor with his or her social security number and the payor must furnish the name and social security number of the payee to the IRS; a $50 penalty may be imposed for failure to comply.

The provision applies generally to decrees and agreements executed after 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with the following modifications:

(1) The divorce or separation instrument must state that there is no liability to make payments for any period after the death of the payee spouse.

(2) If any amount specified in the instrument will be reduced on the happening of a contingency relating to a child, then an equal amount will be treated as child support rather than alimony. Thus, for example, if the divorce instrument provides that payments will be reduced by $100 per month when a child reaches age 18 (or in the month the child happens to reach that age), then $100 of each monthly payment will be treated as fixed for child support.

(3) The conference agreement generally provides that deductible alimony payments must continue for at least 6 years duration and may not vary by more than $10,000 during any of those years. Specifically, the agreement provides that any payment in excess of $10,000 per year will be deductible only if the instrument provides that the payor spouse is required to make alimony payments for at least 6 consecutive calendar years beginning with the year a payment is first made (assuming neither spouse dies during that period and that the payee does not remarry).

Also, if payments are deductible for any year, but in a subsequent year (during the 6-year period) the payments decrease by more than $10,000 from that prior year, then those excess payments (i.e., those earlier year payments in excess of the sum of the later year payments plus $10,000) will be includible in the income of the payor and deductible by the payee in the subsequent year. Thus, for example, if alimony payments of $25,000 are made in year 1 and payments of $12,000 are made in year 2, then $3,000 will be recaptured in year 2. If the payments further decline to $1,000 in year 3, then, in year 3, an additional $11,000 will be recaptured from year 1 and $1,000 will be recaptured from year 2. If, prior to the end of year 6, payments further decline, additional recapture will occur. In applying these rules, years beginning with the year of death of either spouse or remarriage of the payee spouse will be ignored if payments terminate by reason thereof. Also, for purposes of applying these rules, payments pursuant to a support decree (specified in section 71(b)(2)(C)) or payments which fluctuate as a result of a continuing liability to pay, for at least 6 years, a fixed portion of income from the earnings of a business, property or services will not be taken into account.

3. Dependency exemption

Present law

A $1,000 deduction is allowed for a dependent child of the taxpayer; to qualify as a dependent of the taxpayer, the taxpayer must furnish over one-half of his or her support.

Special rules are provided for divorced or legally separated parents or parents sepa-

rated under written separation agreement where the two parents provide more than one-half of the support. The custodial parent is allowed the dependency exemption except that: (1) if the decree or agreement provides that the non-custodial parent is entitled to a deduction and that the parent provides at least $600 of the support, the non-custodial parent is treated as providing over one-half the support; or (2) if the non-custodial parent furnishes at least $1200 of the support, that parent is presumed to furnish over one-half the support unless the custodial parent clearly establishes otherwise.

A medical expense itemized deduction is allowed for expenses of a dependent child.

Numerous different rules relating to status of married individuals living apart apply.

A child is not eligible as a dependent if his or her gross income exceeds $1,000 unless the child is under age 19 or is a student.

House bill

Under the House bill, the dependency special rules will be extended to parents living apart at all times during the last 6 months of the calendar year. The custodial parent will be allowed the dependency exemption unless that parent signs a declaration that he or she will not claim the exemption for the taxable year, and the non-custodial parent attaches the declaration to his or her return. Pre-1985 agreements described under (1) of present law will continue to be recognized.

The House bill treats a child as the dependent of both parents for purposes of the medical expense deduction.

The House bill provides that parents living apart for the last 6 months of the year can be treated as unmarried or head-of-household if the other eligibility tests are met. Eligibility for unmarried status, head-of-household status, earned income credit, and credit for dependent care are not lost where the custodial parent waives the right to claim the dependency exemption.

Income received by a permanently and totally disabled individual at a sheltered workshop school will be disregarded in determining the dependency exemption.

The provision applies to taxable years beginning after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

4. Innocent spouse relieved of liability in certain cases

Present law

Under present law, a spouse filing a joint return may be relieved of liability for tax if (1) there is a more-than-25-percent omission from gross income attributable to the other spouse, (2) the spouse establishes that he or she had no knowledge, or reason to know, of the unreported income, and (3) it would be inequitable to hold the spouse liable, taking into account whether the spouse significantly benefitted from the omission.

Community income is treated as income of both spouses. An exception applies where the spouses live apart for the entire year, file separate returns, and one spouse has earned income which is not transferred to the other spouse.

House bill

The House bill extends the innocent spouse joint return rule to substantial understatements resulting from (1) omitted income and (2) deductions, basis, and credits with no basis in law or fact. A substantial understatement will be an understatement of tax exceeding $500.

The community property rule is extended to situations where a spouse establishes that he or she did not know, or have reason to know, of an item of community income, and it is inequitable to include the item in that spouse's income.

The provision applies to all taxable years to which the Internal Revenue Codes of 1939 and 1954 apply.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with the following two modifications:

(1) The joint return innocent spouse relief, to the extent the understatement is not attributable to an omission from gross income, will be available only if the liability which otherwise would qualify for relief exceeds

(a) 10 percent of the spouse's adjusted gross income for the taxable year prior to which the deficiency notice is mailed if that income was $20,000 or less, or

(b) 25 percent of the spouse's adjusted gross income for the prior taxable year if that income exceeded $20,000. (Where the spouse will meet these tests, it is not necessary to actually mail the deficiency notice.)

The conferees understand that the additional relief in the bill will be available to pending court cases where the decision in the case is not final.

(2) The Secretary may disallow the benefits of any community property law to a taxpayer if the taxpayer acts as if he or she is solely entitled to the income and the taxpayer failed to notify the taxpayer's spouse of that income.

5. Gift and estate tax liability for transfers of property to spouses incident to divorce

Present law

Under present law, there is no gift tax liability for transfers of property to a spouse in settlement of marital or property rights pursuant to a written agreement where divorce occurs within 2 years of agreement.

House bill

The House bill provides an estate tax deduction for transfers pursuant to these written agreements. It also extends the period to enter into an agreement to one year after divorce.

The provision applies to gifts made, and estates of decedents dying, after date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

C. At-risk Provisions

Present law

Investment tax credit

Present law generally limits the amount of property on which a taxpayer (other than a non-closely held corporation) may claim the investment tax credit to the amount the taxpayer is "at risk". Real estate and certain corporate leasing activities are exempt from this rule.

There is an exception for loans from persons in the commercial lending business who are unrelated to the seller or to the taxpayer where the taxpayer is at least 20 percent at risk at all times.

Present law allows a lessor to pass the credit through to the lessee. The application of the at-risk rules to these leases is unclear.

Losses

Present law limits the losses from an activity which a taxpayer (other than a non-closely held corporation) may claim to the amount the taxpayer is at risk in the activity.

House bill

Investment tax credit

The House bill generally clarifies present law by revising the rules (including the recapture rules) so as to specifically disallow the credit with respect to property financed with nonrecourse borrowing.

The House bill generally retains the commercial lending exception. It also adds an exception for recourse loans to a subchapter S corporation where the loan is from an unrelated commercial lender and the property is used in an active trade or business with at least 3 full-time non-owner employees, including one full-time employee managing the business.

In the case of a pass-through lease, the at-risk rule will continue to apply to the lessor. For the lessee to get the full credit in the year the property is placed in service, the lessee must be liable to make non-contingent payments the present value of which at the beginning of the lease (assuming the rate of interest used in computing interest on tax underpayments) must equal or exceed 30 percent (18 percent in the case of 3-year property) of the value of the property.

These rules apply to property placed in service after date of enactment (or as if enacted by ERTA, if the taxpayer so elects).

Losses

Under the bill, an active trade or business of a closely held subchapter C corporation (other than a personal holding company or personal service corporation) will not be subject to any at-risk rules. A trade or business will be required to have three full-time, non-owner employees, one full-time employee actively managing the business, and "out-of-pocket" business expenses exceeding 15 percent of gross income. Losses from an active business may not offset income of a personal holding company or personal service company that is a member of the same affiliated group.

Certain activities will be aggregated if the taxpayer actively participates in the management of each activity.

A taxpayer can be at risk for amounts borrowed from a related party.

These rules will apply to taxable years beginning after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with the following modifications:

(1) "Section 48(d)" leases

(a) In order to reduce the possibility that in the case of a "pass-thru" lease, a lessee subject to the "at risk" rules may claim an inflated value for the property, the agreement requires that the lessor be subject to the investment tax credit at-risk rules with respect to these leases unless the lessor would not otherwise be subject to these rules and either the lessor manufactured or produced the property, the property has a readily ascertainable fair market value, or the Secretary determines by regulation that it is unnecessary for the lessor to be subject to the "at-risk" rules.

(b) The requirement that the lessee be 30-percent at risk is modified to provide that the "at risk" percentage be an amount equal to two times the credit percentage (set forth in section 46(a)) plus 10 percent (60 percent of this amount in the case of three-year property). This change is intended to insure

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

that the lessee have an after-tax investment in the property.

(2) Definition of qualified business

(a) The legislative language is amended to specifically require that a qualifying business be an active business. It is intended that the creation of an active business be treated as the conduct of an active business for this purpose.

(b) The application of the partnership rules are revised. Under the conference agreement, a qualified corporate partner will take into account its proportionate share of the employees of a qualified partnership (or of a qualified corporate partner) substantially all the services of whom are directly related to the business of the partnership, and also will take into account its share of the income and deductions of the partnership for purposes of determining whether the corporation is engaged in a qualifying business. The corporation may aggregate its share of the partnership business with any portion of the business which it conducts directly.

A partnership is qualified if it is engaged in an active business and if there is one full-time employee of the partnership (or of a qualified corporate partner) substantially all the services of whom are involved in the active management of the business.

A qualified corporate partner is a general partner that has at least a 20-percent interest in the profits and losses of the partnership that has contributed an amount equal to the lesser of $500,000 or 10 percent of its net worth to the partnership as of the end of the taxable year.

(3) Aggregation of activities

The agreement provides that all leased section 1245 properties which are placed in service in any taxable year of a partnership or S corporation shall be treated as a single activity. In addition, the authority of the Secretary to aggregate or separate activities (under section 465(c)(3)(C)) is extended to the activities (including activities conducted by partnerships or S corporations) described in section 465(c)(2).

(4) Recapture

The conferees wish to clarify that the disposition of property in a transaction described in section 47(b) (relating to changes in form of doing business) will not result in recapture (under sec. 47(d)) to the extent the taxpayer remains liable on any debt with respect to the property and does not reduce his direct or indirect at-risk investment in the property. For example, if section 38 property financed with nonrecourse financing that is qualified commercial financing is contributed to a wholly-owned corporation by an individual, the at-risk recapture rules ordinarily will not apply where the transferor is not relieved of any personal liability for recourse financing incurred with respect to the property, or the transferor's at-risk investment in the corporation increases by the transferor's at-risk investment in the contributed property (exclusive of the nonrecourse qualified commercial financing). Appropriate exceptions may be provided in regulations.

D. Administrative Provisions

1. Miscellaneous Treasury administrative provisions

House bill

The bill makes a number of minor amendments relating to Treasury administrative provisions. The bill simplifies certain requirements of the Treasury Department to make reports to the Congress, removes the $1 million limitation of the Treasury working capital fund, increases the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, allows an extension of time for court review of a jeopardy assessment where the government is not promptly served, removes the $1 million limitation on the Secretary of the Treasury's special authority to dispose of obligations, allows the Internal Revenue Service a minimum of 60 days to assess unpaid taxes shown on an amended return, provides the government a lien on the assets of all financial institutions which issue an unpaid guaranteed draft for the payment of taxes, and allows the disclosure of windfall profit tax returns to State tax agencies.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and Senate amendment.

2. Distilled spirits administrative provision

a. Repeal of occupational tax on manufacturers of stills and condensers

Present law

An occupational tax of $55 per year is imposed on manufacturers of stills. In addition, a tax of $22 is imposed on each still (or condenser to be used in distilling) manufactured.

Present law also requires notice to the Treasury upon removal of a still from the place of its manufacture and permission from the Treasury before setting up a still for distilling operations. Further, every person having possession or control over a still is required to register with the Treasury immediately after setting up the still.

House bill

The House bill repeals the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still. The House bill also repeals the mandatory notice requirement upon removal of a still from the place of its manufacture and the requirement of permission prior to setting up of a still. In their place, the bill allows the Treasury Department, pursuant to regulations, to require manufacturers of stills to give notice before removal of stills from the factory. The House bill retains the requirement of registration by a user after setting up the still.

These provisions are effective on the first day of the first month beginning more than 90 days after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

b. Return of taxes on spirits used for food or medicinal purposes

Present law

Present law provides for the drawback (i.e., return to the taxpayer) of distilled spirits excise taxes where the spirits are used for food, medicinal, or other nonbeverage purposes. For a drawback claim to be allowed, Treasury regulations require that extensive supporting data be maintained by the manufacturer, including quantitative formulae which must be filed with the Treasury. Failure to comply with these requirements (including any deviation from a previously filed formula) may result in denial of a drawback claim.

House bill

In lieu of denying a claim, the House bill imposes a $1,000 penalty for each failure to comply with applicable laws or regulations, where it is established that the distilled spirits were used for nonbeverage purposes. The aggregate amount of these penalties may not exceed the taxpayer's claim. Additionally, the penalty may be waived where the failure to comply was due to reasonable cause.

This provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

c. Disclosure of information regarding alcohol fuel producers to administrators of State alcohol laws

Present law

The Treasury Department is prohibited from disclosing tax return information (including the identity of taxpayers), without the taxpayer's consent, except under certain limited circumstances. Under this prohibition, Treasury is prohibited from disclosing the names and addresses of alcohol fuel producers to State alcohol enforcement agencies.

House bill

The House bill allows the Treasury Department to disclose the names, addresses, and business locations of persons producing alcohol for fuel use to State agencies having responsibility for the administration of State alcohol laws. This disclosure is to be made solely for use in the administration of State alcohol laws and is subject to the existing confidentiality safeguards for disclosure of tax information to other Federal and State agencies.

This provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

d. Elimination of Government-supplied strip stamps for distilled spirits containers

Present law

Distilled spirits containers transported or sold in the United States are required to bear a stamp indicating that the Federal excise tax on the spirits has been paid. Strip stamps which satisfy this requirement are printed by the Bureau of Engraving and Printing at an estimated cost of $1.7 million per year and are distributed to distillers and bottlers free of charge.

Government-supplied strip stamps must generally be broken in order to open a distilled spirits container; thus, the stamps act as closure devices.

House bill

The House bill repeals the strip stamp requirement for distilled spirits containers and associated penalty provisions. However, the bill requires that distilled spirits containers, on determination of tax, bear a closure or other device which is designed to require breaking in order to gain access to the contents of the container. This requirement does not apply to containers having a capacity in excess of one wine gallon.

These provisions are effective on July 1, 1985. Government-supplied strip stamps may be affixed only until that date.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

e. Removal of distilled spirits without payment of tax for use in production of certain nonbeverage wine

Present law

Distilled spirits (other than wine spirits) used in production of nonbeverage wine products are taxed upon removal from the distilled spirits plant where the spirits are produced or from customs custody. This tax (less a processing fee) is later returned to the taxpayer upon filing of a proper claim for refund.

House bill

The House bill permits removal from a distilled spirits plant of distilled spirits without payment of tax for use in producing nonbeverage wine products (e.g., cooking wine).

This provision is effective on the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

3. Financial accounting for the investment tax credit

Present law

Section 101(c)(1)(A) of the Tax Reform Act of 1971 limits the ability of any Federal agency to compel with respect to any taxpayer a particular method of financial accounting for the investment tax credit. The 1971 Act also requires a taxpayer to use the same method of financial accounting for the investment tax credit in all reports subject to the jurisdiction of any Federal agency unless the Treasury approves a change to another method.

House bill

No provision.

Senate amendment

The Senate amendment repeals the provision requiring Treasury approval of a change of financial reporting method for the investment tax credit, effective as of its original effective date.

Conference agreement

The conference agreement follows the Senate amendment.

E. Tax Court Provisions

1. Certified public accountants and enrolled agents authorized to represent taxpayers

Present law

In any Tax Court proceeding, a taxpayer may appear *pro se* or be represented by any person admitted to practice before the Tax Court.

House bill

The House bill allows certified public accountants and enrolled agents to represent a taxpayer in a small tax case.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the provision of the House bill.

2. Annuities for survivors of Tax Court Judges

Present law

If a Tax Court Judge is survived by a dependent child or children, an annuity is provided. The maximum limits on these annuities have not been changed since 1961.

House bill

The maximum limits on annuities for surviving children is increased to the level provided surviving children of U.S. District Court Judges.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

3. Tax Court Commissioners and jurisdictional limit for small tax cases

Present law

Proceedings involving less than $5,000 may be assigned to Commissioners to make a decision.

House bill

The House bill increases the jurisdictional limit for small tax cases from $5,000 to $10,000.

The House bill also provides that other proceedings may be assigned to be heard by Commissioners, but no decision with respect to these proceedings may be made by a Commissioner. The title of "Commissioner" is changed to "Special Trial Judge."

Senate amendment

The Senate amendment increases the jurisdictional limit for small tax cases from $5,000 to $10,000.

Conference agreement

The conference agreement follows the House bill.

4. Publicity of Tax Court proceedings

Present law

Reports of the Tax Court and evidence received by the Court are open to public inspection.

House bill

The House bill clarifies that the Court may prevent the disclosure of trade secrets and other confidential information.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

5. Elimination of mandatory retirement age for Tax Court judges

Present law

Tax Court Judges must retire upon attaining age 70. After retirement, Judges who have served at least 10 years receive retirement pay generally equal to the salary of active Judges and may continue to hear cases. Retired Judges are not considered in determining whether the authorized maximum number of Judges (currently 19) has been reached. Retirement plan payments are not considered wages for purposes of social security taxes.

House bill

The House bill provides that Tax Court Judges may retire at any time after attaining age 70.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the provision of the House bill.

F. Simplification of Income Tax Credits

Present law

Present law provides a series of income tax credits allowable to reduce a taxpayer's tax liability.

House bill

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) are combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. The research credit will continue to be allowable against 100 percent of tax liability. A 3-year carryback and 15-year carryforward period on a FIFO basis will be allowed for the business credits.

This provision applies to taxable years beginning after 1983. Unexpired credits from each pre-1984 taxable year will be combined into a business credit carryforward from that year to be carried to post-1983 years (for a period not to exceed 15 years from the year of the original credit). Thus, for example, where a taxpayer made an investment entitling it to claim the employee plan percentage, the taxpayer may continue to make an election to claim that percentage as a carryforward from the earlier year under the rules in effect for the year the investment was made.

Carrybacks of the general business credit to pre-1984 years will be allowed.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and Senate amendment.

G. Miscellaneous Simplification

1. Preferred stock eligible under section 1244

Present law

An ordinary loss deduction of up to $50,000 per year ($100,000 in the case of a joint return) is allowed for losses on certain common stock of small business corporations ("section 1244 stock").

House bill

The House bill allows preferred stock to qualify as "section 1244 stock".

The provision applies to stock issued after date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

2. Medical expense deduction for certain lodging

Present law

Present law allows an itemized deduction for unreimbursed medical expenses in excess of five percent of the taxpayer's adjusted gross income (Code sec. 213). Expenses eligible for deduction include costs of transportation primarily for and essential to medical care, but not costs of meals or lodging (except where paid as part of a hospital bill) while away from home to obtain medical care.

House bill

Under the House bill, amounts paid for lodging while away from home, if primarily for and essential to care provided by a physician in a licensed hospital or certain equivalent medical-care facilities, are treated as medical care expenses eligible for the section 213 deduction.

The lodging amount allowable as a deduction cannot exceed $50 per night for the patient or other eligible person (such as a parent accompanying a dependent child). No deduction is allowed for lodging that is lavish or extravagant, if there is any significant element of personal pleasure, recreation, or vacation in the travel away from home, or for any expenses, such as food, other than the cost of lodging.

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

This provision is effective for taxable years beginning after 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill. As in the case of other types of medical expenses eligible for deduction under section 213, the taxpayer must substantiate any deduction claimed for lodging expenses as prescribed by Treasury regulations (see Regs. sec. 1.213-1(h)).

H. Deadwood

1. Government retirement bonds

Present law

Present law provides for the issuance of certain government retirement bonds. Treasury has terminated the sale of these bonds.

House bill

The House bill repeals the provisions of law relating to these bonds. Current holders of the bonds will be governed by present law, but can redeem the bonds at any time.

The provision generally applies to obligations issued after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

2. Farm loss recapture

Present law

Present law provides for the recapture of certain farm losses. These provisions were terminated for losses after 1975.

House bill

The House bill repeals the farm loss recapture provisions for taxable years beginning after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

V. PROVISIONS RELATING TO EMPLOYERS AND TO EMPLOYEES AND TO RETIREMENT

A. Pension Plan Provisions

1. Deduction limits for qualified plans

Present law

Under present law, limits are imposed on the amount of employer deductions for contributions to a qualified pension, profit-sharing, or stock bonus plan ("qualified plan"). In addition, if an employer maintains a defined benefit pension plan or a money purchase pension plan and an annuity, profit-sharing, or stock bonus plan for the same employees, then the employer's deduction for plan contributions for a year is limited to the greater of (1) 25 percent of aggregate compensation paid or accrued during the year to the beneficiaries of the plan or (2) the amount necessary to satisfy the employer's minimum funding requirement under the pension plan. This limitation does not apply if the employer maintains a defined benefit pension plan and a money purchase pension plan for the same employees.

Present law provides overall limits on the dollar amount and percentage of compensation that may be provided to participants as contributions or benefits under qualified plans. In the case of an employee participating in both a defined contribution plan and a defined benefit pension plan maintained by the same employer, the sum of the fractions of the separate limits used by each plan is subject to an overall limit. TEFRA generally reduced the combined limit with respect to dollar amounts from 1.4 to 1.25.

House bill

No provision.

Senate amendment

The Senate amendment applies the 25-percent deduction limitation to situations in which an employer maintains both a defined benefit pension plan and a money purchase pension plan for the same employees. In no event, however, will the deduction limitation for a year be less than the amount necessary to satisfy the minimum funding requirement for the defined benefit pension plan.

In addition, under the Senate amendment, the total amount deductible for a taxable year under all plans of the employer is limited to the aggregate amount of compensation paid or accrued during the taxable year to the beneficiaries of the plans. In applying this aggregate limit, benefits paid by a plan (within limits) are treated as compensation paid during the year.

Under the Senate amendment, in the case of an employee participating in both a defined contribution plan and a defined benefit pension plan maintained by the same employer, the combined limit on the sum of the fractions of the separate limits used by each plan is raised to 1.4. The increased limit applies only if, at all times after June 30, 1982, no plan of the employer is (1) a top-heavy plan or (2) integrated with social security.

The provisions of the Senate amendment are effective for years beginning after December 31, 1984.

Conference agreement

The conference agreement does not contain the Senate amendment.

2. Provisions relating to top-heavy plans

Present law

Under present law, if a qualified plan is top heavy, then certain additional minimum requirements (including minimum contributions or benefits for non-key employees) are imposed. A qualified plan is top heavy if more than 60 percent of the value of accrued benefits are allocable to key employees. The accrued benefits of employees who have separated from service generally continue to be counted until 5 years after they are distributed.

Present law defines a key employee as an individual who (1) is an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000.

In addition, present law provides that the combined limit on contributions and benefits for a key employee participating in both a defined contribution plan and defined benefit pension plan maintained by the same employer is reduced from 1.25 to 1.0. This reduction in the combined plan limit does not apply if additional minimum benefits or contributions are provided to non-key employees. In the case of a super top-heavy plan, (i.e., a plan under which more than 90 percent of the accrued benefits are provided to key employees), the reduction in the combined plan limit applies without regard to whether additional minimum contributions or benefits are provided to non-key employees.

Under present law, in testing whether an employer has satisfied the minimum contribution or benefit requirement with respect to a non-key employee and for purposes of determining the amount that has been contributed to a plan on behalf of a key employee, amounts contributed pursuant to a salary reduction arrangement are not counted.

The present-law rules relating to top-heavy plans (including the requirement that a plan contain provisions that are operative if the plan becomes top heavy) apply to governmental plans (as defined in sec. 414(d)).

House bill

No provision.

Senate amendment

Under the Senate amendment, the special combined limit on contributions and benefits under a super top-heavy plan is repealed. The amendment also revises the definition of the term "key employee" to exclude officers who earn less than twice the dollar limit on contributions under a defined contribution plan ($60,000 for 1984).

The Senate amendment provides that if an individual has not received compensation with respect to any plan of the employer at any time during the 5-year period ending on the determination date, then any accrued benefit of the individual is disregarded for purposes of determining whether the plan is top heavy.

Under the Senate amendment, the amounts contributed to a qualified plan pursuant to a salary reduction arrangement are taken into account under the top-heavy provisions. The amendment also exempts governmental plans (as defined in sec. 414(d)) from the top-heavy plan requirements.

Under the Senate amendment, if the Secretary of the Treasury fails to issue final regulations under the rules of the Code relating to top-heavy plans before January 1, 1985, then a simplified amendment procedure applies.

The provisions generally are effective for plan years beginning after December 31, 1983. The provisions relating to separated employees and salary reduction arrangements are effective for plan years beginning after December 31, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment, with two exceptions. First, the conference agreement retains the special combined limit on contributions and benefits under a super top-heavy plan. Second, the conference agreement revises the definition of the term "key employee" to exclude officers who earn less than 1½ times the dollar limit on contributions under a defined contribution plan ($45,000 for 1984).

Under the conference agreement (as under the Senate amendment), if the Secretary of the Treasury fails to issue final regulations under the Code rules relating to top-heavy plans before January 1, 1985 (as in effect on the day before the date of enactment of these provisions), the Secretary is required to publish plan amendment provisions that may be incorporated into all qualified plans of an employer. If a plan is amended to incorporate these provisions, then the plan is deemed to have met the top-heavy plan requirements and is not required to be amended further to comply with the top-heavy provisions until the date that is 6 months after the issuance of the final regulations.

Under the conference agreement, if the Secretary fails to publish the required plan amendment provisions by January 1, 1985, then a plan is treated as meeting the top-heavy plan requirements if the plan is amended to incorporate such requirements by reference. In any case in which a plan is so amended and the plan does not specify the particular provisions that apply, the conferees intend that the employer is to be considered, in those situations in which more than one provision may apply, to have elected the provision that maximizes the

vested, accrued benefits for each non-key employee. For example, if a plan is amended to incorporate the top-heavy plan requirements by reference and does not specify a vesting schedule, the plan is deemed to provide a vesting schedule that maximizes the vested, accrued benefits of each non-key employee. Thus, if a particular non-key employee separates from service after two years of service, the plan is considered to have incorporated the graduated vesting schedule with respect to that employee and the employee would have a 20-percent vested accrued benefit. On the other hand, if another non-key employee under the same plan has at least three years of Service, the plan is considered to have incorporated the three-year, 100-percent vesting schedule with respect to that employee. Similarly, if an employer maintains a top-heavy group of plans and the plans are amended to incorporate the top-heavy plan requirements by reference without specifying the plan or plans under which the minimum benefits or minimum contributions are provided, then a non-key employee in any plan that is a required member of the group must be provided with the minimum contribution or benefit under each plan that is a required member in which the employee participates.

The conference agreement does not change the effective date of the top-heavy plan rules. In addition, the conferees intend that the issuance, as final regulations, of regulations similar to the proposed regulations under section 416 (published on March 15, 1983) will constitute the issuance of final regulations for purposes of this provision.

3. Distribution rules for qualified plans

Present law

Distributions prior to age 59½

Present law imposes an additional 10-percent income tax on certain distributions to employees in top-heavy plans. Amounts received under a qualified plan before a participant attains age 59½, becomes disabled, or dies are subject to this tax to the extent that (1) the amounts are includible in the participant's gross income and (2) are attributable to years in which the participant was a key employee in a top-heavy plan. The tax is designed to discourage the use of retirement funds for nonretirement purposes.

Before-death distribution rules

Present law requires that benefits provided under a qualified plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, benefits provided for a participant's beneficiaries must be incidental. Under this incidental benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth to others). The rule is supplemented by requirements that benefits be distributed after age 70½.

Under present law, a participant's benefits under a qualified plan must be distributed by a benefit distribution date, which is the last day of the later of the taxable year in which the participant (i) attains age 70½, or (ii) retires. In the case of a key employee participating in a top-heavy plan, distributions must be made in the taxable year in which the key employee attains age 70½, without regard to whether the key employee has retired. Alternatively, distributions must begin no later than the applicable benefit distribution date and must be made over the life of the participant (or lives of the participant and the participant's spouse) or over a period not exceeding the life expectancy of the participant (or the joint life expectancy of the participant and the participant's spouse).

The distribution rules applicable to individual retirement plans (IRAs) are similar to the before-death distribution rules applicable to benefits under qualified plans except that the benefit distribution date for the owner of an IRA is the end of the taxable year in which the owner attains age 70½, without regard to whether the owner has retired.

After-death distribution rules

If a participant dies before the entire interest in a qualified plan is distributed, present law requires that amounts payable to a beneficiary (other than the participant's surviving spouse) generally must be paid to the beneficiary within 5 years after the participant's death. In addition, after the death of the participant's surviving spouse, any amounts payable to a beneficiary of the surviving spouse must be paid within 5 years after the spouse's death. The after-death distribution rules for IRAs are similar to the after-death distribution rules applicable to qualified plans.

Qualifying rollover distributions

If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, tax free, within 60 days after the date of the distribution, to another qualified plan or to an IRA. Under present law, no rollover is permitted for a plan distribution that is not a total distribution. Similar rules apply to distributions from or under a tax-sheltered annuity contract.

House bill

Qualifying rollover distributions

The House bill provides for a tax-free rollover to an IRA of a distribution of at least 50 percent of the balance to the credit of an employee under a qualified plan or tax-sheltered annuity contract. As under present law, the rollover of a partial distribution is to be made within 60 days after the date of the distribution. Any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) is not eligible for the special 10-year income averaging or long-term capital gain treatment accorded lump sum distributions.

Under the House bill, similar plans of the employer are aggregated for purposes of applying the 50-percent test.

The provision is effective for distributions made after the date of enactment.

Senate amendment

Distributions prior to age 59½

Under the Senate amendment, the additional 10-percent income tax on premature distributions applies to a distribution only to the extent that the distribution is attributable to years in which the participant was a 5-percent owner (sec. 416) without regard to whether the plan was top heavy for such years.

Before-death distribution rules

Under the Senate amendment, a qualified plan is required to provide that a participant's entire interest will be distributed before the end of the taxable year in which the participant (i) attains age 70½ or (ii) retires, whichever is later. If a participant is a 5-percent owner (sec. 416) with respect to the taxable year in which the participant attains age 70½, the participant's entire interest is to be distributed no later than the close of such year even though the participant has not retired. The Senate amendment continues the incidental benefit rule of present law.

The Senate amendment provides for an alternative method of distribution over the life of the participant or over the lives of the participant and the participant's spouse. Under the Senate amendment, a qualified plan may provide that a participant's entire interest will be distributed, commencing on or before the applicable benefit distribution date, over the life of the participant (or the lives of the participant and spouse) or over a term certain not exceeding the life expectancy of the participant (or the joint life expectancy of the participant and spouse).

Under the Senate amendment, a qualified plan does not fail to satisfy the before-death distribution rules if it provides for the purchase, by the applicable benefit distribution date, of an immediate annuity contract that provides for substantially nonincreasing annuity payments to be made over the lives of the participant and a nonspouse beneficiary (or over a term certain not exceeding the joint life expectancy of the participant and a nonspouse beneficiary). A defined benefit pension plan is permitted to make substantially nonincreasing payments directly from the plan, in lieu of distributing an annuity contract.

After-death distribution rules

The Senate amendment generally continues the after-death distribution rules of present law. However, the amendment provides that the 5-year payout rule is satisfied, for both qualified plans and IRAs, by the purchase of an immediate annuity contract that provides for substantially nonincreasing payments over the life of the beneficiary or over a term certain not exceeding the life expectancy of the beneficiary. A defined benefit pension plan is permitted to make such payments directly without purchasing an annuity contract.

Qualifying rollover distributions

The Senate amendment generally follows the House bill, except that similar plans of the employer are not aggregated for purposes of applying the 50-percent test.

Effective dates

The provisions generally are effective for plan years beginning after December 31, 1984. For governmental plans, the provisions are effective for plan years beginning on or after December 31, 1986. For collectively bargained plans, the provisions are effective for plan years beginning in or after the earlier of (1) January 1, 1987, or (2) the expiration of the collective bargaining agreement. The qualifying rollover distribution provision is effective for distributions after the date of enactment, in taxable years ending after that date.

Conference agreement

Distributions prior to age 59½

The conference agreement follows the Senate amendment.

Before-death distribution rules

The conference agreement generally follows the Senate amendment, with several exceptions. Under the conference agreement, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required commencement date. Alternatively, the entire interest is to be distributed, beginning no later than the required commencement date, over (1) the life of the employee, (2)

the lives of the employee and a designated beneficiary, (3) a period not extending beyond the life expectancy of the employee, or (4) a period not extending beyond the life expectancy of the employee and a designated beneficiary.

Under the conference agreement, the required commencement date is April 1 of the calendar year following the year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½, the employee's entire interest is to be distributed no later than April 1 of the calendar year following such plan year, even though the employee has not retired. In the case of employer securities that may not be distributed on account of the 84-month holding period of section 409A(d), the rule applicable to 5-percent owners does not apply with respect to such securities until the applicable holding period expires.

Of course, the conferees intend that an individual who is subject to the 701/2 distribution requirement on the effective date of the conference agreement will not be treated as failing to meet the 701/2 distribution requirement merely because the individual would have been required to begin payments if the rules had been effective in earlier years. The distribution requirement with respect to such an individual commences on April 1 of the year following the first year for which the provision is effective, based on the individual's age in that year.

For purposes of the before-death distribution rules, the conferees intend that an employee's "entire interest" does not include ancillary benefits (such as lump sum death benefits) that are, in no event, available to the employee.

The conferees intend that, in implementing these before-death distribution rules, Treasury regulations will require that distributions over any of the permissible periods are to satisfy a minimum distribution rule similar to the rules under present law, except that the participant's life expectancy may be recalculated no more frequently than annually. Similarly, if payments are made over the joint life expectancy of the employee and the employee's spouse, such joint life expectancy may be recalculated no more frequently than annually. The conferees intend that, in the case of payments made over the joint life expectancy of the employee and a nonspouse beneficiary, Treasury regulations will provide a method of recalculation under the minimum distribution rule that takes into consideration the change in life expectancy of the employee, but not the change in life expectancy of the nonspouse beneficiary.

Distributions over any of the permissible periods from or under a defined benefit pension plan are deemed to satisfy the minimum distribution rule if the plan makes substantially nonincreasing annual payments over any of these periods. The conferees intend, however, that regulations will permit defined benefit pension plan distributions to increase under certain circumstances. For example, certain cost-of-living increases in an employee's annual payments, cash refunds of employee contributions upon an employee's death, an increase in annual benefit payments to the employee upon the death of the employee's beneficiary, and increases based on investment experience generally could be permitted. In no event, however, may increasing payments be permitted if the effect of the increase is circumvention of the minimum distribution rules.

Under a defined contribution plan, the minimum distribution rule is satisfied if the payments are subject to an irrevocable payout schedule that satisfies the minimum distribution rule. In addition, a defined benefit pension plan or a defined contribution plan may satisfy the minimum distribution rule by distributing an immediate annuity contract that provides for payments that satisfy the minimum distribution rule (e.g., provides for substantially nonincreasing annual payments).

The conferees intend that, as under present law, plan distributions, including distributions under annuity contracts distributed by a qualified plan, are required to meet the incidental benefit rule. For example, if a plan provides for a before-death distribution of an immediate annuity contract to the employee and a beneficiary, then the present value of the payments projected to be paid to the employee are to be more than 50 percent of the present value of the payments projected to be paid to the employee and the beneficiary. As under present law, distributions in accordance with the rules relating to qualified joint and survivor annuities will satisfy the incidental benefit rule.

After-death distribution rules

The conference agreement provides rules that apply in the case of an employee's death before the employee's entire interest has been distributed. In the case in which distributions have commenced to the employee before death, the conference agreement provides that the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. For example, if an employee elected to receive benefits in the form of equal annual installments for a term of 20 years (which did not extend beyond the life expectancy of the employee) and the employee died after benefits had been paid for 10 years, the remaining interest of the employee could be distributed in equal annual installments over a term not exceeding 10 years. Of course, the beneficiary could elect to accelerate payments of the remaining interest.

In the case in which distributions have not commenced to the employee before the employee's death, the conference agreement provides that the entire interest of the employee is to be distributed within 5 years after the death of the employee. Under the conference agreement, two exceptions apply to this 5-year distribution rule.

The first exception provides that the 5-year rule does not apply if (1) any portion of the employee's interest is payable to (or for the benefit of) a designated beneficiary, (2) the portion of the employee's interest to which the beneficiary is entitled will be distributed over the life of the beneficiary (or over a period not extending beyond the life expectancy of the beneficiary), and (3) the distributions commence no later than 1 year after the date of the employee's death. The conferees intend that this exception applies only if amounts are paid to the beneficiary under rules that satisfy the minimum distribution rule applicable to before-death distributions. Recalculation of life expectancy is not permitted under this provision.

The Secretary may, under regulations, provide exceptions to the 1-year rule under appropriate circumstances (e.g., if a beneficiary cannot be located). The conferees intend, however, that the regulations could require that catch-up distributions be made with respect to amounts deferred under such exceptions.

The second exception applies if the designated beneficiary is the surviving spouse of the employee. Under this provision, the 5-year rule does not apply if (1) the portion of the employee's interest to which the surviving spouse is entitled will be distributed over the life of the surviving spouse (or over a period not extending beyond the life expectancy of the surviving spouse), and (2) the distributions commence no later than the date on which the employee would have attained age 70½. If the surviving spouse dies before payments are required to commence, then the 5 year rule is to be applied as if the surviving spouse were the employee. The conferees intend that payments to the surviving spouse will satisfy the exception to the 5-year distribution requirement if payments are made pursuant to a qualified joint and survivor annuity.

For purposes of the after-death distribution rules, the conference agreement provides that any amount paid to a child is treated as if it had been paid to the surviving spouse of an employee if the amount becomes payable to the surviving spouse when the child reaches the age of majority (or such other event as may be specified in Treasury regulations).

Under the conference agreement, similar rules are provided for after-death distributions from or under an individual retirement account or annuity. In addition, under the conference agreement, the rules applicable to after-death distributions under an annuity contract are to apply to a custodial account that is treated as a tax-sheltered annuity contract (sec. 403(b)(7)).

Qualifying rollover distributions

The conference agreement follows the Senate amendment.

Effective dates

The conference agreement generally follows the Senate amendment.

The conference agreement provides that a plan is not to be disqualified merely because it pays benefits under a designation made before January 1, 1984, in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (as in effect before the amendments made by the conference agreement).

4. Treatmen. of distributions of benefits substantially all of which are derived from employee contributions

Present law

Present law permits a qualified plan, a tax-sheltered annuity contract, or a governmental plan to be funded solely by employee contributions. Nondeductible employee contributions may be withdrawn from a qualified plan at any time without a tax penalty. In addition, the first withdrawals of nondeductible contributions (prior to the annuity starting date) are treated as a return of the nondeductible contributions, which are not includible in gross income. After the balance of the nondeductible contributions has been withdrawn, further withdrawals are considered to be income.

House bill

The House bill provides that a plan is not a qualified plan if substantially all of the accrued benefits under the plan are derived from employee contributions, other than deductible employee contributions.

The provision is effective for plan years beginning after March 31, 1984.

Senate amendment

Under the Senate amendment, if substantially all of the accrued benefits under a qualified plan are derived from employee contributions, then distributions under the plan will be considered to be income until all income has been withdrawn. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan,

the bill treats the amount of the loan as a withdrawal from the plan.

The provision is effective for amounts received or loans made on or after the 90th day after the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment with two exceptions. First, the conference agreement defines a plan in which substantially all of the contributions are employee contributions as a plan with respect to which more than 85 percent of the total contributions during a representative period (such as 5 years as determined under Treasury regulations) are employee contributions. Of course, if less than 85 percent of the total contributions for all years during which the plan is in existence are employee contributions, then the plan is not a plan in which substantially all of the contributions are employee contributions.

In addition, under the conference agreement, in the case of the Federal Government or an instrumentality of the Federal Government, the 85 percent test is to be applied by aggregating all plans maintained by the Federal Government or such instrumentality. This aggregation rule applies only to those plans that are actively administered by the Federal Government or the instrumentality. For example, if a plan of the Federal Government was administered by a commercial financial institution, it would not be aggregated for purposes of applying the 85 percent test.

Of course, the conferees intend that amounts which are contributed to a qualified cash or deferred arrangement pursuant to an employee's election to defer are not treated as employee contributions to the extent that the amounts are not currently includible in gross income (sec. 402(a)(8)).

In the case of a pre-existing thrift or savings feature to an employer-funded defined benefit arrangement, the conferees intend that the 85 percent test is applied by aggregating the thrift or savings feature with the defined benefit arrangement. This aggregation rule applies only if the employer has consistently treated the 2 features as a single plan, as by consistently filing for (and receiving) one determination letter and filing one annual return covering both features. Voluntary employee contributions to a qualified defined benefit pension plan are not treated as a separate defined contribution plan merely because they are taken into account as contributions to a defined contribution plan in applying the overall limits on contributions and benefits.

5. Repeal of estate tax exclusion for qualified plan benefits

Present law

Under TEFRA, a $100,000 aggregate limit was imposed on the estate tax exclusion for certain benefits payable under qualified plans, tax-sheltered annuities, individual retirement plans (IRAs), and certain military retirement plans. The TEFRA provision was effective for decedents dying after December 31, 1982.

House bill

No provision.

Senate amendment

The Senate amendment repeals the separate $100,000 estate tax exclusion for benefits under qualified plans, tax-sheltered annuities, IRAs, and military retirement plans.

The provision is effective with respect to decedents dying after December 31, 1984. An exception is provided for the estate of any decedent whose benefits are in pay status on the date of enactment and who, prior to that date, made an irrevocable election to designate the beneficiaries who will receive the retirement benefits and the form of such benefits. In addition, the effective date of the TEFRA estate tax provision is amended to provide a similar exception with respect to the $100,000 limit imposed by TEFRA.

Conference agreement

The conference agreement generally follows the Senate amendment with two modifications. First, the conference agreement continues the rule of present law applicable to certain interests created by community property laws. Thus, under the conference agreement, if the spouse of an employee on whose behalf contributions or payments are made by an employer to a qualified plan or a tax-sheltered annuity dies, the spouse's gross estate does not include the value of any interest of the spouse in the plan or annuity. This treatment applies only if the spouse's interest is attributable to the employer's contributions or payments and arises solely by reason of the spouse's interest under the community property laws of a State.

Second, the conference agreement modifies the exception to the effective date provision of the Senate amendment. Under the conference agreement, an exception is provided for the estate of any decedent whose benefits are in pay status on the date of enactment and who, prior to that date, made an irrevocable election to designate the form of the retirement benefits (including the form of any survivor benefits). The conference agreement does not require the irrevocable designation of a beneficiary in order to qualify for the exception. In addition, the effective date of the TEFRA estate tax provision is amended to provide a similar exception with respect to the $100,000 limit imposed by TEFRA.

6. Affiliated service groups and employee leasing arrangements

Present law

Affiliated service groups

Under present law, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the requirements for qualified plans. An affiliated service group consists of certain service organizations and related organizations.

Employee leasing arrangements

Present law provides that, for purposes of certain of the tax-law rules for qualified pension plans and simplified employee pensions (SEPs), certain leased employees are treated as employees of the person who receives their services (the recipient). Present law includes a safe harbor rule under which the leased employee is not treated as the employee of the recipient for purposes of the employee leasing rules if certain requirements are met.

House bill

Affiliated service groups

No provision.

Employee leasing arrangements

The House bill clarifies the present law definition of a leased employee to include only those individuals who are not otherwise employees of the recipient.

The provision is effective for plan years beginning after December 31, 1983.

Senate amendment

Affiliated service groups

The Senate amendment provides that, in determining whether a group of employers constitutes an affiliated service group, more comprehensive attribution-of-ownership rules are provided to include "brother-sister" relationships.

The provision is effective for plan years beginning after December 31, 1984.

Employee leasing arrangements

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the Senate amendment. In addition, the conference agreement provides the Secretary of the Treasury with regulatory authority to develop any rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing provisions apply through the use of employee leasing or other arrangements. The conferees do not intend to imply that such regulations could only be applied prospectively.

For example, the conferees are aware of situations in which professionals are hired as leased employees of their own professional corporations in order to avoid the nondiscrimination rules applicable to qualified plans. The conferees intend that regulations will prevent the avoidance of the nondiscrimination rules through the use of such employee leasing arrangements.

The conferees do not intend any inference that this example is the sole situation in which employee leasing is used to avoid the qualified plan requirements. However, the conferees do not intend to imply that legitimate uses of employee leasing are necessarily abuses. For example, the conferees recognize that the historical use by businesses of temporary help company employees on temporary projects generally is not an avoidance situation subject to the Secretary's regulatory authority provided under the conference agreement if the project has an ascertainable termination date and it is not customary under the circumstances to hire permanent employees for such a project.

7. Determination of whether there is a collective bargaining agreement

Present law

Under present law, special rules relating to employee benefits apply with respect to plans covering collective bargaining units. Some of these rules provide effective dates that are more appropriate for these plans. In other cases, rules forbidding discrimination in favor of highly compensated employees are modified or waived with respect to employees included in a collective bargaining unit.

House bill

The House bill clarifies present law by providing that, in determining whether there is a collective bargaining agreement between employee representatives and one or more employers, an organization is not to be considered an employee representative if more than one-half of its members are employees (including a self-employed individual who is considered to be an employee under the rules for qualified pension plans) who are owners, officers or executives of the employer. This provision is effective on April 1, 1984.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

8. Standards for cash-or-deferred arrangements

Present law

Under present law, a cash-or-deferred arrangement is subject to special tests under which the amount that highly compensated employees can elect to defer (and exclude from current gross income) depends upon

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

the level of deferrals by other employees. These special tests do not permit employer-provided social security benefits to be taken into account. However, proposed Treasury regulations permit a cash-or-deferred arrangement to satisfy the general nondiscrimination standards applicable to qualified plans in lieu of the special tests. The general nondiscrimination rules permit employer-provided social security benefits to be taken into account.

House bill

Under the House bill, a cash-or-deferred arrangement is not a qualified cash-or-deferred arrangement unless the special tests applicable to such an arrangement are satisfied. If an arrangement fails to satisfy the special tests, amounts deferred are not excluded from gross income, but the plan of which the arrangement is a part is not to be disqualified if it meets the usual rules for qualification, including the general nondiscrimination requirements.

All plans of an employer required to be aggregated for nondiscrimination purposes are aggregated for purposes of applying the special tests.

The provision is effective for plan years beginning after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement generally follows the House bill, with two amendments. First, the conference agreement provides that the deferral percentage taken into account for purposes of applying the special deferral percentage tests is the sum of the deferral percentages for an employee under each cash or deferred arrangement in which the employee participates.

Second, under the conference agreement, the provision does not apply to a cash or deferred arrangement maintained, on June 8, 1984, by a State government and with respect to which a determination letter had been issued on December 8, 1982. The conferees intend that no inference is to be drawn from this effective date provision with respect to the issue of whether a State government may maintain a profit-sharing plan.

In addition, the conferees intend that the agreement does not change the rule contained in proposed Treasury regulations, nonelective contributions by the employer to a cash or deferred arrangement may be taken into account in applying the special deferral percentage tests. Such contributions may be taken into account only if the contributions (1) are nonforfeitable when made and (2) satisfy the withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement.

9. Treatment of certain medical, etc., benefits under pension plans

Present law

Present law limits contributions and benefits under qualified pension, profit-sharing, and stock bonus plans. Medical benefits provided under a qualified plan are not taken into account in applying the limits.

House bill

Under the bill, in the case of a qualified plan, medical benefits are to be taken into account with respect to any participant who has an individual medical benefit account. A plan is required to maintain such an account for each key employee. The provision applies to years beginning after March 31, 1984.

Senate amendment

The Senate amendment is the same as the House bill, except that the provision is limited to top heavy qualified plans. The provision applies after the date of enactment.

Conference agreement

The conference agreement follows the House bill.

10. Limits on contributions and benefits under qualified plans

Present law

TEFRA reduced the overall dollar limits on contributions and benefits under qualified plans (qualified plans). In addition, TEFRA suspended all cost-of-living adjustments to these dollar limits until 1986. Beginning in 1986, the limits will be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

House bill

The House bill suspends the cost-of-living adjustments to the dollar limits on benefits and contributions under qualified plans until 1988.

The provision is effective on the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

11. Application of cash-or-deferred arrangement rules to pre-ERISA money purchase pension plans

Present law

Through 1979, the tax treatment of cash-or-deferred profit-sharing and stock bonus plans and money purchase pension plans with salary reduction arrangements in existence on June 27, 1974, was grandfathered under the law before January 1, 1972. The Revenue Act of 1978 provided rules (sec. 401(k)) for all profit-sharing and stock bonus plans with cash-or-deferred arrangements. No new rules were provided by the 1978 Act for pre-ERISA money purchase pension plans with salary reduction arrangements.

House bill

The House bill applies the cash-or-deferred arrangement rules relating to profit-sharing and stock bonus plans to money purchase pension plans with salary reduction arrangements in existence on June 27, 1974. This treatment applies only if employer and employee contributions under the plan do not exceed the limits under the plan's contribution formula in effect on June 27, 1974.

The provision is effective for plan years beginning after the date of enactment. The rules in effect prior to ERISA apply for plan years beginning after December 31, 1979, and before the date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

12. Dollar limits on benefits under qualified pension plans for airline pilots

Present law

Under present law, if benefits begin before age 62, the dollar limit on benefits under a defined benefit pension plan is to be actuarially reduced to reflect the value of early payment. Federal regulations require that commercial airline pilots retire after attaining age 60.

House bill

Under the House bill, the reduction of benefits on account of early retirement applies only to those commercial airline pilots whose benefits commence before age 60. The dollar limit on benefits at age 60 is increased to $90,000 for commercial airline pilots.

The provision is effective for years beginning after December 31, 1982.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the Senate amendment.

13. Elimination of retroactive application of amendments made by Multiemployer Pension Plan Amendments Act of 1980

Present law

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) was enacted on September 26, 1980. Under ERISA, as amended by that Act, liability generally is imposed on an employer who withdraws from a multiemployer defined benefit pension plan. The withdrawal liability provisions of the MPPAA generally apply retroactively to withdrawals after April 28, 1980.

House bill

No provision.

Senate amendment

Generally, under the Senate amendment, any liability incurred by an employer under the withdrawal liability provisions of ERISA, as a result of the complete or partial withdrawal from a multiemployer plan before September 26, 1980, is void. The amendment provides for refunds of amounts paid by an employer to a plan sponsor as a result of such withdrawal liability, reduced by a reasonable amount for administrative expenses incurred by the plan sponsor in calculating, assessing, and refunding the payments.

In the case of an employer who, on September 26, 1980, had a binding agreement to withdraw from a multiemployer plan, the effective date for withdrawal liability is changed to December 31, 1980.

This provision is effective on the date of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment. Under the conference agreement, a plan sponsor is required to refund with interest (as determined under sec. 401(a)(2)) any amounts paid by an employer to a plan sponsor as a result of any withdrawal liability imposed by reason of a complete or partial withdrawal from a multiemployer plan before September 26, 1980. The plan sponsor may deduct a reasonable amount for administrative expenses incurred by the plan sponsor, other than legal expenses of the plan, incurred in collecting the liability.

The conferees do not intend that multiemployer plans are to be liable for any legal expenses incurred by the withdrawn employer (e.g., in opposing its withdrawal liability).

14. Treatment of certain distributions from a qualified terminated plan

Present law

If a lump sum distribution is paid to an employee (or the spouse of a deceased employee) under a qualified plan, tax is deferred on the portion of the distribution rolled over, within 60 days, to another qualified plan or to an IRA. A distribution from a qualified plan is not a lump sum distribution unless it consists of the balance to the credit of the employee under the plan and is made within one taxable year of the recipient.

House bill

No provision.

Senate amendment

The amendment provides special relief for certain pension plan distributions received during 1976 and 1977 and transferred to an IRA. Under the amendment, the transfers are treated as a qualifying rollover distributions. Thus, to the extent the payments were, in fact, rolled over to an IRA within 60 days of receipt, the distribution will not be includible in income.

The amendment is effective upon enactment.

Conference agreement

The conference agreement follows the Senate amendment.

15. Special rule for Trans-Alaskan Pipeline employees

Present law

Under a qualified plan, benefits are provided to participants under plan formulas that determine the amount of the benefit a participant may earn; the portion of that benefit that has been earned (accrued), and the portion of the earned benefit that is vested or nonforfeitable.

Under the Code, if an employer maintains a qualified plan and an act of the employer (e.g., dismissing employees) causes a partial termination of the plan, then the rights of all affected employees to benefits accrued to the date of the partial termination generally must be nonforfeitable to the extent those benefits are funded. Under the Code, whether a partial termination of a qualified plan has occurred (and the time of its occurrence) is determined by the Commissioner of Internal Revenue on the basis of all the facts and circumstances in a particular case.

House bill

No provision.

Senate amendment

Under the Senate amendment, a partial termination does not occur in the case of a turnover of employees under a plan in the State of Alaska occurring between December 31, 1975, and January 1, 1980, in connection with the completion of the Trans-Alaskan Oil Pipeline construction project if certain requirements are met.

The provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

16. Distribution requirements for plans, accounts, and annuities of an insurer in rehabilitation proceedings

Present law

Under present law, distributions under a qualified plan generally must commence in the later of the taxable year in which a participant (1) retires or (2) attains age 70½. Distributions under an IRA must commence no later than the year in which the owner attains age 70½. If the IRA distribution rules are not satisfied, a 50-percent excise tax is applied to the amount that should have been distributed.

House bill

No provision.

Senate amendment

The Senate amendment provides that an amount is not required to be distributed under the usual rules for qualified plans and IRAs to the extent that the amounts are held by an insurer that, on March 15, 1984, is engaged in a rehabilitation proceeding under applicable State insurance law (e.g., Baldwin-United). The provision applies only for the period during which the insurer is engaged in the proceedings.

The provision is effective on March 15, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

17. Extension of time for repayment of qualified refunding loans

Present law

TEFRA imposed limits on the extent to which an individual can borrow amounts from a qualified plan without the loan being treated as a distribution to the individual under the plan. Under TEFRA, a transition rule was provided for certain "qualified refunding loans" made on or after August 13, 1982, and repaid before August 14, 1983.

House bill

No provision.

Senate amendment

The bill extends the period for making and repaying a qualified refunding loan to January 1, 1985, with respect to individuals who are not key employees, without regard to whether the plan is top-heavy.

The provision is effective as if enacted in TEFRA.

Conference agreement

The conference agreement follows the Senate amendment.

18. Pension portability involving telecommunications divestiture

Present law

Under the rules for qualified plans, all employees of related employers are treated as employed by a single employer. Consequently, an employee's service with a predecessor employer is treated as service with a successor employer. Generally, two or more employers may agree to provide for transferability of benefit and service credits (portability) under their plans even though they were never related.

Under the modified final judgment requiring the divestiture of AT&T subsidiaries, with respect to an employee's service with AT&T or any of its subsidiaries subject to the judgment, an employee's service performed before 1985 is treated as service for each other employer subject to the judgment. Under the judgment, however, post-1984 service for one of the employers subject to the judgment is not to be taken into account as service by any of the other employers subject to the judgment.

House bill

No provision.

Senate amendment

Under the Senate amendment, the recognition after December 31, 1983, of creditable service of a transferred qualifying employee, and the treatment after that date of associated accrued benefits and assets, are to be governed by the provisions of the modified final judgment as those provisions applied during calendar year 1984 with respect to transfers to or from the divesting corporation and any subsidiary. The provision applies in the case of a qualifying employee who transfers between any entities subject to the modified final judgment. The Senate amendment does not limit benefits that would otherwise be provided under the modified final judgment or under applicable law.

The Senate amendment provides that, in computing the overall limits on contributions and benefits (sec. 415 of the Code) for any employee who, on December 31, 1983, was an employee of an entity subject to the modified final judgment, contributions and benefits under all plans of such entities shall be taken into account. Accordingly, contributions and benefits provided after December 31, 1983, for such employees, are to be taken into account together with contributions and benefits provided as of December 31, 1983. The provision clarifying the application of the overall limits in this case is not to be regarded as a precedent for the determination of how the limits apply in other cases.

The Senate amendment exempts the employees of Sandia Corporation of Albuquerque, N.M., from coverage under the provision.

Generally, the provision applies on the date of enactment. The provisions with respect to the limits on contributions and benefits apply for years ending after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment with several modifications.

Under the conference agreement, in the case of any change in employment on or after January 1, 1985, by a covered employee, the recognition of service credit and the enforcement of such recognition, shall be governed in the same manner and to the same extent as provided under the divestiture interchange agreement for a change in employment by a covered employee during calendar year 1984.

Prior to divestiture, the Bell System Pension Plan provided for the full recognition and interchange of service credit and benefit obligations between and among all participating Bell System companies, and including Cincinnati Bell and Southern New England Telephone. These provisions were formally known as "interchange" agreements.

After divestiture, however, the interchange agreements were no longer applicable. In place of those agreements, a "divestiture interchange agreement" was entered into by AT&T, the regional Bell operating companies, the BOCs' Central Services Organization, Advanced Mobile Phone Service, Inc., and Cincinnati Bell.

The divestiture interchange agreement provides continued mutual reciprocal recognition of post-divestiture service credit between and among AT&T, the divested Bell operating companies, and the other parties to that agreement. Recognition of service credit applies for all purposes, including seniority provisions under applicable collective bargaining agreements.

The applicability of the divestiture interchange agreement is limited to calendar year 1984, in the case of most Bell System employees. The vast bulk of AT&T and Bell company employees, in other words, would not be able to take their accumulated service credit with them in the event of a move from one local Bell company to another, or between a local Bell company and AT&T, after 1984. *See* Plan of Reorganization submitted on December 16, 1982, in *United States* v. *Western Electric Co., et al*, Civil Action No. 82-0192 (D.D.C.), 284-289. The Plan of Reorganization, including this limited portability of service credit, was approved by U.S. District Judge Harold H. Greene on August 5, 1983. *United States* v. *Western Electric Co., et al.*, 569 F. Supp. 1057, 1091-1097 (D.D.C. 1983), aff'd *sub nom. California* v. *United States*, 104 S. Ct. 542 (1983).

Notwithstanding the time limitations in the divestiture interchange agreement, the conference agreement permanently extends beyond 1984 the provisions of the agreement that govern the recognition of service credit and the enforcement of such recognition, in the case of any change in employment by a covered employee on or after Jan-

uary 1, 1985. For such an employee, in other words, there would be no time limitation on the portability of service credit granted under the divestiture interchange agreement. In addition, as noted above, employees of Southern New England Telephone Company would also be covered by the legislation, even though the company did not sign the divestiture interchange agreement.

Under the conference agreement, a covered employee is an employee of an entity subject to the modified final judgment who is serving in an eligible position, and who was either (A) an employee of an entity subject to the modified final judgment, and serving in an eligible position, on December 31, 1983, or (B) a former employee who had rehire or recall rights on December 31, 1983, under applicable collective bargaining agreements, and who is rehired during the period of his or her rehire or recall rights. A covered employee can move from one entity subject to the modified final judgment to another such entity without losing service credit.

A person need not work continuously after December 31, 1983, for an entity subject to the modified final judgment (a "subject entity"), in order to be considered a covered employee. For example, suppose a person who was working for a subject entity on December 31, 1983, continues to work for that company during 1984 and 1985, but leaves in 1986 for a job with a firm that is not a subject entity. In 1987, that person returns to work at a subject entity (although not necessarily the same company he or she left in 1986). Under those circumstances, that person would be a covered employee during 1984 and 1985, and again beginning in 1987. The subject entity for which he or she is working in 1987 must recognize the service credit he or she accumulated during employment with other subject entities. The conferees do not intend that subject entities must recognize service credit earned at firms that are not subject to the modified final judgment; nor do the conferees intend this provision to require employers who are not subject to the modified final judgment to recognize service credit earned at subject entities.

The conference agreement provides that "service credit" means service credit for benefit accrual, vesting, and eligibility for any benefits under pension plan, or any other employee benefits, including seniority rights; the right to other benefits such as medical and dental care, insurance, and disability payments; the ability to bid on vacations and shifts; and any other rights which have been secured under applicable collective bargaining agreements. The term also includes the interchange and treatment of associated benefit obligations and assets.

"Change in employment" means the movement of a covered employee from one entity subject to the modified final judgment to another such entity. Even if there is a break in service—for instance, where a person moves from one entity subject to the modified final judgment to a firm not subject, and from there to another entity that is subject—the eventual movement from the first entity subject to the modified final judgment to the second such entity is a "change in employment" for purposes of this legislation. However, as noted above, only service credit earned at entities subject to the modified final judgment is required to be recognized in the event of a change in employment.

Under the conference agreement, an "eligible position" means a nonsupervisory position, or a position that pays not more than $50,000 (adjusted by the percentage increase in the consumer price index since December 31, 1983). "Modified final judgment" means the settlement of the AT&T antitrust suit, *United States* v. *Western Electric Co., et al.*, Civil Action No. 82-0192 (D.D.C.).

"Entity subject to the modified final judgment" means the 22 Bell operating companies divested under the settlement of the AT&T (except for any subsidiary that does not participate in a defined benefit pension plan, as discussed below); Southern New England Telephone Company and Cincinnati Bell Inc., which were not divested under the antitrust settlement, but in which AT&T held a minority interest on December 31, 1983; and any Interchange Company, as defined in the divestiture interchange agreement, together with any subsidiary of such company which was established as of December 31, 1983, and which participates in a defined benefit pension plan maintained by the Interchange Company.

AT&T, the seven regional Bell holding companies, the BOC's Central Services Organization (now called Bell Communications Research, Inc.), Advanced Mobile Phone Service, Inc., and Cincinnati Bell, Inc. are Interchange companies under the divestiture interchange agreement, and are therefore included in the term "entity subject to the modified final judgment." In addition, it is the conferees' understanding that all Interchange Company subsidiaries established as of December 31, 1983 (except for AT&T's Sandia Corporation, U.S. West's Beta West, Inc. and U.S. West Services, Inc., and Bell South Enterprises) currently participate, or shortly plan to participate, in a defined benefit pension plan. Consequently, they are also entities subject to the modified final judgement. These subsidiaries include, but are not limited to, Bell Labs, Western Electric, AT&T Information Systems, and the cellular radio subsidiaries of the regional Bell operating companies. The conferees do not intend to restrict the ability of any Interchange Company to extend portability of service credit to employees at any other subsidiary, under a collective bargaining agreement, for example, or by any other means.

The conferees recognize that some subsidiaries established as of December 31, 1983, did not participate in defined benefit pension plans until after that date. The conferees intend that any subsidiary which participates in such a plan, regardless of when the decision to participate is made, will be included in the term "entity subject to the modified final judgment." The conferees also intend that such term include any subsidiary which participates in a defined pension plan on the date of enactment of this legislation.

Under the conference agreement, "divestiture interchange agreement" means the agreement among the Bell System companies and AT&T, executed as of November 9, 1983, which provides for mutual reciprocal recognition of service credit. "Consumer price index" means the Consumer Price Index (all items—United States city average) published monthly by the Bureau of Labor Statistics.

Nothing in this conference agreement is intended to limit benefits that are otherwise available to any individual under the provisions of the modified final judgment (including the divesture interchange agreement), under applicable law, or otherwise. This includes, but is not limited to, rights under the Communications Act of 1934, as amended, and the Employee Retirement Income Security Act of 1974 (ERISA), as amended. A person alleging a violation of this legislation may seek redress under the Communications Act of 1934 (which governs communications common carriers), under applicable labor and pension statutes, or at common law.

The conference agreement does not follow the Senate amendment with respect to the limits on contributions and benefits under sec. 415. It is the understanding of the conferees that present law provides for the aggregation of contributions and benefits under plans maintained by separate employers for purposes of the overall limits on contributions and benefits in situations in which prior service with another employer is recognized by the employer.

B. Welfare Benefit Plans

1. Deductions for contributions to funded benefit plans

Present law

An employer's contribution to a fund that is a part of a welfare benefit plan may be deductible in the year it is made rather than at the time the benefit is provided. Deductions for employer contributions to a nonqualified deferred compensation plan are generally not allowed until an amount is includible in the gross income of the employee.

House bill

The House bill generally limits employer deductions for a contribution to a VEBA, SUB to the amount that would be deductible by a cash-method taxpayer for a payment under an unfunded plan. An additional deduction is allowed for an addition to a funded reserve. Generally, the reserve is limited to 75 percent of insurance-type benefits provided by the plan during the current year and the preceding year. A transitional rule is provided for pre-enactment accumulations.

The House bill would generally apply to contributions paid or accrued after March 31, 1984 in taxable years ending after that date. The bill provides a delayed effective date for collectively bargained plans.

Senate amendment

No provision.

Conference agreement

a. Contributions to funded welfare benefit plans

The conference agreement generally follows the House bill, with modifications. In general, deductions for contributions to a welfare benefit fund are limited to qualified costs, which is the sum of (i) qualified direct costs, and (ii) additions, within limits, to a qualified asset account. Several changes are made to the definitions of qualified direct cost and welfare benefit and substantial modifications are made to the allowable limit on a qualified asset account.

Child care facilities.—Under the conference agreement, in determining qualified direct costs with respect to a child care facility held by a fund, the adjusted basis of the facility is treated as deductible ratably over a period of 60 months. A child care facility is tangible property of a character subject to depreciation and located in the United States, and must be a child care center primarily for children of the employees of the employer. As under the House bill, qualified direct costs with respect to other capital expenditures are those which would be allowed under the usual Code rules which would be applied if the employer owned the asset.

Definition of welfare benefit fund.—In general, this section of the bill applies to contributions to welfare benefit funds which are organizations, reserves or accounts held by organizations, through which an employer provides welfare benefits to employees or their beneficiaries. In prescribing regulations relating to the definition of the term "fund," the conferees wish to emphasize that the principal purpose of this provision of the bill is to pre-

vent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer. Thus, a retired life reserve or premium stabilization account ordinarily is to be considered a fund or part of a fund, since such an account is maintained for an individual employer and that employer has a determinable right to have the amount in such an account applied against that employer's future costs of benefit claims or insurance premiums. A similar situation exists with respect to premium arrangements, under which an employer may, in some cases, pay an insurance company more in a year than the benefit costs incurred in that year and the employer has an unconditional right in a later year to a refund or credit of the excess of payments over benefit costs. In contrast, an ordinary disability income policy under which an employer pays a premium so that employees who become disabled in that year may collect benefit payments for the duration of disability is not a fund, since the employer has no right to recover any part of the premium payment and the future benefit payments to an employee whose disability occurs during the period for which the premium is paid is not contingent on any further payments by the employer. While in many cases welfare benefit funds are designed to function in a manner similar to insurance arrangements, the conference is concerned that there are no clear standards or limitations applicable to such funds that prevent their utilization for substantial nonqualified deferred compensation funding outside the general pension plan funding, accrual and vesting rules.

Limitations on qualified asset account.—The conference agreement includes substantial modifications to the provisions setting forth the limitation on additions to a qualified asset account. Such an account consists of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment or severance pay benefits, and life insurance or death benefits.

In general, the account limit is the amount estimated to be necessary under actuarial assumptions that are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid, for benefits described in the previous paragraph and administrative costs of such benefits, as of the close of the taxable year. Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death actually occurs. The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid. An example of an incurred but unpaid claim is the occurrence of the death of an employee during the year under a plan that provides for payments to a survivor of the employee for the survivor's remaining life. Under the conference agreement, the qualified asset account may include the estimated present value of the future stream of benefits payable to this survivor, using reasonable assumptions as to earnings of the fund and mortality experience.

With respect to disability benefits, the conferees expect that Treasury regulations will provide more specific guidance as to the time at which claims are incurred. It is the intention of the conferees that a disability is to be defined as any serious physical or mental impairment which causes an inability to perform a substantial portion of the duties of an individual's ordinary employment. The conferees intend that funding of claims with respect to an indefinite period of time is to be allowed only in connection with disabilities which are determined to be long-term disabilities. Such disabilities are those which (1) a medical evaluation determines is expected to last for more than 12 months and (2) has persisted for at least 5 months. With respect to such disabilities, current deductions are to be allowed for contributions necessary to fund the expected future stream of benefit payments using reasonable assumptions as to morbidity, mortality, and fund earnings. Other disabilities which have persisted for at least 2 weeks are to be considered short-term disabilities; no more than 5 months of benefit payments may be deemed to have been incurred with respect to short-term disabilities.

In general, in addition to requiring that actuarial assumptions are to be reasonable in the aggregate, Treasury regulations may prescribe specific interest rate and mortality assumptions to be used in all actuarial calculations. Such assumptions are to be consistent with requirements provided elsewhere in conference agreement for the computation of tax reserves held by life insurance companies.

Limitation on disability, or SUB, or severance benefits taken into account.—In the case of any disability benefit, a reserve may not be established with respect to a benefit payment in excess of the lesser of the limit for the year on an annual benefit under a qualified defined benefit pension plan ($90,000 for 1984) or 75 percent of a disabled employee's annual compensation from the employer.

With respect to supplemental unemployment compensation benefits (SUB) and severance pay benefits the portion of an annual benefit in excess of 1.5 times the limit on contributions under a qualified defined contribution plan ($45,000 for 1984) for any employee is not to be taken into account in determining the limit.

Prefunding of life insurance, death benefits, or medical benefits for retirees.—The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the medical benefit or life insurance (including death benefit) payable to a retired employee during retirement is fully funded upon retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of the employee, with the employer of each employee. Each year's computation of contributions with respect to retiree medical benefits is limited to the use of assumptions that the medical benefits provided to retirees in the future will have the same cost as medical benefits currently provided to retirees (projected inflation is not to be taken into account). Of course, no advance deduction is to be allowed with regard to a plan which provided medical or life insurance benefits exclusively for retirees, since such a plan would be considered a deferred compensation plan subject to the rules of section 404 rather than the provision applicable to funded welfare benefit plans. The conferees intend that the Treasury Department prescribe rules requiring that the funding of retiree benefits be based on reasonable and consistently applied actuarial cost methods, which take into account experience gains and losses, changes in assumptions, and other similar items, and be no more rapid than on a level basis over the remaining working lifetimes of the current participants (reduced on the basis of reasonable turnover and mortality assumptions).

Further, contributions for any employee who is a key employee are required to be accounted for separately by a welfare benefit fund. The separate account is to include amounts contributed to the plan with respect to any service after the employee becomes a key employee as well as a reasonable allocation (determined under Treasury regulations) of amounts contributed to the fund on account of the employee before key employee status was attained. Medical and life insurance benefits with respect to such an employee may be only from such account. In addition, in the case of a key employee, the conference agreement provides that post-retirement medical benefits are to be taken into account in applying the limitations on contributions and benefits under qualified plans (sec. 415) under principles similar to those applicable to post-retirement medical benefits provided by qualified pension plans.

In addition, under the conference agreement, if the life insurance or medical coverage provided by a plan discriminates in favor of employees who are officers, shareholders, or highly compensated, then the limit on the qualified asset account may not take account of contributions to provide such coverage.

Finally, the amount of life insurance or death benefit that may be taken into account with respect to prefunding of retiree benefits of any employee is not to exceed the amount of the insurance that may be provided to the employee tax-free under section 79. This amount generally is limited to $50,000 but the $50,000 limit may not apply in the case of certain grandfathered employees defined by amendments to section 79 elsewhere in the conference agreement.

SUB and severance pay reserve.—The conference agreement provides an additional reserve for SUB and severance pay benefits equal to 75 percent of the sum of (a) the average annual qualified direct cost of such benefits provided and (b) the administrative costs, during any 2 of the immediately preceding 7 years. Such benefits may include medical or other benefit payable to severed or unemployed workers. The agreement also authorizes Treasury regulations under which an interim limit is to be provided in the case of a new SUB or severance pay plan. The interim reserve is not available, under the agreement, in the case of a plan that provides SUB or severance benefits for any employee who is a key employee.

Safe-harbor.—The conference agreement provides that an actuarial certification by a qualified actuary (determined under Treasury regulations) justifying the taxpayer's reserve computations is not necessary if the amount in the qualified asset account is below a prescribed safe harbor, equal to the sum of separate safe harbor amounts computed with respect to each benefit. For short-term disability benefits, the safe harbor amount is 17.5 percent of benefit costs plus administrative costs in the prior taxable year; for medical benefits, the safe harbor amount is 35 percent of prior year medical benefits and allocable administrative costs. For SUB or severance benefits, the safe harbor amount is the additional reserve described above. Safe harbor amounts for long-term disability, life insurance and retiree medical benefits may be prescribed by Treasury regulations. For any safe harbor limitation based on prior plan costs, insurance premiums may not be taken into account, because the conferees do not intend that a fund is to be used as a vehicle for prepayment of insurance premiums for current benefits. Even if the safe harbors are satisfied, the taxpayer is to show that

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the reserves, as allowed under the general standards provided by the bill (e.g., claims incurred but unpaid) are reasonable.

Certain collectively bargained plans.—By July 1, 1985, the Treasury Department is to publish final regulations establishing special reserve limit principles with respect to welfare benefit funds maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence of good faith bargaining over the benefits provided by the plan between the employee representatives and the employer (or employers).

In establishing these limits, the Treasury is to presume that reserves in such plans are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process. Because contributions under such plans are often made on the basis of a defined contribution fixed over a multiyear period on the basis of economic assumptions which prove to be incorrect and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits are to allow substantial flexibility in determining the application of these provisions with respect to such plans.

Transitional rule.—Under the conference agreement, in the case of a plan that was in existence on June 22, 1984, special rules are provided for the determination of the limit for each of the first four years to which the provision applies. In particular, the agreement provides that for the first year, the limit for the year is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the excess reserve amount. The excess reserve amount for any year is the excess of the reserve as of the end of the first plan year ending after the date of enactment over the limit determined without regard to the transitional rule. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively, of the excess reserve amount for such years is to be added to the limit determined under the usual rules.

Elective aggregation.—Under the conference agreement, an employer may elect to aggregate plans and funds in applying the deduction limits and the rules prohibiting discrimination in favor of certain employees. The agreement provides, however, that the election to aggregate must be consistent for deduction and discrimination purposes. For example, if an employer elects to aggregate 2 plans for deduction purposes, those 2 plans must be aggregated for discrimination purposes.

10 or more employer plans.—For a plan year in which no employer (or employers related to an employer) are required to contribute more than 10 percent of the total contributions, the conference agreement provides that the deduction limits do not apply. The exclusion is provided because under such a plan, the relationship of a participating employer to the plan often is similar to the relationship of an insured to an insurer. The agreement authorizes Treasury regulation under which the percentage may be increased in appropriate cases. For example, a higher percentage could be appropriate in the case of a plan maintained by employers in the construction industry if unusual building activity in the geographic area covered by the plan causes temporary and unusual distortions in the contribution pattern under the plan.

The agreement provides, however, that notwithstanding compliance with the 10-percent rule, and consistent with the discussion above on definition of a fund, a plan is not exempt from the deduction limits if the liability of any employer who maintains the plan is determined on the basis of experience rating because the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer.

Effective date.—These provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained under a collective bargaining contract in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.

In addition, these provisions apply to any contribution of a facility to a welfare benefit fund after June 22, 1984, so that deductions with respect to this contribution are to be determined under usual Code rules applicable to recovery of the cost of assets (but taking account of the special rule for child care facilities described above). Further, these rules apply to other contributions, such as cash, made after that date which are to be used to acquire a facility, so that later acquisition of facility with the use of such funds will limit the deduction for the original contribution. This rule does not apply for any facility acquired under a binding contract in effect on and at all times after that date or any facility under construction on June 22, 1984.

b. Unfunded deferred benefits

The conference agreement follows the House bill, with two modifications. First, the agreement provides that any vacation benefit to which an election applies under section 463 is not to be considered a deferred benefit subject to the rules of section 404. Second, the bill provides that that provision generally is effective for amounts paid or incurred after the date of enactment. However, in the case of an extended vacation pay plan in effect on June 22, 1984 and maintained under a collective bargaining agreement, the provision is not effective until the agreement terminates (without regard to any extension agreed to after June 22, 1984). An extended vacation pay plan is one under which employees gradually over a period of years earn the right to additional vacation which cannot be taken until the end of this period. Such a plan is a deferred benefit plan, which under the conference agreement is subject to the deduction-timing rules of section 404.

However, the conferees intend that payment of bonuses or other amounts within 2½ months after the close of the taxable year in which significant services required for payment have been performed is not to be considered a deferred compensation or deferred benefit plan. The conferees also intend that the reference in the House bill to deferred compensation arrangements under section 404(b) includes all compensation, fee, and similar payments, however denominated, except those which are specifically exempted.

2. Excise taxes on funded benefit plans

Present law

No provision.

House bill

No provision.

Senate amendment

Under the Senate amendment, an excise tax is imposed on an employer who maintains a top heavy funded welfare benefit plan with an excess reserve. The tax is equal to the sum of (1) for each year in which an excess arose, the product of the addition to the excess and the highest corporate income tax rate in effect for the current year, and (2) a tax equal to interest on that amount from the time the excess arose to the current year.

The Senate amendment defines excess reserves for a year as reserves in excess of the reserve limit. The reserve limit for a year is the sum of (1) 3 times the average annual benefits paid by the fund during the current year and the preceding year for total and permanent disability, and (2) ⅓ of the average annual benefits paid by the fund during that period for medical care, severance pay, and supplemental unemployment compensation.

Under the Senate amendment, a fund is generally top heavy for a year if more than 50 percent of any class of its benefits are provided to key employees. Special rules are provided for educational benefits and in the case of a benefit that consists of the use of a facility, top heavy use of the facility would result in excise taxes on the employer and on key employees. Benefits provided by a top heavy fund to a key employee are subject to an excise tax imposed at the highest individual income tax rate for the year.

The Senate amendment defines a key employee as (a) an owner of more than 5 percent of the employer, (b) an officer of the employer, or (c) a member of the family of a key employee. Key employee status is permanent under the Senate amendment.

The Senate amendment applies to years beginning after December 31, 1984.

Conference agreement

Under the conference agreement, an excise tax is imposed with respect to disqualified benefits provided by a fund under a welfare benefit plan. The tax is equal to 100 percent of the disqualified benefits provided during a taxable year and is imposed on the employer who maintains the fund.

Under the agreement, a disqualified benefit is (1) (any medical benefit or life insurance benefit provided with respect to a key employee (sec. 416(i)) other than from a separate account established for that employee under the new rules relating to deductions under funded welfare benefit plans (sec. 419(A)(d)), (2) any medical or life insurance benefit provided with respect to a retired employee unless the benefit is provided from a fund that meets the additional requirements for tax exempt status provided by the agreement (sec. 505(b)(1)), and (3) any portion of the fund reverting to the benefit of the employer.

The amount to be charged against a key employee's account is to be determined under Treasury regulations. The conferees intend that these regulations will provide for the computation of this amount on the basis of the key employee's allocable share of the cost of providing the benefit for the year to all covered employees.

This provision is effective under the same rules applicable to the provisions relating to deductions for plan contributions.

3. Tax treatment of exempt benefit organizations

Present law

The income of certain tax-exempt organizations, including a supplemental unemployment compensation benefit trust (SUB) and a group legal service organization (GLSO) generally is not subject to income tax. However, a tax applies to the unrelated business income of such an organization. In addition, the other income of a voluntary employees' beneficiary association (VEBA) is subject to the tax on unrelated business income to the extent it is not set aside for an exempt purpose. No specific limit is provided on the amount that may be set aside for an exempt purpose.

No part of the net earnings of a tax-exempt VEBA may inure to the benefit of any private shareholder or individual other than through the payment of permissible benefits. Under Treasury Regulations, a VEBA violates this standard if it does not meet rules prohibiting discrimination in favor of employees who are officers, shareholders, or highly compensated. The eligibility criteria for VEBA membership and benefits under a VEBA may not be established or administered in a manner that limits membership or benefits to officers, etc., or entitles them to benefits that are disproportionate to benefits for other employees. A tax-exempt VEBA is required to benefit at least 2 employees.

Under present law, an organization or trust created or organized exclusively to form part of a group legal services plan (within the meaning of sec. 120) may be entitled to tax exemption.

House bill

Unrelated business income tax.—The income of a VEBA, SUB, or GLSO for a year is subject to the tax on unrelated business income to the extent that benefit plan reserves for the year exceed the reserve limit.

Benefits for certain employees.—A VEBA, SUB, or GLSO is not tax exempt if more than 25 percent of any class of benefits it provides is provided to an individual who (a) is one of the 5 highest paid officers, (b) owns more than 10 percent of the value of the employer, or (c) is one of the 10 percent highest paid employees. The provision does not apply to a collectively bargained plan.

Discrimination.—A VEBA, SUB, or GLSO is not tax exempt if any class of benefits discriminates in favor of highly compensated employees. The new nondiscrimination standard does not apply to a class of benefits for which a nondiscrimination standard is otherwise provided by the Code. The provision does not apply to a collectively bargained plan.

Reporting requirements.—A VEBA, SUB, or GLSO is not tax exempt unless it notifies the IRS of its claim to tax exempt status.

Effective date.—The provision applies to taxable years beginning after December 31, 1984.

Senate amendment

Unrelated business income tax.—No provision.

Benefits for certain employees.—Similar to the House bill except that the limit is applied to benefits provided to key employees. Under the Senate amendment, the following are key employees permanently: (1) an owner of more than 5 percent of the employer, (2) an officer of the employer, or (3) a member of the family of a key employee. The provision does not apply to a multiemployer plan.

Discrimination.—Same as the House bill except that if the Code provides standards under which a class of VEBA, SUB, or GLSO benefits is excludible from gross income, then the nondiscrimination rules of the Senate amendment are met only if those standards are satisfied. The provision does not apply to a multiemployer plan.

Reporting requirements.—An employer who maintains a VEBA, SUB, or GLSO is required to report on whether the organization meets the nondiscrimination and concentration of benefits standards.

Effective date.—Same as the House bill.

Conference agreement

Unrelated Business Income.—Under the conference agreement, the special rules applicable to voluntary employees' beneficiary associations (VEBAs) and social clubs for purposes of the tax on unrelated business taxable income are extended to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). In addition, under the agreement, more specific limits are provided with respect to the amount that may be set aside for exempt purposes by such an organization.

Under the agreement, in the case of a VEBA, etc., the amount set aside for an exempt purpose is generally not to exceed the qualified asset account limit (sec. 419A(c)) for the taxable year (without taking into account any reserve for medical benefits provided to retired employees). In addition, the amount set aside for exempt purposes is not to include any facility used to provide recreational and other certain other benefits. The limit on the set-aside applies to more-than-10-employer VEBAs which are exempt from the deduction limitations.

The agreement provides a transitional rule for existing reserves to provide medical benefits and life insurance benefits to retired employees. Under the agreement, the income attributable to an existing reserve is not subject to the new rules for calculating unrelated business taxable income. The agreement provides that an existing reserve is the amount of assets set aside as of the close of the last plan year ending before the date of the enactment of the bill for purposes of providing such benefits. The transition relief applies to a reserve to provide such benefits only to the extent the reserve does not exceed the amount that could be accumulated under the principles of Rev. Ruls. 69-382, 1969 C.B. 28, and 73-599, 1973-2 C.B. 40. All future payments of medical or life insurance benefits to retirees under plans of the employer are to be charged against the reserve to which the transition rule applies.

The new rules for calculating unrelated business taxable income are not to apply to any organization if substantially all of the contributions to the organization are made by employers who were exempt from income tax throughout the 5-taxable year period ending with the taxable year in which the contributions are made.

The agreement also provides for a tax on an employer who maintains a welfare benefit fund that is not exempt from income tax. Under the agreement, in the case of any welfare benefit fund, such as a retired life reserve account, that is not exempt from income tax as a social club, VEBA, SUB, or GLSO, the employer who maintains the fund is to include in gross income for the taxable year an amount equal to the deemed unrelated income of the fund. The agreement provides that deemed unrelated income of such a welfare benefit fund is the amount that would be unrelated business taxable income of the fund if it were a tax exempt social club, VEBA, SUB, or GLSO. In determining deemed unrelated income, at the election of the employer, 2 or more nonexempt welfare benefit funds of the employer may be treated as a single fund. Also, under the rules relating to deemed unrelated income, the aggregation rules applicable to qualified pension plans are to apply.

This provision is effective under the same rules applicable to the provisions relating to deductions for plan contributions.

Benefits for Certain Employees.—The conference agreement does not contain the provisions of the House bill on the Senate amendment.

Discrimination.—The conference agreement generally follows the provisions of the House bill establishing new nondiscrimination standards for a tax-exempt voluntary employees' beneficiary association (VEBA), or group legal services organization (GLSO). With respect to the nondiscrimination rules, certain employees who are not covered by a plan may be excluded from consideration in applying the nondiscrimination standards. These employees are employees who have not attained the age of 21, employees who have not completed 3 years of service with the employer, less than ½-time employees, employees who are included in certain collective bargaining units, and certain nonresident aliens.

The conferees wish to clarify the rules of the House bill relating to integration of benefits under a VEBA with social security. In testing whether a disability plan funded with an exempt trust violates the rules forbidding discrimination in favor of employees who are officers, shareholders, or highly compensated, a part of each employee's Social Security benefit (the part considered to be paid for by the employer) can be taken into account as if it were provided under the employer's plan. Similar integration rules are provided for qualified pension plans.

For example, a pension plan may provide a retirement benefit that is reduced by up to 83⅓ of the primary insurance amount for the employee under Social Security. This 83⅓ percent offset represents the part of the employee's Social Security benefit that the employer is considered to have provided. It includes the value of the employer's Disability Income (DI) contribution, as well as his Old-Age and Survivor's Insurance (OASI) contribution. The Disability Income benefit is considered to make up 10 percent of the value of employer-provided Social Security benefits. Thus, if the employer provides a disability benefit under the pension plan and the disability benefit is reduced by 100 percent of the Social Security benefit, then the employer may "take credit" for only 90 percent of employer-provided Social Security benefits when paying a retirement benefit. Accordingly, only 75 percent (90 percent of 83⅓) of Social Security benefits could be subtracted from the retirement benefit.

Thus, under the agreement, if an employer's pension plan is not more than 90 percent integrated—that is, it does not reduce benefits by more than 90 percent of the amount by which they could be reduced (e.g., by more than 75 percent of social security benefits)—then double integration does not occur. In this case, the agreement requires no change in either the pension plan or the disability plan.

On the other hand, if an employer's pension plan is more than 90 percent integrated, the full value of the Disability Income benefit under Social Security could not be used to reduce long-term disability benefits under the employer's plan. For example, if the pension plan is 93 percent integrated (so that 30 percent of the employer's Social Security Disability Income benefit has been used by the pension plan), then no more than 70 percent of the Disability Income benefit could be applied to reduce long-term disability benefits under the employer's plan. Of course, if the pension plan were 100 percent integrated, the long-term disability benefit under the employer's plan could not be integrated with Social Security. The rules relating to integration of long-term disability benefits apply to benefits funded by employer contributions as well as benefits funded by employee contributions.

Of course, the agreement also permits the integration of long-term disability benefits with workers' compensation benefits.

In addition, the agreement does not affect the integration of long-term disability benefits for employees who are disabled before the effective date.

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Effective date.—The conference agreement follows the House bill.

Reporting Requirements.—The conference agreement follows the House bill.

Studies.—Under the conference agreement, the Secretary of the Treasury is directed to study the possible means of providing for minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary is to report to the Congress with respect to the study by February 1, 1985. The conferees expect that the Secretary will provide suggestions for minimum standards where appropriate.

4. Employer and welfare benefit fund treated as related persons

Present law

Under present law, the gain from the sale of depreciable property between certain related taxpayers is treated as ordinary income but an employer and a welfare benefit fund to which the employer contributes are not generally treated as related parties.

House bill

The House bill treats an employer and a welfare benefit fund as related parties if the employer controls the fund directly or indirectly.

The provision applies to sales and exchanges after the date of enactment, in taxable years ending after that date.

Senate amendment

The Senate amendment is the same as House bill except that the provision applies to a welfare benefit fund whether or not the fund is exempt from tax.

Conference agreement

The conference agreement follows the Senate amendment.

C. Employee Benefits

1. Exclusions for certain employer-provided fringe benefits; moratorium

Present law

General rule

Gross income, for income tax purposes, includes "all income from whatever source derived" (Code sec. 61(a)). This provision "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected" (*Comm'r v. Smith*, 324 U.S. 177, 181 (1945)). However, certain fringe benefits, such as health benefits, are expressly excluded from gross income by specific statutory provisions.

Moratorium

A moratorium first enacted in 1978 prohibited issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. The legislative moratorium expired on December 31, 1983. The Treasury Department has announced that Treasury and the IRS "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

Employment taxes

The social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding apply to "wages," defined in the Code as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (secs. 3121(a), 3306(b) and 3401(a)). The railroad retirement tax (RRTA) applies to any form of money remuneration (sec. 3231(e)). Regulations applicable to these provisions specify that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

Employer-provided housing

Present law (Code sec. 119) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution under the circumstances involved in those cases did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.

House bill

General rule

The House bill provides a statutory exclusion from income and employment taxes for: (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, and (5) employer-operated athletic facilities provided to employees. No fringe benefit (other than a de minimis fringe) is excluded under the bill if another section of the Code provides rules for the tax treatment of that general type of benefit.

The House bill does not extend the moratorium on regulations which expired on December 31, 1983. Under the House bill, any fringe benefit that does not qualify for a statutory exclusion is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The rules of the bill do not make any change in existing statutory or regulatory exclusions for benefits for military personnel.

Exclusion provisions

No-additional-cost service

A service provided to an employee is excluded if:

(1) the employer incurs no substantial cost (including foregone revenue) in providing the service;

(2) the service is provided by the employer or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works;

(3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and

(4) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Qualified employee discount

A discount on merchandise provided to an employee is excluded to the extent it does not exceed the employer's gross profit percentage (in the relevant line of business). The exclusion does not apply to discounts on real property or on personal property of a kind commonly held for investment.

A discount on services provided to an employee is excluded to the extent it does not exceed 20 percent of the selling price of the services to nonemployee customers (with no gross profit percentage restriction).

The following conditions generally must be satisfied for the exclusion to apply:

(1) the property or service is provided by the employer and is of the same type ordinarily sold to the public in the line of business in which the employee works,

(2) the property or service is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee, and

(3) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Under a special rule, the exclusion applies to discounts provided by a department store to employees of another employer (such as a cosmetic firm) who make over-the-counter sales of merchandise within the store.

A grandfather rule relaxes the line-of-business limitation for employees of members of an affiliated group which consists primarily of a retail department store business, if, as of October 5, 1983, such employees were entitled to discounts at the store.

Working-condition fringe

Property or services provided to an employee are excluded to the extent that they would be deductible as ordinary and necessary business expenses (under Code secs. 162 or 167) if the employee had paid for them.

Under a special rule, all of an auto salesman's automobile use in the dealer's sales area is excluded if the use is provided primarily to facilitate the salesman's performance of services and there are substantial restrictions on personal use.

The bill excludes, as a working condition fringe, the value of free or reduced-cost parking provided to employees on or near the employer's business premises. Under the House bill, the exclusion is available to highly compensated employees only if such parking is available on a nondiscriminatory basis.

De minimis fringe

Property or services not otherwise tax-free are excluded if their value is so small, considered in the aggregate, as to make accounting for the benefits unreasonable or administratively impracticable. For example, benefits which generally are excluded as de minimis fringes include the typing of a personal letter by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value.

Subsidized eating facilities operated by the employer also are excluded as a de minimis fringe if located on or near the employer's business premises, if revenue equals or exceeds direct operating costs, and if (for certain highly compensated employees) nondiscrimination requirements are met (see below).

Athletic facilities

An exclusion is allowed for the value of athletic facilities provided and operated by an employer for use of its employees.

Nondiscrimination requirements

The exclusions for no-additional-cost services, qualified employee discounts, free parking, subsidized eating facilities, and qualified tuition reduction (item 2 below) are available to officers, owners, or highly compensated employees only if the property or service is provided on substantially the

same terms to each member of a group of employees defined under a reasonable classification, set up by the employer, which does not discriminate in favor of officers, owners, or highly compensated employees.

Effective date

The House bill generally is effective on January 1, 1984.

Senate amendment

Moratorium

The Senate amendment extends through 1985 the legislative moratorium on issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

Faculty housing

Under the Senate amendment, the extended legislative moratorium is applied to prohibit the issuance of income tax regulations providing for the inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of the operating costs paid in furnishing the lodging or the rent received. The application of the extended moratorium with respect to qualified campus lodging applies only with respect to lodging furnished after December 31, 1983 and before January 1, 1986.

Conference agreement

General rules

The conference agreement follows the House bill, with modifications to the effective date and certain provisions as described below. Thus, under the conference agreement, the general legislative moratorium on regulations that expired December 31, 1983 is not extended. Instead, the conference agreement sets forth statutory provisions under which (1) certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA, and (2) any fringe benefit that does not qualify for exclusion under the bill and that is not excluded under another statutory fringe benefit provision of the Code is includible in gross income for income tax purposes, and in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit. The latter rule is confirmed by clarifying amendments to Code sections 61(a), 3121(a), 3306(b), and 3401(a) and section 209 of the Social Security Act.

The conferees intend that Treasury regulations are to be issued to implement the statutory fringe benefit provisions of the bill. Such regulations are to be consistent with the language of the bill in the legislative history as reflected in House Report No. 98-432 (Pt. 2) and this Statement of Managers. Thus, for example, as stated in the report of the Ways and Means Committee, the bill does not modify the existing rules under which benefits to military personnel, such as subsistence, housing, and uniform allowances, are excludable from gross income.

The conference agreement adds a rule giving the Treasury Department regulatory authority to provide the time and manner for collection (or payment) by an employer of employment taxes on noncash fringe benefits. To the maximum extent practicable, such regulations may provide for collection (or payment) of FICA taxes under sections 3101 and 3111 with respect to noncash fringe benefits in a calendar quarter not later than the time for collection (or payment) of such taxes on cash wages paid on the last day of that quarter. The regulations may provide similar rules for other employment taxes.

Exclusions

No-additional-cost-services; qualified employee discounts

The conference agreement provides an additional, elective grandfather rule which in certain circumstances relaxes the line of business limitation requirement for the exclusion for qualified employee discounts and (to the extent described below) for the exclusion for no-additional-cost-services.

Under this grandfather rule, if all the following requirements are met, the exclusion for qualified employee discounts (if otherwise available) extends to the providing by an employer of discounts on goods or services in a particular line of business to an employee who works in a different line of business of the employer than that line of business in which such goods or services on which the discount is available are offered for sale by the employer:

(1) On and after January 1, 1984, the employer offers such discounts on goods or services in that particular line of business to substantially all its employees in all of its lines of business which existed on January 1, 1984;

(2) The employee works in a line of business of the employer which was a line of business of the employer on January 1, 1984; and

(3) The employer timely elects the applicability of this grandfather rule.

This grandfather rule also applies, if requirements of the same nature are met, with respect to no-additional-cost services which are provided by an employer to an employee notwithstanding that the service is not the same type of service sold to the public in the line of business of the employer in which the employee works, except that this grandfather rule does not apply with respect to no-additional-cost services provided to the employee by a person other than an employer of the employee (i.e., pursuant to a reciprocal agreement between employers).

Thus, where all these requirements are met, all employees of any line of business of the employer which was in existence on January 1, 1984 are treated, for purposes of new Code sections 132(a)(1) and 132(a)(2) but not for purposes of new Code section 132(g)(2), as employees of the particular line of business (which was in existence on January 1, 1984) in which such goods or services are offered for sale by the employer.

This additional grandfather rule applies on a calendar year basis. If elected, the rule applies to the first calendar year following the year of election and to all subsequent years unless revoked by the employer. A revocation must be made prior to the beginning of the calendar year to which the grandfather rule is not to apply. The election is to be made in the manner prescribed by Treasury regulations. For purposes of the grandfather rule, all members of the same affiliated group of corporations (as defined in sec. 1504) are treated as one corporation.

Under the conference agreement, an employer making the election is subject to an excess fringe benefit excise tax for any calendar year as to which the grandfather rule election is in effect if the aggregate fair market value of all excludable no-additional-cost service benefits and qualified employee discount benefits (whether or not excludable only pursuant to the grandfather rule) provided by the employer during the calendar year to all its employees exceeds one percent of the total of all taxable compensation paid to all employees of the employer for the year. This computation takes into account all employees in all lines of business of the employer, including lines of business as to which the elected grandfather rule does not apply (e.g., where the line of business did not exist on January 1, 1984). The rate of the new excise tax is 30 percent of the excess described in the preceding sentences. The amount of tax is not deductible by the employer.

In addition, the conference agreement modifies the grandfather rule in the House bill to provide a revised definition of an affiliated group for such purposes.

Working condition fringe

The following modifications are made by the conference agreement with respect to working condition fringes:

(1) The nondiscrimination requirement in the House bill for the exclusion (as a working condition fringe) of employee parking provided on or near the business premises of the employer is deleted;

(2) The availability of the exclusion of qualified auto demonstration use (as a working condition fringe) is limited to full-time auto salespersons. The exclusion is not available to any other persons, such as part-time auto salepersons, mechanics, the dealer's bookkeeper, etc.; and

(3) The availability of the working condition fringe exclusion for certain consumer product testing and evaluation as described in the report of the Ways and Means Committee is clarified by providing that gross income does not include personal use of such consumer goods provided to an employee primarily for such product testing and evaluation which does not qualify under the requirements in such report to the extent that the employee pays or reimburses the employer for such personal use.

De minimis fringe

In lieu of the aggregation rule in the House bill, the conference agreement provides that the frequency with which similar fringe benefits (otherwise excludable as de minimis fringes) are provided by the employer to its employees is to be taken into account, among other relevant factors, in determining whether the fair market value of the property or service is so small that accounting for the property or service would be unreasonable or administratively impracticable. Under this rule, where an employer exercises sufficient control and imposes significant restrictions over personal use of a copying machine such that substantially all (at least 85 percent) of the use of the machine can be shown to be for business purposes, the employer may treat as a de minimis fringe any personal use of the machine by a particular employee which might occur.

Nondiscrimination requirements

As stated above, the conference agreement deletes the nondiscrimination requirement for the exclusion of employee parking as a working condition fringe.

Faculty housing

The conference agreement generally follows the Senate amendment in imposing a moratorium on the issuance of income tax regulations providing for the inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of the operating costs paid in furnishing the lodging or the rent received. This moratorium with respect to qualified campus lodging applies only with respect to lodging furnished after December 31, 1983 and before January 1, 1986. No inference is intended by imposition of a moratorium for such period as to the proper

income tax treatment of faculty housing furnished prior to 1984 or after 1985.

Effective date

Under the conference agreement, the provisions are effective beginning January 1, 1985, except that the moratorium with respect to qualified campus lodging applies only with respect to lodging furnished after December 31, 1983 and before January 1, 1986.

2. Qualified tuition reduction

Present law

Gross income does not include scholarships or fellowships, subject to certain limitations, unless such amounts are paid as compensation for services or for studies or research primarily for the benefit of the grantor (Code sec. 117). Treasury regulations provide that remission of the tuition of a child of a faculty member provided by another education institution under a tuition-exchange plan is considered to be a scholarship (Reg. sec. 1.117-3(a)).

House bill

The House bill provides that a reduction in tuition provided to an employee of an educational institution is excluded for income and employment tax purposes if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met (see under item 1, above). Under a special rule in the House bill, availability of a tuition reduction benefit only to faculty members is not a discriminatory classification for purposes of the nondiscrimination requirement.

In addition, the House bill provides that a tuition reduction provided to an employee of an educational institution is excluded if the tuition is for education at the graduate level provided by the employer to a teaching or research associate or assistant at that institution.

This provision is effective with respect to education furnished after June 30, 1984.

Senate amendment

See item 1, above (relating to extension of moratorium).

Conference agreement

The conference agreement follows the House bill, with modifications (1) deleting the exclusion for graduate tuition reduction provided to teaching or research associates or assistants; (2) deleting the special nondiscrimination rule in the House bill as applicable to the exclusion for tuition reduction for education below the graduate level (which deleted rule would have provided that availability of the benefit only to faculty members is not a discriminatory classification); and (3) changing the effective date to qualified tuition reductions for education furnished after June 30, 1985. In deleting the exclusion (in the House bill) for certain graduate tuition reduction, the conference committee notes that tuition reductions for graduate education remain eligible for exclusion as scholarships under Code section 117(b) if they satisfy the requirements of that provision of present law.

3. Cafeteria plans

Present law

The cafeteria plan rules of the Code provide that a participant in a nondiscriminatory cafeteria plan will not be treated as having received a taxable benefit offered under the plan solely because the participant has the opportunity, before the benefit becomes available to the participant, to choose among the taxable and nontaxable benefits offered under the plan. The term "taxable benefit" includes cash, property, and other benefits that are currently taxable to the participant upon receipt. "Nontaxable benefit" includes any benefit that is not currently taxable to the participant upon receipt (e.g., group-term life insurance up to $50,000, coverage under an accident or health plan, and coverage under a dependent care assistance program).

Present law does not permit a cafeteria plan to offer either vanpooling or any benefit that defers the receipt of compensation, with the exception of the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement.

The cafeteria plan rules generally do not affect whether any particular benefit offered under the plan is a taxable or nontaxable benefit. Thus, a benefit that is nontaxable under the Internal Revenue Code when offered separately is a nontaxable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is provided under the cafeteria plan.

On February 10, 1984, the Internal Revenue Service issued a news release (IR-84-22), which stated that so-called "flexible spending arrangements" offered as part of cafeteria plans do not provide employees with nontaxable benefits under the Code because, under such arrangements, employees are assured of receiving the benefit of what they would have received had no covered expenses been incurred.

In May 1984, the Internal Revenue Service issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income. These proposed regulations state that an otherwise nontaxable benefit will be nontaxable if offered in a cafeteria plan only if it continues to satisfy the provisions governing its exclusion from gross income. Accordingly, the proposed regulations state that employer contributions with respect to an accident or health plan, a qualified group legal services plan, or a dependent care assistance program are not excluded from a participant's gross income under the Internal Revenue Code to the extent that the participant is assured of receiving benefits under the plan without regard to whether he or she incurs covered expenses.

House bill

The House bill amends the definition of "cafeteria plan" to provide that such plans may offer employees choices limited to cash and those fringe benefits (other than scholarships or fellowships, vanpooling, and those benefits excludable under the nonstatutory fringe benefit provisions of the bill) that are excludable from gross income under a specific section of the Internal Revenue Code. Thus, group-term life insurance, coverage under a qualified group legal services plan, coverage under an accident or health plan, and coverage under a dependent care assistance program are permissible nontaxable benefits in a cafeteria plan. For purposes of this rule, group-term life insurance that is includible in gross income only because the amount of the insurance exceeds $50,000 or because the insurance is on the life of the employee's spouse or children is treated as a nontaxable benefit. Similarly, vacation days offered under a cafeteria plan are treated as nontaxable benefits only if the plan precludes any participant from cashing-out or using, in a subsequent plan year, any vacation days remaining unused as of the end of any plan year.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill provisions on cafeteria plans, and adopts several additional provisions.

First, the conference agreement amends the cafeteria plan rules to provide that if, for a plan year, more than 25 percent of the total nontaxable benefits are provided to employees who are key employees with respect to the plan for such year (as determined under the rules of section 416(i)(1)), such key employees will be taxed as though they received all available taxable benefits under the plan. Generally, in determining the portion of the total nontaxable benefits that is provided to key employees, coverage under a plan (e.g., an accident or health plan) and not actual expense reimbursements under such a plan are to be counted.

Second, the conference agreement applies certain reporting requirements with respect to cafeteria plans. Under regulations prescribed by the Secretary of the Treasury, each employer that maintains a cafeteria plan during a taxable year beginning after December 31, 1984, will be required to file a return for such year showing the number of employees of the employer, the number of employees participating in the plan, the total cost of the plan for the taxable year, and specified employer identification information. Based on these general returns, the Secretary is to require a select and statistically significant group of employers to file additional information returns with respect to their cafeteria plans. These additional returns will contain such information as the Secretary may require. Examples of such information include a breakdown of the above information by salary range and type of benefit provided, as well as information which may be necessary to allow Treasury to develop a plan to insure that the requirements of the cafeteria plan rules (such as nondiscrimination and maximum percentage of benefits to key employees) are adequately enforced.

Third, the conference agreement provides both general and special transition relief, with respect to the proposed Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984. (A "flexible spending arrangement" consists of a benefit of a type to which a statutory exclusion may be applied, such as an accident or health plan under sections 105 and 106, with respect to which an employee is assured of receiving, in cash or some other benefit, amounts available for expense reimbursement without regard to whether the employee incurs the covered expenses.) The general relief rule provides that a plan will not fail to be a cafeteria plan merely because of a failure to satisfy the rules relating to cafeteria plans under the proposed Treasury regulations and that a flexible spending arrangement will not fail the requirements of the applicable statutory exclusions merely because of a failure to satisfy the rules relating to such exclusions under these regulations. This general relief is provided until the earlier of January 1, 1985, or the effective date of any modification of the plan or arrangement to provide additional benefits if such modification becomes effective after February 10, 1984. The conference agreement does not prevent the application of the proposed Treasury regulations after the earlier of such dates.

Thus, for example, if on February 10, 1984, a flexible spending arrangement failed to satisfy the rules relating to accident or health plans under the proposed Treasury

regulations and thereafter continues to fail such rules because such arrangement provides for the cash-out or carryover of unused amounts at the end of the plan year, such arrangement will be treated as qualifying as an accident or health plan until the earlier of the two dates provided above.

The general transition rule is applicable to both benefit bank flexible spending arrangements and zero balance reimbursement account (ZEBRA) type flexible spending arrangements. Under a benefit bank arrangement, the employee generally allocates a specified amount of dollars to a reimbursement account for specified benefits, e.g., medical, legal, and dependent care, at the beginning of the plan year. As expenses are incurred during the year, the employee is entitled to reimbursement of these expenses from the account. For example, if an employee with $500 allocated to his account incurred medical expenses of $250, he could be reimbursed for these expenses from the account. At the end of the year, he would receive the remaining $250 in cash. In contrast, under the ZEBRA-type arrangement, amounts generally are not specifically allocated to an account before the beginning of the year, but instead amounts are allocated only after an expense in incurred.

The conference agreement also provides special transition relief with respect to the rules contained in the proposed regulations relating to the statutory nontaxable benefits. This relief provision provides that a flexible spending arrangement in existence under a cafeteria plan on February 10, 1984, will not fail to be a nontaxable benefit under the applicable exclusions merely because a participant will receive amounts available but unused for expense reimbursement. An arrangement will qualify for the special relief only if, under the arrangement, the employee must fix the amount of contributions to be made on his or her behalf before the beginning of the applicable period of coverage and taxable cash is not available before the end of such period or, if earlier, at the termination of employment. In lieu of distributing taxable cash to a participant at the end of the applicable period of coverage, it would also be permissible for the unused amounts to be carried over to the succeeding year. Further, an arrangement could permit a participant to terminate contributions during the period of coverage or to change the rate or amount of contributions during the period of coverage on account of certain changes in family status or change in employment status from full-time to part-time, or vice versa. The conferees intend that this special transition relief will be available to arrangements that, on February 10, 1984, and thereafter, failed to satisfy these restrictions if such arrangements are modified, before January 1, 1985, to comply with such restrictions. The special relief under this rule is for benefits provided before the earlier of July 1, 1985, or the effective date of any modification of the arrangement to provide additional benefits if such modification becomes effective after February 10, 1984. The conference agreement does not prevent the application of the proposed Treasury regulations after the earlier of the applicable dates.

Cafeteria plans and flexible spending arrangements that were not in existence on February 10, 1984, generally do not qualify for either the general or the special transition rules under the conference agreement. Thus, the conference agreement does not prevent the current application of the proposed Treasury regulations to such plans and arrangements. However, plans that were not actually in existence as of February 10, 1984, but with respect to which substantial implementation costs had been incurred by the employer by such date are to be treated as having been in existence on such date. The conferees intend that if an employer has incurred, as of February 10, 1984, either more than $15,000 of implementation costs or more than one-half of the total costs of implementing a cafeteria plan, the transition rules are to be available with respect to the cafeteria plan. In making this determination, total implementation costs are the costs of designing and installing computer programs for operation of the plan and the costs of printing cafeteria plan brochures for employees. Costs associated with more than one plan of the same employer are to be allocated among the plans on the basis of the number of participants in the plans.

Finally, the conference agreement provides that the Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, is to submit a report to the House Committee on Ways and Means and the Senate Committee on Finance on the effect of cafeteria plans on the containment of health costs. This report is to be submitted by April 1, 1985. The study is to examine the impact which the use of cafeteria plans (including flexible spending arrangements) has on the containment of health care costs and to recommend what modifications might be desirable with respect to the cafeteria plan rules to optimize the potential to reduce medical costs while balancing against other health care policy goals. Included within the study should be an analysis of the advisability of establishing Federal guidelines relative to the type of medical plans that can qualify for cafeteria plan treatment in a manner similar to that applicable to qualified pension plans and the advisability of adding additional benefits to cafeteria plans. In this regard, the conferees intend to examine, before January 1, 1986, the operation of the nondiscrimination rules and the forfeitability requirements with respect to cafeteria plans, and the effect of such provisions on the Federal tax base and on health cost containment.

4. Nonqualified options

Present law

Generally, employees recognize income upon the exercise of a nonqualified employee stock option to the extent the value of the stock exceeds the price paid. Employers are allowed a corresponding deduction.

House bill

No provision.

Senate amendment

Under the Senate amendment, income and deductions with respect to certain employee options are deferred until the stock is disposed of. In order to qualify, the option must meet the following requirements: (1) the option price must at least equal the fair market value of the stock on the date of issue; (2) the option may be transferable only by reason of death; (3) the option must be exercised in sequence; and (4) certain notification procedures must be met.

The maximum value of stock for which options which may be granted in any one year is $100,000 (reduced by value of stock under incentive stock options). The option program may not discriminate in favor of 5-percent owners or highly paid officers.

The amount deferred on exercise is an item of tax preference.

The provision applies to options exercised after date of enactment.

Conference agreement

The conference agreement does not include the provision in the Senate amendment.

5. Incentive stock options

Present law

Incentive stock options allow an employee to receive capital gains on the sale of stock acquired on the exercise of an option, rather than ordinary income at the time of exercise.

The option price of an incentive stock option must equal or exceed the fair market value of the stock at the time the option is granted.

The "spread" on the exercise of an incentive stock option is an item of tax preference for purposes of the minimum tax.

House bill

No provision.

Senate amendment

The Senate amendment disregards "lapse restrictions" in determining the fair market value of the stock. It also treats the modification of an option making it nontransferable as the grant of a new option, thus requiring the fair market value to be determined on the modification date.

The provision generally applies to options granted, exercised or modified (as the case may be) after March 20, 1984. If an option granted after March 20, 1984, pursuant to corporate action taken before that date, the provision will not apply if the option is issued before September 20, 1984 (or, in the case of the minimum tax, if the option is exercised before December 31, 1984).

Conference agreement

The conference agreement generally follows the Senate amendment. The date by which corporate action must be taken under the transitional rule is changed to May 15, 1984.

6. Certain section 83(b) elections

Present law

Property transferred to an employee in connection with the performance of services is includible in income (to the extent the value of the property exceeds the amount paid) in the first taxable year the property is transferable and not subject to a substantial risk of forfeiture (sec. 83). A taxpayer may elect, within 30 days of the transfer of property, to include in gross income the excess of the value of the property (determined without regard to restrictions) over the amount paid, for the year the transfer occurs (sec. 83(b)). A recent Tax Court decision held that section 83 may apply where the employee paid fair market value for the property (determined without regard to restrictions). *Alves* v. *Commissioner*, 79 T.C. 864 (1982), aff'd by the 9th Cir. on June 5, 1984.

House bill

No provision.

Senate amendment

The Senate amendment allows a taxpayer to make the election under section 83(b) with the first tax return filed after date of enactment with respect to transfers of property made after June 30, 1976 and before the date of enactment, if the taxpayer paid fair market value for the property (determined without regard to restrictions), and the employer consents to the election.

Conference agreement

The agreement generally follows the Senate amendment. However, the provision applies only to transfers before November 18, 1982 (the date of decision of the *Alves* case).

7. Employee achievement awards

Present law

Code section 274(b) generally disallows business deductions for gifts to the extent

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

that the total cost of all gifts of cash, tangible personal property, etc., to the same individual from the taxpayer during the taxable year exceeds $25. The statute expressly defines the term gift to mean any amount excludable from gross income under section 102 (relating to gifts and bequests) which is not excludable under another statutory provision. The U.S. Supreme Court, in a case involving payments made "in a context with business overtones," defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r v. Duberstein*, 363 U.S. 278 (1960)).

In the case of an excludable gift of an item of tangible personalty awarded to an employee for length of service, safety achievement, or productivity, the ceiling on the deduction allowed to the employer is increased to $400 of the item's cost. In addition, the ceiling on the business gift deduction is $1,600 for such an employee award under a qualified award plan provided that the average cost of all plan awards in the year does not exceed $400.

House bill

No provision.

Senate amendment

The Senate amendment provides a new income-tax exclusion to employees for awards received from an employer for productivity, safety, or length of service, in the form of watches, clocks, certain emblematic jewelry or rings, certain personal accessories, and other traditional retirement or nonretirement awards, effective for awards made after the date of enactment.

The exclusion, and the employer's deduction, for such awards to a particular employee during the year are limited to $1,600 in each achievement category (i.e., a maximum of $4,800 in cost) for awards under a qualified award plan, or $400 in each category (maximum of $1,200) for other such awards. Other restrictions, including nondiscrimination rules, apply.

Any excess of the lesser of the employer's cost for or the value of such awards over the exclusion dollar limits is expressly includible in the employee's gross income, as is the value of nontraditional employee achievement awards or any other awards to employees.

Conference agreement

The conference agreement does not include the Senate amendment.

8. Exclusion for educational assistance benefits; deferred educational benefits

a. Educational assistance

Present law

Employer-provided educational assistance benefits were excluded from gross income for income tax purposes and from wages for FICA and FUTA purposes under a provision which expired on December 31, 1983.

House bill

No provision.

Senate amendment

The Senate amendment extends the exclusion to apply to taxable years beginning before January 1, 1986.

Conference agreement

The conference agreement does not include the Senate amendment.

b. Deferred educational benefits

Present law

Deductions for contributions to a nonqualified deferred compensation plan are not allowed until an amount is includible in the employee's income. However, contributions to a fund that is part of a welfare benefit plan generally are deductible in the year made regardless of the time a benefit is provided. In one case (*Greensboro Pathology Associates, P.A. v. U.S.*, 699 F.2d 1196 (Fed Cir. 1982)), a court held that a plan to pay future college tuition of employees' children was a welfare benefit plan, rather than a deferred compensation plan.

House bill

No provision.

Senate amendment

The Senate amendment treats a plan for providing deferred educational benefits as a plan of deferred compensation, thus generally delaying deductions for plan contributions until the benefit is includible in the employee's income (or would be includible but for provisions excluding the benefits from income). This provision applies to taxable years ending after December 31, 1983.

Conference agreement

The conference agreement does not include the Senate amendment.

D. Employee Stock Ownership Provisions

Present law

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer stock is held for the benefit of employees. An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. Under present law, the income tax credit is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

House bill

Freeze on maximum credit

The House bill freezes the income tax credit for contributions to a tax credit ESOP at one-half of one percent with respect to compensation paid or accrued in 1985 through 1987.

The provision is effective on the date of enactment.

Senate amendment

Freeze on maximum credit

Under the bill, the income tax credit for contributions to a tax credit ESOP is limited to one-half of one percent for compensation paid or accrued in 1985. The limit for contributions in 1986 and 1987 remains at three-quarters of one percent.

Tax-free rollover on sale to employees

The Senate amendment provides for nonrecognition of gain, at the election of the seller, from the sale of "qualified securities" if (1) the securities are sold to an ESOP or to an eligible worker-owned cooperative, and (2) within a qualified period, the seller acquires securities of certain domestic corporations.

Deduction for dividends paid on ESOP stock

The Senate amendment permits a deduction for dividends paid on stock held by an ESOP (including a tax credit ESOP), provided the dividends are either paid out currently to employees or used to repay an ESOP loan. Dividends may either be paid directly to plan participants by the corporation or may be paid to the plan and distributed to participants no later than 60 days after the close of the plan year in which paid.

Alternatively, the dividends (or some portion thereof) will qualify for the deduction if applied by the plan to repay a loan incurred under the plan to acquire employer securities. Because such dividends are deductible by the employer corporation, they do not qualify for the partial exclusion from income otherwise permitted under Code sec. 117.

Partial exclusion of interest earned on ESOP loans

Under the Senate amendment, a bank, insurance company, or other commercial lender that is a corporation may exclude from income 50 percent of the interest received on loans to a leveraged ESOP, the proceeds of which are applied by the plan to acquire employer securities. For this purpose, the loan may be made directly to an ESOP or may be made to the sponsoring corporation which, in turn, lends the proceeds to an ESOP.

Reduced tax rate for sales of stock to certain corporations

In the case of a sale or exchange of securities acquired by a taxpayer as part of an original issue in a company with a specified degree of employee stock ownership by a taxpayer other than a corporation, the bill generally increases from 60 percent to 80 percent the amount of the gain (qualified corporate gain) on the sale that is allowed as a deduction from gross income. Similarly, a lower tax rate applies with respect to the qualified corporate gain on a sale of securities by a corporation.

Assumption of estate tax liability by ESOP

The Senate amendment permits an ESOP to assume the liability of a decedent's estate for estate taxes in return for a transfer from the estate to an ESOP of stock of an equal value, provided the sponsor company guarantees payment of the tax and agrees to pay such tax over a period of years.

The executor of the estate for which the ESOP agrees to assume estate tax liability must elect the application of the provision by the time prescribed for filing the estate tax return in the manner prescribed by Treasury regulations.

Estate tax exclusion for sales to employees

The Senate amendment permits an exclusion from the gross estate of 50 percent of the proceeds from the sale of employer securities to an ESOP or a worker-owned cooperative. The proceeds from such sale are disregarded for this purpose to the extent that such securities are allocated under the plan to the donor (or decedent), family members of the donor (or decedent), or shareholders owning more than 25 percent in value of any class of outstanding employer securities.

Charitable contributions to ESOPs

Under the Senate amendment, a taxpayer generally is allowed an income, gift, or estate tax deduction under the charitable contribution rules for contributions of employer securities to an ESOP.

Under the Senate amendment, if the taxpayer is permitted a charitable contribution deduction with respect to the contribution of stock to an ESOP, no deduction is permitted for the contribution under the usual rules for deductions for employer contributions to a qualified pension plan, and no portion of the amount contributed is eligible for any credit against income taxes.

Effective dates

The provisions generally are effective for years beginning after December 31, 1984. The provisions relating to the assumption of estate tax liability and partial exclusion from estate tax apply with respect to those

estates of decedents that are required to file returns after the date of enactment.

Conference agreement

Freeze on maximum credit

The conference agreement follows the House bill with a technical amendment.

Tax-free rollover on sale to employees

The conference agreement generally follows the Senate amendment. Nonrecognition will be available only if, after the sale, the ESOP or cooperative holds at least 30 percent of the employer securities.

Deduction for dividends paid on ESOP stock

The conference agreement generally follows the Senate amendment. The deduction for dividends paid with respect to stock held in an ESOP will be permitted only if the dividends are paid out currently to employees.

Partial exclusion of interest earned on ESOP loans

The conference agreement follows the Senate amendment.

Reduced tax rate for sales of stock to certain corporations

The conference agreement does not contain the Senate amendment.

Assumption of estate tax liability by ESOP

The conference agreement generally follows the Senate amendment. The Secretary has the authority to require the employer to post appropriate security, such as a bond, to insure payment of the estate taxes.

Estate tax exclusion for sales to employees

The conference agreement does not contain the Senate amendment.

Charitable contributions to ESOPs

The conference agreement does not contain the Senate amendment.

Effective dates

The conference agreement follows the Senate amendment.

E. Individual Retirement Account (IRA) Provisions

Present law

Under present law, an individual generally is entitled to deduct IRA contributions up to the lesser of $2,000 or 100 percent of compensation. The $2,000 deduction limit is increased to $2,250 for any year in which (1) at least $250 is contributed to an IRA for the spouse of the individual, and (2) the spouse has no compensation for the year. Under certain circumstances, alimony may be considered compensation for purposes of the IRA deduction limits.

Present law provides that, except for tax-free rollovers, no nondeductible contributions may be made to an IRA. An annual 6-percent excise tax applies to prohibited nondeductible contributions (i.e., excess contributions) held in an IRA.

Distributions from an IRA made before age 59½ (other than those distributions attributable to disability or death) are subject to an additional 10-percent income tax.

House bill

Nondeductible IRA contributions

Under the House bill, nondeductible IRA contributions of up to $1,750 annually are not treated as excess contributions subject to the 6-percent excise tax. The first withdrawals from an IRA are treated as coming out of earnings on the nondeductible contributions, second as out of the nondeductible contributions, and then out of other amounts.

The provision is effective for contributions made in taxable years beginning after December 31, 1983.

Senate amendment

Spousal individual retirement arrangements

The Senate amendment increases the IRA deduction limit for a married couple to (1) $2,750, for taxable years beginning in 1985 and 1986, (2) $3,250, for taxable years beginning in 1987 and 1988, (3) $3,750, for taxable years beginning in 1989 and 1990, and (4) $4,000, for taxable years beginning in 1991 and thereafter. The 100 percent of compensation limit of present law continues to apply.

The provision is effective for taxable years beginning after December 31, 1984.

Alimony treated as compensation

The Senate amendment treats all alimony received by a divorced spouse as compensation for purposes of the IRA deduction limit.

The provision is effective for taxable years beginning after December 31, 1984.

IRA withdrawals by dislocated workers

Under the Senate amendment, a dislocated worker is permitted to withdraw amounts from an IRA prior to age 59½ without incurring the additional 10-percent income tax. A dislocated worker must (1) have at least 20 quarters of social security coverage and (2) have exhausted all rights to compensation under State law.

The provision is effective on the date of enactment.

Conference agreement

Nondeductible IRA contributions

The conference agreement does not contain the House bill.

Spousal individual retirement arrangements

The conference agreement does not contain the Senate amendment.

Alimony treated as compensation

The conference agreement contains the Senate amendment.

IRA withdrawals by dislocated workers

The conference agreement does not contain the Senate amendment.

VIII. TAX-EXEMPT OBLIGATIONS

A. Mortgage Subsidy Bonds

1. Extension of authority to issue qualified mortgage bonds

Present law

Under the Mortgage Subsidy Bond Tax Act of 1980 (as amended) State and local governments were allowed to issue limited amounts of tax-exempt bonds before January 1, 1984, to finance mortgages on owner-occupied residences. Generally, at least 90 percent of the lendable proceeds of such bonds were required to be used to finance mortgage loans to individuals who had not owned a present interest in their principal residence within the 3 preceding years. The purchase price of residences was required to be less than 110 percent (120 percent in certain targeted areas) of the average area purchase price. At least 20 percent of lendable proceeds generally were required to be made available for financing in targeted areas for at least one year.

The State volume ceiling for qualified mortgage bonds was the greater of (1) 9 percent of the average area mortgage originations for single family, owner-occupied residences in the State during the preceding 3 years, or (2) $200 million.

House bill

The House bill extends the tax exemption for qualified mortgage bonds for five years, (i.e., for bonds issued through December 31, 1988).

This provision is effective for bonds issued after December 31, 1983.

Senate amendment

The Senate amendment extends the tax exemption for qualified mortgage bonds for four years, (i.e., for bonds issued through December 31, 1987).

This provision is effective for bonds issued after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment with regard to extension of the qualified mortgage bond program and the House bill with regard to effective date. Thus, the tax exemption for qualified mortgage bonds is extended through December 31, 1987, effective for bonds issued after December 31, 1983.

2. Allocation of State volume ceiling

Present law

The State volume ceiling for qualified mortgage bonds is generally allocated by the State legislature. If the State legislature does not adopt an alternative method, 50 percent of the State volume ceiling is allocated among local issuers based upon the average mortgage volume in the area of the local issuer during the 3 preceding years and the remaining 50 percent is allocated to the State.

House bill

Under the House bill, if the State does not adopt an alternative method, 50 percent of the State ceiling is allocated among local issuers on the basis of the relative populations in the areas of the local issuers and the remaining 50 percent to the State.

This provision is effective for bonds issued after December 31, 1984.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the Senate amendment.

3. Interim authority to allocate State volume ceilings

Present law

The State legislature is generally required to approve an alternative allocation of the State volume ceiling for qualified mortgage bonds. As a transitional rule under the Mortgage Subsidy Bond Tax Act of 1980, the governor of any State was given authority to allocate that State's cap until the legislature met in its first regular session after 1980.

House bill

The House bill provides that, where a State had in effect a formula to allocate the State ceiling, which formula expired as of December 31, 1983, that allocation method shall remain in effect until the effective date of any State legislation which provides for a different allocation formula. If the expiring formula requires action by a State official to allocate the State ceiling, actions of such officials will continue to be effective during this period.

Senate amendment

The Senate amendment includes the provision of the House bill, but also provides that the Governor of Kentucky will have the power to allocate the State ceiling until December 31, 1986.

Conference agreement

The conference agreement follows the Senate amendment. Additionally, the conference agreement provides the Governors of Texas and Nevada with interim authority to allocate their respective State volume ceilings.

4. Reporting requirements

Present law

There is no special reporting requirement with respect to mortgage subsidy bonds. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), reporting requirements were imposed with respect to certain private purpose bonds.

House bill

The House bill requires issuers of mortgage subsidy bonds (including qualified mortgage bonds and qualified veterans' mortgage bonds) to submit, by the fifteenth day of the second calendar month after the close of the calendar quarter during which the bonds was issued, a statement containing specified information to the Treasury. This statement is to include the name and address of the issuer, the date of the issue, the amount of lendable proceeds, the rate, term, and face amount of each obligation which is part of the issue, and such other information as the Treasury may require (including information required in order to determine whether the issue qualifies for tax-exemption and the extent to which proceeds of the issue have been made available to lower-income individuals). The Treasury is permitted to grant extensions of time for providing any information where there is reasonable cause for delay.

This provision is effective for bonds issued after December 31, 1983.

Senate amendment

The Senate amendment extends the reporting requirements of the House bill to qualified mortgage bonds but not to qualified veterans' mortgage bonds. Under the Senate amendment, this provision is effective for bonds issued after the date of enactment.

The Senate amendment further requires elected officials of governmental units issuing qualified mortgage bonds to submit to the Treasury Department an annual report which states the housing, development, and income distribution policies which the governmental unit is to follow in issuing mortgage subsidy bonds and mortgage credit certificates (discussed below). This report also is to include an assessment of (1) the compliance of the governmental unit during the preceding 1-year period with the equivalent statement of policy that was set forth in the next previous report (if any) of such unit, and (2) the performance of the issuer's program relative to the stated intent of Congress, discussed below, that bonds and credits be made available, to the greatest extent possible, to lower-income families. This provision is effective for bonds issued after December 31, 1984 (i.e., the first statement must be filed by December 31, 1984, for bonds issued in 1985).

Conference agreement

Reporting requirements

The conference agreement extends the information reporting requirements contained in the House bill and the Senate amendment to all mortgage subsidy bonds (including qualified mortgage bonds and qualified veterans' mortgage bonds). Information regarding the use of proceeds by lower-income individuals is not required to be supplied with the report for each issue, but may be consolidated with the annual policy statement to be completed by the issuer as described below.

This provision is to apply to bonds issued after December 31, 1984.

Policy statements

The conference agreement includes the requirement of an annual policy statement contained in the Senate amendment. This requirement applies only to qualified mortgage bonds.

The conferees intend that, in the case of multiple jurisdiction issuers, the requirement of an annual report will be satisfied if the issuer files a single report with the Treasury which is signed by (1) an elected official of each governmental unit on whose behalf bonds have been issued, or (2) the governor of the State in which the issuer is located.

This provision is effective for bonds issued after December 31, 1984.

5. Statement of program goals

Present law

Present law includes various rules designed to direct mortgage subsidy bond financing to individuals having the greatest need for the subsidy. There is no general statement of Congressional intent regarding the use of qualified mortgage bond proceeds.

House bill

No provision.

Senate amendment

The Senate amendment includes a statement of Congressional intent that issuers are expected to use qualified mortgage bonds and mortgage credit certificates, to the greatest extent possible, to make loans available to lower-income families who can use the loans to afford home ownership before making such loans available to higher-income families, taking into account prevailing conditions in the housing market and prevailing interest rates. Elected officials of issuing jurisdictions are required to submit an annual report to the Treasury Department which states the policy of the issuer in distributing proceeds of qualified mortgage bonds and mortgage credit certificates and evaluates the performance of the issuer's program relative to the Congressional intent. In addition, the Treasury Department, in consultation with the Department of Housing and Urban Development (HUD), is required to make an annual report to Congress on the performance of issuers relative to program goals.

Conference agreement

The conference agreement generally follows the Senate amendment. The Treasury Department is to prepare a report concerning the performance of issuers relative to Congressional policy goals at a reasonable time prior to the December 31, 1987 sunset date for qualified mortgage bonds.

This provision is effective for bonds issued after December 31, 1984.

6. Qualified veterans' mortgage bonds

Present law

Under present law, unlimited amounts of tax-exempt general obligation bonds may be issued to provide mortgages for the purpose of financing residences for veterans (qualified veterans' mortgage bonds). Unlike qualified mortgage bonds, the authority to issue these bonds did not expire on December 31, 1983.

House bill

The House bill provides that, beginning in 1985, the State ceiling for qualified mortgage bonds is to be reduced by the volume of qualified veterans' mortgage bonds issued by the State during the preceding year. In addition, the authority to issue qualified veterans' mortgage bonds is to sunset (together with the sunset for qualified mortgage bonds) on December 31, 1988.

This provision is generally effective for qualified veterans' mortgage bonds issued after December 31, 1983, except for bonds authorized by a State referendum before October 18, 1983, or pursuant to a State referendum before December 31, 1983, which referendum was authorized by action of the State legislature taken before October 18, 1983.

Senate amendment

No provision. However, the Senate amendment includes a sense of the Senate resolution (1) that qualified veterans' mortgage bonds not be considered in applying State volume ceilings for qualified mortgage bonds, and (2) that no sunset date be enacted for qualified veterans' mortgage bonds.

Conference agreement

The conference agreement does not include the volume limitations or sunset date for qualified veterans' mortgage bonds contained in the House bill. However, the conference agreement provides that (1) the authority to issue qualified veterans' mortgage bonds is limited to programs that issued such bonds before June 22, 1984; (2) loans made with the proceeds of qualified veterans' mortgage bonds issued after June 22, 1984, are to be limited to veterans who served in active duty for any period before 1977; and (3) applications for a loan made with the proceeds of qualified veterans' mortgage bonds must be made before the later of (a) the date which is 30 years from the date of discharge from military service, or (b) January 31, 1985. Additionally, under the conference agreement, qualified veterans' mortgage bonds are limited to principal residences as defined for purposes of qualified mortgage bonds.

The conference agreement further provides that State qualified veterans' mortgage bond programs may not issue bonds in excess of the average annual volume of bonds issued for the period 1979–1983.

7. Advance refunding of qualified veterans' mortgage bonds

Present law

Neither qualified mortgage subsidy bonds nor qualified veterans' mortgage bonds may be advance refunded.

House bill

No provision.

Senate amendment

The Senate amendment allows the State of Oregon, under specified conditions, to advance refund up to $300 million of qualified veterans' mortgage bonds.

This provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the House bill. Additionally, the conference agreement allows the State of Oregon, under specified conditions, the option of borrowing from the Federal Financing Bank in amounts necessary to meet the debt service on the bonds.

8. Limited equity cooperatives

Present law

Tenant-shareholders of cooperative housing corporations are allowed a deduction for rents paid to the cooperative equal to their allocable share of interest and real estate taxes paid by the cooperative. Cooperative housing corporations are eligible to use tax-exempt financing under the rules applicable to owner-occupied housing (i.e., qualified mortgage bonds).

House bill

Under the House bill, limited equity cooperative housing corporations may make an irrevocable election to be eligible for tax-exempt financing under the rules applicable to multi-family rental housing, including the requirement that 20 percent of units (15 percent in certain targeted areas) must be occupied by individuals of low or moderate

income. If such an election is made, the tenant-shareholders of the cooperative will not be entitled to a deduction for interest and taxes paid by the cooperative. Additionally, the volume of such bonds will count toward the State ceiling for qualified mortgage bonds, except to the extent that the financing has previously been counted toward the State's volume cap for private activity bonds.

Limited equity housing cooperatives eligible to make an election include cooperative housing corporations (as defined under sec. 216(b)(1)) in which (1) the cost of any stock in the cooperative does not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increases), increased by certain payments and contributions attributable to the stockholder, and (2) the excess assets of the cooperative are used only for public or charitable purposes or directly to benefit the cooperative and are not to be used directly to benefit any stockholder.

This provision is effective for bonds issued after December 31, 1984.

Senate amendment

There is no provision regarding the treatment of housing cooperatives for purposes of qualified mortgage bonds; however, the Senate amendment specifies that mortgage credit certificates may be issued to residents of cooperatives who otherwise qualify under the credit program.

Conference agreement

The conference agreement follows the Senate amendment.

9. Termination of transitional rules under the Mortgage Subsidy Bond Tax Act of 1980

Present law

The Mortgage Subsidy Bond Tax Act of 1980 was enacted generally to direct the subsidy provided by tax-exempt housing bonds to those individuals having the greatest need for the subsidy, to increase the efficiency of the subsidy, and to reduce the overall revenue loss to the Federal Government from the use of tax-exempt bonds for housing. The 1980 Act provided a number of transition rules designed to permit issuers who were in the process of issuing mortgage subsidy bonds during Congress' consideration of that Act to issue those bonds without regard to the rules in the 1980 Act (including State volume ceilings). In addition, the Act provided a general grandfather rule under which the limitations did not apply to bonds issued before January 1, 1981, for which loan commitments were made, or construction begun, within 1 year from the issue date.

House bill

No provision.

Senate amendment

Under the Senate amendment, most bonds issued to finance new mortgages for owner-occupied, single-family housing after June 15, 1984, and before January 1, 1985, pursuant to the transitional rules of the 1980 Act, will not be tax-exempt unless the State allocates a portion of its 1984 State volume ceiling to that issue, under the general rules for allocation of State volume ceilings, prior to the date of issuance. In addition, most of the transitional rules of the 1980 Act are to terminate after December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

10. Treatment of Kansas City, Missouri and Kansas City, Kansas as a unified metropolitan statistical area

Present law

Metropolitan statistical areas are used for various purposes under Federal law, including the determination of purchase price limitations applicable to qualified mortgage bonds. Kansas City, Missouri and Kansas City, Kansas, together with surrounding countries, currently are treated as separate metropolitan statistical areas.

House bill

No provision.

Senate amendment

The Senate amendment provides that Kansas City, Missouri and Kansas City, Kansas (and surrounding counties) are to be treated as one metropolitan statistical area for tax and all other purposes of Federal law.

This provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

B. Mortgage Credit Certificates

1. Authority to issue mortgage credit certificates (MCCs)

Present law

Before January 1, 1984, State and local governments were allowed to issue limited amounts of tax-exempt bonds to finance mortgages on owner-occupied residences (qualified mortgage bonds). There was no provision for exchanging qualified mortgage bond authority for authority to issue mortgage credits.

House bill

The House bill allows States to trade in all or part of their authority to issue qualified mortgage bonds (as extended under the bill) for authority to issue mortgage credit certificates (MCCs). Home purchasers receiving MCCs are entitled to a non-refundable income tax credit equal to a specified percentage of the interest that the home purchaser pays during the taxable year on the mortgage on his principal residence. This percentage may not exceed 50 percent, but may not be less than 10 percent, of the interest on the qualifying indebtedness. The amount of the homebuyer's interest deduction in any year is reduced by the amount of the MCC for that year. Excess unused credits may be carried forward by the recipient to later taxable years.

Senate amendment

The Senate amendment generally is the same as the House bill. However, under the Senate amendment, excess credits may not be carried forward by the recipient to later taxable years.

Conference agreement

The conference agreement adopts the House provision with a modification limiting the time during which credits may be carried forward to three years.

2. Volume of MCC Authority

Present law

No provision.

House bill

Under the House bill, the amount of MCCs that a State may issue for any year (determined by aggregating the amount of the products resulting from multiplying the principal amount of each certificate by the applicable percentage rate) is equal to 15 percent of the amount of qualified mortgage bond authority that the State trades in for that year. The maximum amount of qualified mortgage bond authority that a State may trade in for MCCs may not exceed 9 percent of the average annual amount of mortgages originated in the State during the preceding 3 years. Where a State issued less than its statutory ceiling of qualified mortgage bonds in 1983, a phase-in rule limits the amount of qualified mortgage bond authority that the State may trade in during the first 5 years (i.e., through 1988) for authority to issue MCCs.

Under the House bill, an MCC does not apply to any debt incurred after the close of the calendar year following the calendar year for which the issuing authority elects to trade in qualified mortgage bond authority. Thus, under the House bill, authority to issue MCCs may be held over for a maximum of one year before the credits are issued.

Senate amendment

Under the Senate amendment, a State may issue MCCs in an amount equal to 20 percent of the amount of qualified mortgage bond authority that the State trades in for that year. The amount of bond authority which the State may trade in for MCCs is not limited to 9 percent of average mortgage originators.

The Senate amendment applies a phase-in rule, similar to that under the House bill, for States which issued less than their statutory ceiling of qualified mortgage bonds in 1983. However, under the Senate amendment, the phase-in rule applies for a 4-year period (i.e., through 1987), and is applied at the State level, rather than at the level of each individual issuer. Additionally, the Senate amendment requires an affirmative election by issuers within the State to forego authority in excess of the phase-in level.

Under the Senate amendment, once a State has exchanged qualified mortgage bond authority for authority to issue MCCs, the State may issue the MCCs in any calendar year. Thus, the authority to issue MCCs may be held over on an indefinite basis.

Conference agreement

The conference agreement provides that a State may issue MCCs in an amount equal to 20 percent of the amount of the qualified mortgage bond authority that the State trades in for that year. However, if (1) the State volume ceiling exceeds 20 percent of the average annual amount of mortgages originated in the State during the preceding three years, or (2) the State issued less than $150 million of qualified mortgage bonds in 1983, then the average size of credits issued in the State may not exceed 20 percent. There is no special phase-in rule for States which issued less than their statutory maximum of qualified mortgage bonds in 1980.

Under the conference agreement, an MCC will not apply to any debt incurred after the close of the second calendar year following the calendar year for which the issuer elects to trade in qualified mortgage bond authority for authority to issue the MCC. Thus, authority to issue MCCs may be held over for a maximum of two years before the credits are issued.

3. Eligibility to receive MCCs

Present law

No provision.

House bill

Under the House bill, eligibility for MCCs is generally limited to the same individuals who are eligible for qualified mortgage bonds. Thus, the recipient of an MCC must generally be a first-time homebuyer, the purchase price of the residence generally may not exceed 110 percent (120 percent, in certain targeted areas) of the average area purchase price, the residence must be the

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

principal residence of the individual, and the mortgage must be a new mortgage except in the case of certain rehabilitation and improvement loans and certain mortgage assumptions. In addition, at least 20 percent of MCCs under each program must be made available for financing in targeted areas for at least one year.

Senate amendment

The Senate amendment is similar to the House bill, except that the purchase price of residences eligible for MCCs is limited to 90 percent of the average area purchase price (including residences in targeted areas). Additionally, the Senate amendment includes an annual income limitation under which the amount of the credit is limited to 25 cents for each dollar by which the greater of (a) area median income for a family of four, or (b) $20,000, exceeds the taxpayer's income for the year in question. Adjustments to this formula are provided based on family size and in the case of adjustable rate mortgages. Finally, under the Senate amendment, there is no requirement that a specific portion of MCCs be made available in targeted areas.

The Senate amendment specifically provides that MCCs are available (1) to shareholders in housing cooperatives who otherwise meet the MCC eligibility requirements, and (2) under Treasury regulations, to finance manufactured homes which qualify as real property for depreciation purposes of (sec. 168(g)(7)).

Conference agreement

The conference agreement follows the House bill with respect to the purchase price limitations and the other general eligibility requirements for MCCS. The conference agreement further specifies that no assumptions of MCCs are to be allowed.

There is no income limitation for recipients of MCCs under the conference agreement. However, the maximum credit which a taxpayer may receive in any year is limited to the greater of (1) 20 percent of the qualifying indebtedness on the taxpayer's principal residence, or (2) $2,000. The conferees intend that this limitation will encourage States to issue higher percentage credits to individuals who purchase lower-priced residences and who can therefore benefit from a higher percentage credit despite the $2,000 limitation.

Under the conference agreement, MCCs will be available for manufactured homes that have a minimum of 102 inches in width and have a minimum of 400 square feet of living space. The conferees further intend MCCs will not be available for recreational vehicles, campers, and other similar vehicles. Manufactured homes will not be taken into account in computing the average area purchase price or statewide volume limitation formula applicable to MCCs. MCCs are additionally to be available to shareholders in housing cooperatives who are otherwise eligible to receive MCCs.

The conferees intend that, as in the case of qualified mortgage bonds, a State or locality may establish more stringent criteria for participation in an MCC program, subject to the rules against limiting MCCs to loans provided by a particular lender or to residences in a particular development (discussed below). The conferees intend that any such additional criteria will be consistent with the goal of making credits available to those individuals most in need of a subsidy.

4. Restrictions on MCC Distribution

Present law

No provision.

House bill

Under the House bill, MCCs must be issued under a plan that does not limit the credits to mortgages provided by specified lenders. MCCs may be limited to residences in a particular development if the developer certifies that the price is not increased because of the presence of the MCCs. No MCC is allowed for loans between related parties or for interest on mortgages financed with tax-exempt bonds.

Senate amendment

The Senate amendment generally is the same as the House bill, except that (1) the prohibition against limiting MCCs to specified lenders may be waived by Treasury regulations, and (2) there is no provision allowing MCCs to be limited to residences in a particular development.

Conference agreement

The conference agreement follows the Senate amendment with respect to specific lenders and the House bill with respect to particular developments.

5. Administration of MCC program

Present law

No provision.

House bill

The House bill contemplates administration of the MCC program by the State and local governments, under Treasury regulations, with certain Federal reporting requirements. The States are to be responsible for ensuring that the total amount of MCCs and qualified mortgage bonds does not exceed the applicable State ceiling. Where a State does issue excess MCCs, the State's mortgage bond ceiling for the succeeding year is to be reduced by two times the excess issuance. Individuals granted MCCs but who are not properly eligible are not entitled to the credits.

Under the House bill, lending institutions are required to certify, under penalty of perjury, that recipients meet the applicable purchase price and first-time homebuyer requirements. Lenders are further required to file regular informational reports with the IRS, with a $200 penalty for failure to file information with respect to any homebuyer.

Senate amendment

The Senate amendment contemplates central administration of the MCC program, under regulations, by the Treasury Department or its delegate, which is to maintain current accounts regarding the total amount of MCCs and qualified mortgage bonds that each State has issued. State or local issuers (alternatively, central State authorities) are to inform Treasury of each decision to exchange bond authority for authority to issue credits. Excess credits would be invalid and excess bonds would forfeit tax exemption. The Treasury is authorized to enter into contracts with a private firm or a quasi-public agency to administer the MCC program on the Treasury's behalf.

Under the Senate bill, eligibility of a particular individual for an MCC is to be based upon verified statements provided by the homebuyer (for the principal residence and first-time homebuyer requirements) and the lender (with regard to purchase price limitations). Credits issued based on erroneous certifications would remain valid, but monetary penalties would be imposed for negligent ($1,000) and fraudulent ($10,000) misstatements in connection with an MCC. The Senate amendment also permits certain fees to be charged by the central administration facility (not exceeding $200 per MCC) and the State or local issuer (not exceeding $100) to cover program costs.

Under the Senate amendment, borrowers would secure a letter of MCC entitlement from the issuer and would then be allowed to "shop" for an appropriate lending institution. The lender would verify with Treasury or its delegate that the letter was valid (including verification that the State volume ceiling had not been exceeded) and would inform Treasury of the actual amount of the loan for which the credit was being issued (to allow accurate recordkeeping).

Conference agreement

The conference agreement adopts the House bill with modifications.

To the extent permitted by regulations, the conference agreement permits issuers to charge MCC recipients a fee to cover the cost of administering the program. This provision is similar to a statement in the Senate Finance Committee Report that would permit fees to be charged to cover administrative costs.

The conference agreement requires by statute that issuers of MCCs file reports concerning the volume of MCCs issued under each election that the issuer makes to issue MCCs. The time and manner of filing the report and the information to be contained in the report is to be specified in regulations. The conferees intend that issuers will be subject to penalties for failure to file the requisite reports and for the filing of false or fraudulent reports. This requirement codifies a statement in the House report that anticipated regulations would require such a report and clarifies that penalties are to be imposed for failure to file and for the filing of false or fraudulent reports.

The conference agreement provides that Treasury shall issue regulations requiring MCC recipients to file with the lender statements, under penalties of perjury with respect to whether the MCC recipient meets the eligibility requirements for an MCC. If statements are filed, as required by the regulations, the conferees intend that the MCC will not be revoked for failure to meet the eligibility requirements unless the MCC recipient provided fraudulent statements to the lender. If an MCC recipient provides fraudulent information to the lender, it is intended that the MCC recipient's tax return will be treated as a fraudulent return and the MCC will be revoked. The government will have the burden of proving that the statements submitted to the lender were fraudulent. The conference agreement is a modification of the provision in the Senate amendment that would treat an MCC as valid under all circumstances if specified verified statements and information were filed with the lender.

Under the conference agreement, before issuing qualified mortgage bonds or MCCs, issuers are required to obtain a certification from a State official that the bond issue or MCC election does not exceed the issuer's allocation of the State's volume limitation. The fact that an issuer obtains a certification from the State does not preclude the application of penalties for overissuance if overissuance in fact occurs. This provision modifies and adds to the statute a requirement contained in the Ways and Means Committee Report.

The penalty for issuance of MCCs in excess of the volume limitations and issuance of MCCs that do not meet certain statutory requirements (i.e., prohibition against the use of MCCs with tax-exempt financing and the linkage of MCCs with indebtedness of a particular lender, and requirements where a block of MCCs is used in connection with a particular development) is reduced from twice the amount of the "correction amount" to the correction amount multiplied by 1.25.

In lieu of the system contemplated by the House bill, Treasury is authorized, under the conference agreement, to adopt a centralized system of administration similar to the system contemplated by the Senate amendment.

6. Effective date of MCC program

Present law

No provision.

House bill

Under the House bill, the authority to issue MCCs is effective for interest paid or accrued after December 31, 1983, on mortgages executed after that date, with respect to elections to trade in qualified mortgage bond authority for years after 1983.

Senate amendment

Under the Senate amendment, the MCC program is effective for credits issued after December 31, 1984, using exchanged qualified mortgage bond authority for years after 1983.

7. Termination of MCC program

Present law

No provision.

House bill

Under the House bill, the authority to trade in qualified mortgage bond authority for authority to issue MCCs expires on December 31, 1988.

Senate amendment

The Senate amendment does not contain a specific sunset provision for MCCs. However, under the Senate amendment, the authority to issue qualified mortgage bonds terminates on December 31, 1987. Thus, the ability of States to exchange qualified mortgage bond authority for MCCs would expire on that date.

Conference agreement

The conference agreement provides that the MCC program will terminate on December 31, 1987, together with the qualified mortgage bond program.

C. Private Activity Bonds

1. Volume limitation for certain IDBs and student loan bonds

Present law

Interest on State and local government obligations is exempt from Federal income tax. However, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of which are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business.

Interest on IDBs is tax-exempt if the bonds are issued to finance the following activities ("exempt purpose" IDBs): (1) projects for low-income residential rental property; (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass commuting facilities, and parking facilities, (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electric energy or gas, (6) air or water pollution control facilities, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, (9) qualified mass commuting vehicles, and (10) local district heating and cooling facilities. In addition, the interest on certain IDBs issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Present law also permits tax-exemption for interest on certain "small issue" IDBs if the proceeds are used for the acquisition of land or depreciable property. A small issue cannot exceed $1 million ($10 million if certain capital expenditures are counted). The small issue exception is scheduled to expire on December 31, 1986.

Present law also allows tax-exempt financing for student loans and organizations that qualify for tax-exemption under section 501(c)(3)), (The small issue exception is schedule to expire on December 31, 1986. (such as private, nonprofit hospitals and private, nonprofit educational institutions).

There is no per capita limitations under present law on the face amount of private activity bonds that a State or local government may issue.

House bill

The House bill limits the maximum face amount of private activity bonds that a State and local governments within the state may issue annually to $150 per capita (reduced to $100 per capita after 1986 to reflect the scheduled expiration of the small-issue exception). Private activity bonds include (subject to the exceptions described below) and student loan bonds (defined as any bond whose proceeds are used, directly or indirectly, to finance loans to individuals for educational purposes).

Unless a State otherwise allocates its volume ceiling, 50 percent of the State ceiling is allocated to State and 50 percent to local jurisdictions within the State on the basis of population.

Under the House bill, states may elect to carry over for up to 3 years a portion of their annual ceiling for a specified project (6 years for pollution control projects).

The House bill provides a one-year phased reduction to $150 per capita for States whose 1983 volume exceeded that amount not treated as private.

Exceptions.—The following bonds are not subject to the volume limitations under the House bill:

(1) IDBs to finance multifamily residential rental property and bonds exempt under section 11(b) of the U.S. Housing Act of 1937.

(2) IDBs to finance convention or trade show facilities or airports, docks, wharves, or mass commuting facilities (including mass commuting vehicles), if the financed facility being financed is owned for tax purposes by a governmental unit.

(3) Refunding bonds (other than advance refundings) if amount of such bonds does not exceed the amount of the refunded obligations and, in the case of student loan bonds, the maturity date of the refunding bonds does not exceed the later of the maturity date of refunded bonds or 15 years after issuance of refunded bonds.

Effective date.— The volume limitation under the House bill applies generally to bonds issued after December 31, 1983. A transitional rule provides priority of allocation for certain bonds with respect to which an inducement resolution was given before October 1983, but only if the beneficiaries of those bonds notify the issuing authority within 30 days of enactment.

Senate amendment

The Senate amendment does not impose a per capita volume limitations on private activity bonds.

Conference agreement

The conference agreement limits the maximum face amount of private activity bonds which a state or local issues within the state may issue annually to the greater of (1) $150 per capita, or (2) $200 million. Private activity bonds include IDBs and student loan bonds subject to the exceptions below.[1]

The $150 per capita amount will be reduced to $100 in 1986 to reflect the scheduled expiration of the small issue exception. For purposes of the volume limitation, the District of Columbia is to be treated as a state (and therefore entitled to a $200 million volume limitation). However, U.S. territories with authority to issue tax-exempt bonds will be limited to the $150 per capita rule.

Under the conference agreement, unless a state otherwise allocates, 50 percent of the state's volume ceiling is allocated to state and 50 percent to local jurisdictions on the basis of population. State statutes and the actions of state governors to implement allocation of the volume limitation are to be effective whether occurring before or after enactment. The governor or other official designated in a state statute may retroactively allocate bond authority for bonds issued in 1984 (i.e., allocate to projects for which bonds have already been issued). However, bonds issued during 1984 but before the date of enactment or, if earlier, the date of public action to allocate the state balance ceiling, action in (3) above may not be denied allocation to the extent (of the authority which the issuer would receive based upon population) (i.e., if no alternative allocation method has been adopted).

As under the House bill, states may elect to carry over portions of their annual ceiling for up to 3 years for specified projects (6 years for pollution control projects.

States which issued private activity bonds equal to more than $150 per capita in 1983 (based on annualized volume for the first 9 months of the year) are allowed a two years phased down to the volume ceiling.

Exceptions.—The conference agreement includes the exceptions to the private activity bond volume ceiling for certain housing bonds (including IDBs for multi-family residential property and section 11(b) bonds) and refunding bonds contained in the House bill. The conference agreement also includes the exception for IDBs used to finance publicly owned airports, docks, wharves, mass facilities, and convention or trade show facilities, with the following additional provisions.

(a) Parking facilities subsidiary to qualified public facilities are exempt from volume ceiling, but only if the parking facilities satisfy the same requirements for exemption as the facility to which they are subsidiary and that facility is also exempt from the ceiling;

(b) Qualified public owned facilities owned by a governmental unit are exempt from the volume limitation only if all rents charged to tenants are not front-loaded to achieve an effect more accelerated than a straight-line rent over the life of the property.

(c) qualified public facilities owned by corporations issuing bonds on behalf of governmental units (Rev. Proc. 63-20) are exempt from the volume ceiling if the facilities satisfy the requirements applicable to governmentally owned facilities.

Effective date.—The volume ceiling for private activity bonds is effective for bonds issued after December 31, 1983, with the following transitional rules:

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[1] The State of Texas has a program called the Texas Veterans' Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount which is not a major portion of the proceeds, are used; for example, for the acquisition of land for recreational or investment purposes, the issue would not be subject to this limitation. The use of the proceeds by the veteran may be established by an affidavit of the veteran.

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Projects for which an inducement resolution was adopted before June 19, 1984, are exempt from any volume ceiling if the bonds are issued on or before December 31, 1984.

Projects for which an inducement resolution was adopted before October 19, 1983) *and* for which either (1) the construction of the facilities had commenced before October 19, 1983, and the user is the original user of the facilities, or (2) a binding contract existed before October 19, 1983, and at all times thereafter which committed the purchaser to incur significant expenditures for construction or acquisition of the facilities, will receive priority of allocation for 1985 and later years (in addition to being exempt from the 1984 ceiling). For purposes of this rule, significant expenditures will generally mean expenditures equal to 20 percent of the estimated cost of the facilities.

2. Restrictions on cost recovery deductions

Present law

Property financed with tax-exempt bonds generally is restricted to straight-line cost recovery deductions over the applicable ACRS periods.

Full ACRS deductions are allowed for low-income rental housing, municipal sewage or solid waste facilities, air or water pollution control facilities, and certain facilities with respect to which a UDAG grant is made.

House bill

The House bill requires straight-line cost recovery deductions for property, other than multifamily residential rental property, that presently is eligible for full ACRS deductions.

This provision of the House bill applies to property placed in service after December 31, 1983, to the extent financed with tax-exempt bonds issued after October 18, 1983. Transitional rule exempts facilities with respect to which (1) a binding contract to incur significant expenditures was entered into before October 19, 1983, or (2) construction began before October 19, 1983 (and original use of facility begins with taxpayer).

Senate amendment

The Senate amendment makes no change in the cost recovery rules for property presently eligible for full ACRS deductions. However, the Senate amendment extends the cost recovery period for property restricted under present law to straight-line deductions over the ACRS periods as follows:

3-year property	4 years
5-year property	7 years
10-year property	13 years
15-year public utility property	20 years
18-year residential real property	18 years
18-year nonresidential real property	22 years

This provision applies to property placed in service after June 30, 1984, to the extent financed with tax-exempt bonds issued after March 15, 1984. A transitional rule exempts facilities with respect to which (1) a binding contract to incur significant expenditures was entered into before March 15, 1984, or (2) construction began before March 15, 1984 (and original use of facility begins with taxpayer).

Conference agreement

The conference agreement follows the House bill.

3. Denial of tax-exemption to Federally guaranteed bonds

Present law

Present law imposes no general statutory restrictions on Federal guarantees of tax-exempt bonds. However, the Internal Revenue Code denies tax exemption for interest on obligations where (1) payment of principal or interest is guaranteed (in whole orin part) by the United States under a program with the principal purpose of encouraging production or conservation of energy, or (2) payment of principal or interest is to be made (in whole or in part) with funds provided under such a program of the United States, a State, or a political subdivision of a State.

House bill

The House bill denies tax-exemption to interest on bonds that are Federally guaranteed. Bonds are considered to be Federally guaranteed where the payment of principal or interest is guaranteed directly or indirectly by the United States or any agency or instrumentality thereof; where a significant portion of the bond proceeds is to be used to make Federally guaranteed loans; or where a significant portion of the bond proceeds is to be invested in Federally insured deposits (FDIC, FSLIC, NCUA, etc.) For purposes of these restrictions, an entity with statutory authority to borrow from the United States is treated as an instrumentality of the United States. Exceptions to this rule are provided for the District of Columbia and for bonds other than private activity bonds issued by U.S. possessions.

Exceptions.—The House bill provides the following exceptions to the restrictions on Federally guaranteed tax-exempt bonds:

(1) Federal Housing Authority (FHA), Veterans Administration (VA), Fannie Mae, Freddie Mac, and Ginnie Mae guarantees;

(2) Small Business Administration (SBA) guarantees under the SBA pollution control program, only if the SBA charges a fee for making the guarantee of at least 1 percent of the amount guaranteed;

(3) Bond proceeds invested for an initial temporary period or in bona fide debt service funds, qualified reserve funds, SLGs, or other investments permitted by Treasury regulations;

(4) Bond proceeds loaned to Federally insured financial institutions under a loans-to-lenders program; and

(5) IDBs for low-income residential rental property, mortgage subsidy bonds, and bonds issued under section 11(b) of the Housing Act of 1937 (except for proceeds invested in Federally insured deposits or accounts).

Effective date.—These provisions of the House bill apply generally to bonds issued after December 31, 1983. The restrictions with respect to bonds, the proceeds of which are invested in Federally insured deposits apply to bonds issued after April 14, 1983.

Senate amendment

The Senate amendment includes no general rules prohibiting Federal guarantees, but contains a provision identical to the House bill with respect to bonds the proceeds of which are invested in federally insured deposits (FDIC, FSLIC, NCUA, etc. Bond proceeds invested for an initial temporary period, in a bona fide debt service fund, or in a qualified reserve fund, are exempted from this rule.

The Senate amendment also denies tax exemption for bonds where a significant portion of proceeds is to be used for a facility also benefitting from (including indirect guarantees) under the SBA. This rule does not apply if the SBA charges a "reasonable" (as determined by the Secretary of the Treasury).

The Senate restrictions on investment of tax-exempt bond proceeds in Federally insured deposits in financial institutions apply to bonds issued after April 15, 1983, except to bonds issued pursuant to a contract binding at all times after March 3, 1983. The SBA guarantee rules apply to bonds issued after the date of enactment.

The House bill denies tax-exemption to interest on bonds that are Federally guaranteed. Bonds are considered to be Federally guaranteed where—

(1) Payment of principal or interest is guaranteed directly or indirectly by U.S. or any agency or instrumentality thereof;

(2) A significant portion of bond proceeds is to be used to make Federally guaranteed loans; or

(3) A significant portion of bond proceeds is to be invested in Federally insured deposits (FDIC, FSLIC, NCUA, etc.).

For purposes of these restrictions, an entity with statutory authority to borrow from U.S. is treated as instrumentality; exceptions are provided for D.C. and possessions bonds other than private activity bonds.

The House bill provides the following exceptions to the restrictions on Federally guaranteed tax-exempt bonds:

(1) FHA, VA, FNMA, FHLMC, GNMA guarantees;

(2) SBA guarantees under the SBA pollution control program, but only if the SBA charges a fee for making the guarantee. Fee must be at least 1 percent of the amount guaranteed;

(3) Bond proceeds invested for an initial temporary period, in bona fide debt service fund, in qualified reserve funds, in SLGs, or other investments permitted by Treasury regulations; and

(4) Bond proceeds loaned to Federally insured financial institutions under a loans-to-lenders program; and

(5) Bonds issued under section 11(b) of Housing Act of 1937 and mortgage subsidy bonds (except for proceeds invested in Federally insured deposits or accounts).

These provisions of the House bill apply generally to bonds issued after December 31, 1983. The restrictions with respect to bonds, the proceeds of which are invested in Federally insured deposits apply to bonds issued after April 14, 1983.

Senate amendment

The Senate amendment includes no general rules prohibiting Federal guarantees, but contains provision the same as the House bill with respect to bonds the proceeds of which are invested in Federally insured deposits (FDIC, FSLIC, NCUA, etc.).

The Senate amendment also restricts tax-exemption for bonds where a significant portion of proceeds is to be used for facility also benefitting from SBA guarantee (or subordination) under SBA—

(1) pollution control loan guarantee program, or

(2) certified development loan program.

Exceptions.—The Senate amendment provides exceptions for

(1) SBA guarantees under—

(i) SBA's pollution control program, or

(ii) SBA's certified development loan program,

but only if the SBA charges a fee for making the guarantee. Fee must equal at least 1 percent of the amount guaranteed, and fee must be "reasonable," as determined by the Secretary of the Treasury; and

(2) Bond proceeds invested for an initial temporary period, in a bona fide debt service fund, or in a qualified reserve fund.

The restrictions on investment of tax-exempt bond proceeds in Federally insured deposits in financial institutions apply to bonds issued after April 15, 1983, except to bonds issued pursuant to a contract binding at all times after March 3, 1983.

The SBA guarantee rules apply to bonds issued after the date of enactment.

Conference agreement

The conference agreement generally follows the House bill except for certain transitional rules with respect bonds benefitting from certain Federal insurance programs contained in the Senate amendment.

4. Arbitrage restrictions

Present law

Present law includes rules which limit the amount of arbitrage (i.e., the difference between the interest rate paid on tax-exempt bonds and the rate of income earned on investments made with the bond proceeds). Under these rules, the maximum income permitted to be earned generally cannot exceed the interest rate paid on the bonds by more than ⅛ of 1 percentage point. Unlimited amounts of income can be earned on all bond proceeds for a temporary period and on reasonably required reserves.

Where the issuer elects not to have unlimited income during a temporary period, the maximum permitted earnings are increased to ½ of 1 percentage point over the interest rate paid on the bonds.

In addition, in the case of program related investments (such as student loans), the maximum permitted earnings are increased to 1½ percentage points over the interest rate paid on the bonds.

Finally, in the case of student loan bonds, the student assistance payment (SAP) is excluded from the arbitrage computation, so that permitted arbitrage is 1½ percentage points plus the SAP.

Under these rules, certain costs also are excluded from the arbitrage limitation, so that these costs can be earned in addition to the permitted spreads.

Present rules permit issuers to retain any arbitrage earned under these rules.

Present law also provides additional arbitrage rules in the case of qualified mortgage bonds. Under these rules, the maximum permitted difference between the earnings rate on mortgages and interest rate paid on the bonds is 1⅛ percentage points. No costs, including costs related to the bond issue, are excluded from this arbitrage limitation so all costs must be covered within the 1⅛ percentage points. Subject to certain temporary period exceptions, all bond proceeds other than proceeds invested in debt service reserves not in excess of 150% of the debt service on the bonds, must be invested in mortgages. In addition, any arbitrage earned on nonmortgage investments must be either paid to the mortgagors (i.e., homebuyers) or to the Federal Government.

House bill

The House bill provides that, pursuant to Treasury regulations, arbitrage rules similar to the arbitrage rules applicable to mortgage subsidy bonds are to apply to industrial development bonds and student loan bonds. These new rules are in addition to the existing arbitrage rules of Code section 103. Also, as under the present arbitrage rules, special assistance payments are not considered for purposes of the new arbitrage rules.

Exceptions from the new arbitrage rules are provided for—

(1) Bonds for financing of multifamily residential rental property (including bonds issued under section 11(b) of the U.S. Housing Act),

(2) Bonds to refund student loan bonds issued before January 1, 1986.

Except for student loan bonds, these provisions of the House bill are effective with respect to bonds issued after December 31, 1983.

In the case of student loan bonds, the provisions are effective with respect to bonds issued after December 31, 1985.

Senate amendment

Like the House bill, the Senate amendment provides new arbitrage rules (in addition to those provided under present law) for IDBs and student loan bonds. The rules in the Senate amendment are similar to the rules of the House bill.

Industrial development bonds

The Senate amendment provides the following new arbitrage rules for IDBs:

(1) After the initial temporary period, and except for temporary periods related to debt service, all bond proceeds must be applied to the governmental purpose of the issue (except for an amount which may not exceed 150% of the annual debt service on the bonds and which may be otherwise invested; and

(2) Arbitrage earned on investments that are not acquired in order to carry out a governmental purpose (i.e., all nonpurpose obligations) must be paid to the Federal Government. At least every 5 years, 90 percent of the arbitrage earned to that date must be paid with any remaining balance paid 30 days after the bonds are retired. Exceptions are provided if arbitrage is less than $100,000 or if the loan proceeds are expended for governmental purposes within 6 months from the date of issue.

Student loan bonds

The Senate amendment directs the Treasury Department to prescribe new arbitrage regulations for student loan bonds. These new regulations may provide that (1) the exceptions for temporary period and reasonably required reserve funds and the special treatment of student assistance payments will not apply, and (2) the new arbitrage rules prescribed for IDBs apply to student loan bonds.

Exceptions are provided for—

(1) Bonds for financing of multifamily residential rental property;

(2) Bonds for financing of municipal sewage and solid waste facilities.

These provisions of the Senate amendment apply generally to bonds issued after December 31, 1984.

The new arbitrage regulations for student loan bonds would be effective with respect to bonds issued after the later of—

(1) the date that the Higher Education Act of 1965 expires or is extended, or

(2) six months after the date of publication of the regulations.

Conference agreement

The conference agreement follows the Senate amendment with respect to IDBs and Guaranteed Student Loan (GSL) bonds, and the House bill with respect to non-GSL student loan bonds.

In addition, the conference agreement clarifies that a certain State permanent university fund does not violate the arbitrage restrictions or present law as that fund is presently operated.

5. Limitations on acquisition of land and existing facilities

Present law

Acquisition of land and existing facilities may be financed with tax-exempt bonds to the extent the land or facilities are (1) used for an exempt purpose; or (2) the requirements of the small-issue exception are satisfied.

House bill

The House bill restricts the use of all IDBs (exempt purpose and small issue) to finance the acquisition of land or existing facilities, as follows:

(1) *Nonagricultural land.*—Tax-exemption is denied for bonds if 25 percent or more of proceeds of issue are used for nonagricultural land.

(2) *Agricultural land.*- Tax-exempt financing for agricultural land (and facilities located on such land) is restricted to a maximum of $250,000 and is further restricted to first-time farmers.

(3) *Existing facilities.*—Tax-exempt financing for existing facilities is permitted only if amount equal to at least 15 percent of cost of building (and equipment therefor) is spent for rehabilitation of building (and equipment).

These provisions apply generally to bonds issued after December 31, 1983. A transitional rule exempts property where (1) binding contract to incur significant expenditures was entered into before October 19, 1983, or (2) construction began before October 19, 1983 (and original use of facility begins with taxpayer).

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with various modifications and exceptions and appropriate transition rules, including a provision that the determination of whether a substantial rehabilitation occurs is made on a project, rather than a building, basis.

6. Elimination of IDB-financing for certain facilities

Present law

Present law does not include a list of facilities for which tax-exempt financing generally is prohibited. However, interest on small-issue IDBs is not exempt if—

(1) more than 25 percent of the proceeds of the issue are used to provide a facility the primary purpose of which is automobile sales or service or the provision of recreation or entertainment; or

(2) any portion of the proceeds of the issue is to be used to provide the following: any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating), racquet sports facility (including handball and racquetball courts), hot tub facility; suntan facility, or racetrack.

House bill

The House bill eliminates tax-exemption for interest on all types of IDBs (exempt purpose, industrial park, and small issue), if any portion of the proceeds of an issue are used for—

(1) any airplane,

(2) a skybox, or other private luxury box,

(3) any facility primarily used for gambling, or

(4) any store the principal business of which is sale of alcoholic beverages for consumption off-premises.

This provision of the House bill applies generally to bonds issued after December 31, 1983. A transitional rule exempts property where (1) binding contract to incur significant expenditures was entered into before October 19, 1983, or (2) construction began before October 19, 1983 (and original use of facility begins with taxpayer).

Senate amendment

The Senate amendment generally is the same as the House bill, but also eliminates tax-exemption for interest on all types of IDBs (exempt purpose, industrial park, and small issue), if—

(1) any portion of the proceeds of an issue is used to finance a health club facility, or

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(2) more than 20 percent of the proceeds of an issue is used to finance facilities in any one of the following categories:

(a) office equipment;

(b) medical and health facilities (other than hospitals;

(c) facilities used by doctors, lawyers, accountants, or similar professions; or

(d) parking facilities.

Additional restrictions in the Senate amendment do not apply to certain projects with respect to which a UDAG grant is made.

The additional restrictions included in the Senate amendment apply to bonds issued after April 13, 1984. A transitional rule related to additional restrictions exempts property where binding contract existed or construction began before April 14, 1984.

Conference agreement

The conference agreement includes the Senate provision with respect to health clubs, but not with respect to other additional facilities. A special transition rule delays the effective date for certain race tracks with respect to which an inducement resolution was approved before June 19, 1984.

7. Repeal of advance refunding for qualified public facilities

Present law

Advance refunding of IDBs generally is prohibited. Advance refunding issues are bonds issued more than 180 days before retirement of the original bonds.

Advance refundings are permitted for certain convention and trade show facilities, airports, docks, wharves, and mass commuting facilities.

House bill

The House bill repeals the provision of present law that permits advance refundings for certain convention and trade show facilities, airports, docks, wharves, and mass commuting facilities.

This provision applies to refunding bonds issued after the date of enactment.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill with appropriate transition rules.

8. Amendments to small-issue exception

a. Extension of small-issue exception

Present law

Present law permits tax-exemption for certain "small-issue" IDBs if the proceeds are used for acquisition of land or depreciable property. A small issue may not exceed $1 million ($10 million if certain capital expenditures are counted). The small-issue exception expires after December 31, 1986.

House bill

No provision.

Senate amendment

The Senate amendment extends the small-issue exception for 4 years, through December 31, 1990.

Conference agreement

The conference agreement extends the small issue exception only with respect to bonds used to finance manufacturing facilities.

b. Aggregate limit per taxpayer for small-issue exception

Present law

Present law imposes no overall limitation per beneficiary for small-issue IDBs.

House bill

The House bill provides that interest on small-issue IDBs is not tax-exempt if the face amount of issue allocated to any beneficiary (when increased by outstanding tax-exempt IDBs of the beneficiary) exceeds $40 million. Beneficiary means any person who is a user of the financed facilities. The bill provides the following rules for allocating IDBs to beneficiaries of a facility:

(1) Entire amount to beneficiary using more than 50 percent of facility; or

(2) If no one uses over 50 percent, equally among all beneficiaries using at least 25 percent (but no more than 50 percent to any one beneficiary); and

(3) To extent not allocated in (1) or (2), to owner/lessor of facility.

Bonds to refund outstanding issues are not allocated under the provision.

This provision applies generally to bonds issued after December 31, 1983. A transitional rule exempts property where (1) binding contract to incur significant expenditures was entered into before October 19, 1983, or (2) construction began before October 19, 1983 (and original use of facility begins with taxpayer).

Senate amendment

The Senate amendment is the same as the House bill except for allocation rules and exceptions to the restriction.

Under the Senate amendment, bonds are allocated as follows:

(1) To each user of 5 percent or more of facility, the percentage of the face amount of the issue equal to percentage of facility he uses; and

(2) To lessor, portion of face amount of issue equal to percentage of facility with respect to which he is lessor.

In addition to the exception for refunding bonds, the Senate amendment also provides exceptions for—

(1) Bonds to finance manufacturing facilities (including equipment therefore), and

(2) Bonds to finance facilities with respect to which a UDAG grant is made.

Conference agreement

The conference agreement follows the Senate amendment with modified allocation rules and a transition rule for facilities with respect to which an inducement resolution was approved before June 19, 1984. The conference agreement does not include the exceptions contained in the Senate amendment.

c. Aggregation of issues for single project

Present law

It is possible under present law to divide the ownership of a single building or project in such a manner that it is treated as multiple buildings or projects each of which qualifies for small-issue IDB financing (under the $1 million, or elective $10 million, volume limitations).

House bill

Two or more issues to be used with respect to a single project are treated as one issue in applying the small-issue volume limitations.

A project is defined as a single building, an enclosed shopping mall, or a strip of offices, stores, etc., using substantial common facilities.

A principal user of any single issue is treated as a principal user with respect to the aggregated issue.

This provision applies generally to bonds issued after December 31, 1983. A transitional rule exempts projects (1) with respect to which a binding contract to incur significant expenditures was entered before October 19, 1983, (2) on which construction began before October 19, 1983 (and the original use of the facility begins with the taxpayer).

Senate amendment

The Senate amendment is generally the same as the House bill.

Conference agreement

The conference agreement follows the Senate amendment with a transition rule for facilities with respect to which an inducement resolution was approved before June 19, 1984.

d. Clarification that residential property may be in a mixed use structure

Present law

Exempt purpose IDBs may be issued to finance low- and moderate-income residential rental property. Present law is unclear as to whether an entire building must consist of such housing for interest on the bonds to be tax-exempt.

House bill

The House bill clarifies that a part of a building qualifying as low-and moderate-income residential rental property may be used for nonresidential purposes, but limits tax-exempt financing to portion of building used for such housing.

This provision applies to bonds issued after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

e. Increase in small-issue IDB capital expenditure limitation for facilities with respect to which a UDAG grant is made

Present law

In lieu of the $1 million small-issue IDB volume limitation, an election may be made to issue up to $10 million of such bonds, if certain capital expenditures over a 6-year period are counted towards the $10 million limitation. The $10 million limitation is increased to $20 million in the case of a project with respect to which a UDAG grant is made.

House bill

The House bill increases $20 million limitation to $25 million for facilities with respect to which a UDAG grant is made.

This provision applies to bonds issued after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision.

f. Extension of substantial user rules

Present law

Interest on IDBs (exempt purpose, industrial park, and small issue) is not tax-exempt if the bonds are held by a substantial user of the facilities financed by the bonds or a related party.

Related parties include family members, fiduciaries, and corporations or partnerships subject to common control.

House bill

The House bill expands the definition of related party to include all partners of a partnership and spouses and dependent children of partners.

This provision applies to bonds issued after December 31, 1983.

Senate amendment

The Senate amendment includes the same provision as the House bill, and also treats all shareholders of an S corporation and spouses and dependent children of such shareholders as related persons.

Conference agreement

The conference agreement follows the Senate amendment.

(g) Extension of certain requirements of the Internal Revenue Service Code to bonds exempt from tax pursuant to other provisions of law

Present law

Interest on bonds issued by the District of Columbia, by U.S. possessions, and under section 11(b) of the Housing Act of 1937 is exempt from tax by virtue of provisions outside of the Internal Revenue Code, and such bonds are not subject to the Code requirements for tax-exemption.

The Surface Transportation Assistance Act of 1982 provided that any tax-exemption for such bonds is deemed to exist by reason of Code section 103. This provision was repealed because of the order in which that Act and another Act were signed into law.

A court has ruled that section 11(b) bonds are exempt from Federal estate tax. Bonds with respect to which interest is exempt from tax under Code section 103 are not exempt from estate tax.

House bill

The House bill generally subjects bonds, the interest on which is tax-exempt by virtue of a provision of law outside the Code, to the Code rules governing tax-exempt bonds.

Senate amendment

The Senate amendment is the same as the House bill, except the Senate amendment also authorizes the Virgin Islands and American Samoa to issue IDBs, subject to the restrictions of the Code.

Conference agreement

The conference agreement follows the House bill with certain modifications and a special effective date in the case of bonds issued pursuant to section 11(b) of the Housing Act of 1937.

* (5) Prohibition on use of tax-exempt bonds for consumer loans

Present law

Present law does not provide limitations on the use of the proceeds of tax-exempt bonds for private purposes except in the case of bonds where the proceeds are used in the taxable trades or businesses (i.e., industrial development bonds) or bonds where the proceeds are used to provide financing for owner-occupied housing (i.e., mortgage subsidy bonds).

House bill

No provision.

Senate amendment

The Senate amendment provides that tax-exempt bonds may be used to make loans or finance loans to persons which are not governmental units or tax-exempt organizations.

Exceptions are provided for:

(1) bonds issued before October 1, 1986, to finance student loans receiving special allowance payments;

(2) bonds issued after September 30, 1986, to finance any student loans;

(3) mortgage subsidy bonds;

(4) industrial development bonds;

(5) bonds whose proceeds are used to finance any governmental tax or general assessments;

(6) bonds whose proceeds are used to acquire obligations other than obligations for the governmental purpose giving rise to the issue (i.e., nonpurpose obligations) to the extent permitted under the arbitrage rules;

(7) Texas Veterans' Land Bonds (for bonds issued before January 1, 1987); and

(8) certain student loan bond refunding issues.

This provision applies generally to bonds issued after the date of enactment.

* Probably should read "(h)."

Conference agreement

The conference agreement generally follows the Senate amendment, with certain modifications regarding student loan bonds.

D. Miscellaneous Tax-exempt Bond Provisions

1. Tax-exempt obligations issued by Pennsylvania State University

Present law

Interest on obligations is excluded from gross income where the obligations are issued by or on behalf of a State or local government. The determination of whether an entity is a State or local government depends upon whether that entity has sovereign powers or is controlled by an entity with sovereign powers.

House bill

The House bill provides that the Pennsylvania State University is to be treated as a State governmental unit for purposes of issuing tax-exempt obligations.

This provision applies to obligations issued after December 31, 1953.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

2. Clarification of public approval requirement in the case of certain public airports

Present law

Issuance of private activity tax-exempt bonds must be approved by a public hearing, an elected official, or by a voter referendum. Facilities located in more than one jurisdiction must satisfy the public approval requirements in all such jurisdictions.

House bill

The House bill provides that in the case of airports located in more than one jurisdiction, but owned and operated by the jurisdiction issuing the tax-exempt bonds, only the issuing jurisdiction is required to satisfy the public approval requirements of present law.

This provision applies to bonds issued after December 31, 1983.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

3. Principal users of certain solid waste disposal facilities

Present law

Unlimited amounts of tax-exempt IDBs can be issued to finance solid waste disposal facilities. Under Treasury regulations, facilities cease being solid waste disposal facilities when the solid waste is processed to produce the first marketable product. In the case of solid waste that is burned to produce heat, the first marketable product is steam. Facilities for processing beyond the first marketable product can be financed with tax-exempt IDBs only under the small-issue exception. In determining whether the requirements of the small-issue exception are satisfied, the capital expenditures of all principal users of financed facilities must be taken into account.

House bill

No provision.

Senate amendment

The Senate amendment provides that the purchaser of all of the steam output of a specified solid waste disposal facility is not to be treated as a substantial user of the solid waste disposal facility.

This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

4. Tax-exempt financing for Power Authority of the State of New York

Present law

Under present law, tax-exempt financing is available for the acquisition of facilities which are used in taxable business of an electric utility only if the service area of the utility does not exceed two contiguous counties (or a city and one contiguous county) or the bond meets the requirements of the small-issue exception.

House bill

No provision.

Senate amendment

The Senate amendment provides that tax-exempt bonds may be issued (1) to finance facilities for the Power Authority of the State of New York (PASNY) if there is not mark up by the purchasing utility of the electricity from PASNY when the purchasing utility sells the electricity to its ratepayers.

This provision applies to bonds issued after the date of enactment and to certain bonds issued after December 31, 1969, which were tax-exempt when issued.

Conference agreement

The conference agreement follows the Senate amendment with certain modifications.

5. Tax-exempt financing for acquisition of railroad track and rights-of-way of bankrupt railroads

Present law

Tax-exempt financing is available for the acquisition of facilities which are used in taxable businesses of railroads only if the requirements of the small-issue exception are satisfied.

House bill

No provision.

Senate amendment

The Senate amendment provides that tax-exempt bonds may be issued to finance the acquisition of railroad track and rights-of-way from bankrupt railroads where the Federal Railroad Administration provides joint financing for such facilities.

This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

6. Exemption from local furnishing rule for Long Island Lighting Company and Bradley Lake Hydroelectric Facility

Present law

Tax-exempt financing is available for the acquisition of facilities which are to be used in taxable business of an electric utility only if the service area of the utility does not exceed two contiguous counties (or a city and one contiguous county) or if the requirements of the small-issue exception are satisfied.

House bill

No provision.

Senate amendment

The Senate amendment provides an exception from the local furnishing rule for the Long Island Lighting Company and the Bradley Lake Hydroelectric Facility. This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement allows advance usage of the State volulme cap, under speci-

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fied conditions, for certain specially identified projects.

7. Exemption from restriction on financing food and beverage facilities for certain catering facility

Present law

In 1982, TEFRA provided that interest on small-issue IDBs is not tax-exempt if more than 25 percent of the proceeds of an issue are used to finance any retail food and beverage service facility.

House bill

No provision.

Senate amendment

The Senate amendment provides that a facility the primary purpose of which is to provide catering services and meeting rooms for groups of 2,500 or more individuals is not treated as a facility the primary purpose of which is providing retail food and beverage services.

This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement does not include the Senate provision.

8. Review of Department of Education determinations on tax-exempt student loan bonds

Present law

The Student Loan Consolidation and Technical Amendments Act of 1983 eliminates tax-exemption for interest on student loan bonds unless the Department of Education approves issuance of the bonds.

House bill

No provision.

Senate amendment

The Senate amendment provides for review and filing of a report by the Department of the Treasury with respect to any adverse determinations by the Department of Education regarding issuance of tax-exempt student loan bonds.

This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

9. Issuance of taxable bonds by agencies issuing qualified scholarship funding bonds

Present law

Interest on qualified scholarship funding bonds is tax-exempt. Such bonds are bonds issued by State authorities meeting prescribed requirements, including the requirement that the authorities be organized exclusively to acquire student loan notes funded with tax-exempt bonds.

House bill

No provision.

Senate amendment

The Senate amenament permits student loan bond issuers to issue taxable bonds without prejudice to their ability to issue tax-exempt bonds.

This provision applies to bonds issued after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

10. Study of role of tax-exempt student loan bonds

Present law

No provision.

House bill

No provision.

Senate amendment

The Senate amendment requires the General Accounting Office and the Congressional Budget Office to conduct a study of the appropriate role of tax-exempt bonds in financing student loans and to report to Congress within 9 months after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment with certain technical modifications.

VII. TECHNICAL CORRECTIONS

House bill

The bill contains technical, clerical, and conforming amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983, and other recently enacted tax legislation. The amendments are meant to carry out the intent of Congress in enacting the original legislation.

Senate amendment

The Senate amendment contained no separate technical corrections title.

Conference agreement

The conference agreement generally follows the House bill with the following modifications:

1. Alternative minimum tax

(a) The amount includible in gross income with respect to the alcohol fuels credit (sec. 87) will not be included in alternative minimum taxable income since that credit is not allowed against the minimum tax; (b) The House bill contains a provision clarifying the treatment of losses from limited business interests, for purposes of the investment interest limitations of the alternative minimum tax. In order to further clarify the application of that provision, the following example is given:

Assume that a taxpayer had $100,000 of dividend income and also held a limited partnership interest in a partnership all of whose income is derived from a trade or business. The taxpayer's distributive share of partnership income included $200,000 of gross income and $300,000 of deductions which are not preferences (including partnership deductions for business interest). Because any income or loss derived from the limited partnership interest is taken into account for purposes of computing net investment income, the taxpayer would have no net investment income for the taxable year and, therefore, could deduct no "below the line" interest (other than eligible housing interest), including interest on debt used to purchase or carry the limited partnership interest.[2]

2. Casualty loss deduction

The House bill provides that adjusted gross income, for purposes of computing the 10-percent floor for the casualty loss deduction, is determined without regard to the application of section 1231 to gains or losses from involuntary conversions arising from casualty or theft. The conference agreement retains this rule for taxable years beginning in 1983, but replaces this rule with a new set of rules for determining capital gains treatment and applying the 10-percent floor with respect to these gains and losses for taxable years beginning after December 31, 1983.

Under the conference agreement, gains and losses from an involuntary conversion of property described in section 165(c)(3) arising from fire, storm, shipwreck, or other casualty or from theft will no longer be subject to the application of section 1231. Section 1231 will thus be applied without regard to these gains and losses. Gains and losses from these personal casualties (without regard to the period the property was held) will be netted. If the recognized gains exceed the recognized losses from these transactions, then all such gains and losses will be treated as gains and losses from the sale or exchange of a capital asset, and the losses will not be subject to the 10-percent floor. (The amount of any recognized loss will be subject to the $100 floor before netting). If the recognized losses exceed the recognized gains, all gains and losses will be ordinary. Losses to the extent of gains will be allowed in full. Losses in excess of gains will be subject to the 10 percent adjusted gross income floor.

Thus, for example, assume a taxpayer has $100,000 of adjusted gross income (without regard to casualty gains and losses described in section 165(c)(3)), $50,000 of such casualty gains, and $40,000 of such casualty losses (after applying the $100 floor) for a taxable year. All the taxpayer's personal casualty gains and losses for that year will be treated as capital gains and losses. The 10-percent floor will not be applicable. Assume, however, that the taxpayer's losses for the year are $70,000 rather than $40,000. The gains and losses will all be treated as ordinary. $60,000 of losses will be allowed as a deduction ($50,000 plus the $10,000 excess of the remaining $20,000 over the $10,000 (10 percent of $100,000) AGI floor).

3. Amendments to section 338

(a) Deemed sales price.—The House bill provides that the deemed sales price will be the fair market value of the target corporation's assets. Under the conference agreement, the fair market value deemed sale price of the target corporation's assets may be determined in a manner to be prescribed by regulations. It is contemplated, for example, that the regulations may provide the determination of fair market value using an elective formula which takes into account liabilities (including recapture taxes) and other relevant items. The regulations may also provide that if the taxpayer chose not to use the formula approach a proper appraisal of the target corporation's assets will be considered evidence of fair market value.

(b) Deemed purchase price.—Under present law, the deemed purchase price is an amount based on the grossed-up basis of all of the purchasing corporation's stock in the target corporation. Under the conference agreement, the deemed purchase price to be used in determining the basis of the target corporation's assets is the grossed-up basis of the target corporation's stock purchased by the purchasing corporation during so much of the acquisition period as ends on the acquisition date plus its basis in other target corporation stock which it owns on the acquisition date. As under present law, adjustments are to be made under regulations for target corporation liabilities (including any recapture taxes) and other relevant items. The grossed-up basis of the purchased stock is determined by multiplying the basis (before grossing up) of such stock by a fraction, the numerator of which is the percentage by value of the target corporation's outstanding stock represented by such purchased stock plus stock not owned by the purchasing corporation, and the denominator of which is the percentage by value of such purchased stock. The total basis, as under present law, is to be allocated among the target corporation's assets under regulations.

[2] See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, page 20, for similar example under the TEFRA provisions as enacted.

An election is provided under the conference agreement pursuant to which the deemed purchase price of the target corporation's assets may be determined by stepping up the basis of the target corporation's stock held by the purchasing corporation that was not purchased during the acquisition period. The stepped-up basis is to be determined under regulations and is applicable if the purchasing corporation elects to recognize gain as if the stock were sold on the acquisition date. The deemed sale price and basis of such stock is the amount determined by multiplying the grossed-up basis of the stock purchased during so much of the acquisition period as ends on the acquisition date by a fraction, the numerator of which is the percentage of the value of the target corporation's stock represented by such stock held but not purchased by the purchasing corporation during so much of the acquisition period as ends on the acquisition date and the denominator of which is the percentage by value of all the remaining target corporation stock.

Thus, for example, assume that the purchasing corporation purchases 80 percent of the target corporation's stock for $8 million during the 12-month acquisition period, that it held an additional 8 percent of the stock with a basis of $200,000 on the acquisition date, and that 12 percent of the stock was not held by the acquiring corporation on the acquisition date. Assume that there are no liabilities (including recapture liabilities). Under the conference agreement, the target corporation's basis in its assets will be $9.4 million (92%/80% times $8 million (i.e., $9.2 million) plus $200,000). The purchasing corporation may elect to treat the 8 percent stock as sold for $800,000 ($9.2 million multiplied by the fraction 8 percent over 92 percent). If the election is made, the purchasing corporation will recognize gain of $600,000 and then the target corporation will have a basis in its assets of $10 million.

(c) Exceptions to the deemed election rule (sec. 338(e)(2)).—Under present law, a section 338 election is deemed made in certain cases where the purchasing corporation acquires assets directly from the target corporation or an affiliate of the target. Exceptions to this treatment are made for property the basis of which is determined in whole or in part by reference to its basis to the transferor, assets located outside the United States to the extent provided in regulations, and other acquisitions described in regulations.

The conference agreement modifies the carryover basis exception by requiring the basis of the acquired property to be determined wholly by reference to its basis to the transferor in order to qualify for this exception.

The conference agreement clarifies the scope of the present law regulatory authority under section 338(e)(2) by specifically providing that conditions may be imposed by the regulations in order to come within the scope of this exception. It is contemplated, for example, that the regulations may permit the purchasing corporation to elect, with respect to property acquired from the target corporation or a target affiliate during the consistency period, to take as its basis in the acquired property the adjusted basis of such property in the hands of the person from whom acquired. It is contemplated that such an election would not apply to any item of property if the result would be a basis to the purchasing corporation in excess of the cost of such item to the purchasing corporation. A corporation making such an election would be bound by all of the terms and conditions prescribed in the regulations, notwithstanding any other provision of the Internal Revenue Code.

(d) Miscellaneous amendments.—The acquisition date applicable in the case of a deemed purchase of stock by the target corporation is to be determined pursuant to regulations under the Conference agreement. The assets of a target corporation, including stock held in subsidiary corporations, are deemed purchased on the day following the acquisition date applicable to the target (sec. 338(a)(2)). The application of this rule may result in several acquisition dates when sec. 338 is applied to successive deemed purchases of several tiers of corporations acquired by the direct purchase of a target corporation which is the parent corporation of an affiliated group. The regulatory authority is intended to enable the Treasury Department to provide a single acquisition date when sec. 338 is applied to such a group.

Under the conference agreement, stock acquired in the course of certain reorganizations and other transactions set forth in regulations in which the transferor does not recognize the entire amount of gain shall be treated as not purchased.

Stock and asset acquisitions by 2 or more members of the same affiliated group will be treated as made by one corporation. Thus, the aggregate purchases of target corporation stock by several members of an affiliated group will be counted in determining whether there has been a qualified stock purchase. Similarly, the deemed sales price and basis of a target corporation's assets and gain recognized under section 338(c)(1) will be determined on a group basis.

A combined return may be filed, under the conference agreement, where an election applies to 2 or more target corporations purchased from a group which files a consolidated return that includes the target corporations for the taxable period in which the transaction occurs. The combined return will include the combined tax liability attributable to the deemed asset sales by the target corporations.

The regulatory authority provided in section 338(i) is amended by the conference agreement to delete the reference to the target corporation and its target affiliates and to apply such authority to certain transactions made by a purchasing group.

The conferees intend that the amendment in the House bill to the rules applicable to acquisitions made to evade or avoid income tax will not cause the disallowance of loss carryover deductions and other tax benefits of a corporation because of its qualified stock purchase and liquidation of a profitable corporation without a section 338 election, where the transaction results in no change in ownership of the purchasing corporation.

Finally, the time for making an election under section 338 with respect to pre-September, 1982, purchases is extended until 60 days after date of enactment.

4. Amendments to section 304

(a) Dividend treatment.—The conference agreement modifies the provision in the House bill amending the rules relating to redemptions through use of related corporations (sec. 304). Under the House bill, the amount to be treated as a dividend to selling shareholders when the stock sale involves two commonly controlled corporations (so-called brother-sister cases), is to be determined as if the distribution were by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. When stock is sold to a subsidiary of the issuing corporation (so-called parent-subsidiary cases) present law provides that the amount of any dividend to the selling shareholder is determined as if the proceeds were first distributed to the issuing corporation, then to the selling shareholders.

Hypothetical distributions to the acquiring or issuing corporation for the purpose of determining the amount of a dividend to the selling shareholder have been considered not to affect the taxable status of the putative distributee corporation under present law. *Broadview Lumber Co. v. U.S.*, 561 F. 2d 698 (7th Cir., 1977); TEFRA Conference Report (H. Rept. No. 97-760, 97th Cong., 2d Sess., p. 543). However, the effect of such distributions on the earnings and profits of the corporation deemed to have made the distribution is unclear. If the earnings and profits are reduced, a corporation can shift earnings and profits from one member of a controlled group to another at the cost of the tax, if any, on intercorporate dividends (at most, 6.9%), and create an opportunity for the deemed distributor to make nondividend distributions to noncorporate shareholders. If a corporation sells stock in a foreign subsidiary to a domestic subsidiary, it may be argued that the effect of these rules is to characterize the distribution as a U.S. source dividend from the domestic subsidiary whereas, under present law, gain from the sale would be treated as a dividend from the foreign corporation's earnings and profits if section 304 were inapplicable. In other cases, the application of the foreign tax credit is unclear with respect to a dividend resulting from the application of section 304 to a sale of stock in a foreign corporation to a related corporation in cases where there would be a foreign tax credit under section 902 if the issuing corporation paid a dividend directly to the U.S. selling corporation.

To address these issues, the Conference agreement revises the deemed distribution rules of section 304 to provide that in all cases, i.e., both brother-sister and parent-subsidiary transactions, the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distribution as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution. Also, the earnings and profits of the corporation which is treated as having made a distribution will be reduced.

(b) Effective dates.—The effective dates of paragraphs (1) and (3) of section 712(l), relating to earnings and profits and acquisition indebtedness, will apply to transfers after June 18, 1984, unless the taxpayer elects to have the provisions apply as if enacted in TEFRA. Transfers to a Bank Holding Company where regulatory approval was requested on or before June 18, 1984, and the transfer is made within 90 days of final regulatory approval will be treated as a transfer on or before June 18, 1984, for this purpose. Notwithstanding the above, in the case of a transfer to which section 351 does not apply, the acquisition indebtedness rule in the bill will apply if the debt was incurred after October 20, 1983.

5. Compliance

(a) The conference agreement applies the exceptions from interest reporting (sec. 6049) for payments to certain specified persons to dividend reporting (sec. 6042). Substitute dividends paid to corporations and

other persons are reported under sec. 6045, as amended by this bill.

(b) The conference agreement amends the broker reporting rules (sec. 6045) to include government agencies in the definition of a person. Consequently, a government agency (such as the Bureau of Public Debt) acting as a broker is required to provide a broker report and to implement backup withholding.

(c) The conference agreement deprives the Claims Court of jurisdiction over refund cases involving the tax shelter promoter penalty (sec. 6700) and the penalty for aiding and abetting the understatement of tax liability (sec. 6701). This is done because the Claims Court lacks jurisdiction to hear the likely counterclaim of the Government for an injunction.

(d) The conference agreement provides that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a "quickie refund" is filed (sec. 6411), the refund is not treated as claimed earlier than the time the "quickie refund" is claimed. If a "quickie refund" is not claimed, interest is computed under present law rules. Also, a "quickie refund" is treated as a claim for refund for interest purposes.

The conference agreement also provides that underpayments arising from claims for rebates (such as quickie refunds) are subject to the substantial understatement penalty (sec. 6661).

(e) The conference agreement corrects an incorrect reference to sec. 7602(a)(2) in sec. 7609(c)(1).

(f) The conference agreement requires that trusts or estates furnish copies of returns to their beneficiaries and that S corporations furnish copies of returns to their shareholders. The conference agreement also provides a $50 penalty on trusts, estates, partnerships, and S corporations for failures to provide copies of their returns to beneficiaries, partners, or shareholders.

(g) The conference agreement provides rules for backup withholding relating to the manner of notification from a broker to a payor with respect to readily tradeable instruments.

(h) The conference agreement amends backup withholding to permit the IRS to tell a payor enough of the reasons why a taxpayer is being placed on backup withholding to enable the taxpayer and payor to know how withholding can be stopped. Therefore, when the Secretary notifies a payor that a payee is subject to backup withholding, the Secretary will also notify the payor that backup withholding is being imposed because the TIN furnished by the payee is incorrect or because of notified payee underreporting. The prohibition on disclosure by the Secretary of the nature or details of the payee's underreporting is continued.

(i) The conference agreement restores the technical rules applicable to trusts under interest and dividend withholding to backup withholding. These rules were inadvertently repealed by the Interest and Dividend Tax Compliance Act of 1983.

(j) The conference agreement clarifies that backup withholding does not apply in the pension area. The conference agreement provides that, if a payee has not provided a proper social security number in the manner required by the Secretary or if the Secretary notifies the payor that the social security number is not correct, any election out of pension withholding is not effective. In addition, the withholding convention treating the payee as a married individual claiming three exemptions is not effective. Consequently, the payee is treated as a single individual claiming no exemptions if no withholding exemption certificate is in effect (see Treas. Reg. sec. 31.3402(f)(2)-1(a)).

The conferees anticipate that the Secretary will consider a payee's social security number to have been properly furnished so long as, before January 1, 1985, the payee provides the social security number in a manner acceptable to the payor. Therefore, if the payee has previously furnished his social security number in response to a request relating to pension withholding or backup withholding, or if the payor has otherwise obtained the number, that number is considered to have been properly furnished. The Secretary may require that, on or after January 1, 1985, the social security number must be furnished in the manner that the Secretary determines. The Secretary may, for example, require these social security numbers to be certified under penalties of perjury, if he determines that to be appropriate.

6. Energy

(a) The conference agreement amends section 44(D) (relating to the credit for producing fuel from nonconventional sources) to provide that in the case of a fiscal year taxpayer, the reference price on which the amount of the credit depends will be the reference price for the calendar year in which the fuel is sold rather than for the calendar year in which the producers fiscal year begins. This amendment ensures that producers of nonconventional fuels sold on the same day will have the same credit regardless of whether they have the same tax accounting year.

(b) The conference agreement provides for a simplified procedure under which refunds arising by reason of section 201(h)(1)(E) of the Technical Corrections Act of 1982 for periods before 1983, may be made to a partnership rather than its partners individually.

7. Subchapter S

(a) The House bill extends the grace period to make an election to be treated as a qualified subchapter S trust from 60 days to 75 days. The conference agreement changes the 75 days to 2 months and 15 days, to conform to the time for making a subchapter S election (see Treasury Temp. Reg. sec. 18.1362-(b)).

(b) The House bill provides that amounts in the accumulated adjustment account will be allocated pro-rata among all distributions made during the year. The conference agreement allows exceptions to this rule to be provided by the Treasury Department. It is anticipated that this authority would be used to provide a different rule where substantial amounts of stock in the corporation are sold or exchanged during the taxable year.

(c) The House bill provides that a corporation can make a subchapter S election within 2½ months from the beginning of a taxable year although the taxable year is less than 2½ months duration. The conference agreement clarifies that when the election for the short year is late filed but is timely for the subsequent taxable year, it will be effective for the subsequent year. This provision will apply to elections after October 19, 1982.

(d) Present law imposes a tax on subchapter S corporations with passive income and subchapter C earnings and profits. Under the conference agreement, this tax could be waived by the Internal Revenue Service if the corporation had determined, in good faith, that it had no such earnings and profits, and the earnings are distributed after their discovery.

(e) The subchapter S Act requires the basis of debt which is reduced by losses to be restored by subsequent income. The conference agreement clarifies that this applies only to the extent the basis in the debt was reduced in taxable years beginning after 1982.

(f) Present law provides that the revocation of a subchapter S election requires the consent of the shareholders holding a majority of the shares of stock. Although no statutory amendment is made, the conference agreement clarifies that this is the rule notwithstanding language in the 1982 committee reports to the contrary.

(g) The House bill provides that the basis of stock in an S corporation is to be adjusted to reflect adjustments required to the basis of corporation property when investment credits are allowed or recaptured. Corresponding adjustments are also to be made to the accumulated adjustments account.

8. Partnerships

(a) The Tax Reform Act of 1976 provided that gain is recognized when property is contributed to a partnership which is an investment company (sec. 721(b)). The conference agreement clarifies that the basis of the contributed property and the basis of the partnership interest is increased only by the gain recognized under section 721(b).

(b) Under present law, the basis of a partnership interest is generally increased by the excess of depletion deductions in excess of basis (sec. 705(a)(1)(C)). The language relating to oil and gas depletion (sec. 705(a)(3)) is amended to clarify that similar treatment applies to oil and gas depletion.

9. Highway Revenue Act

The conference agreement follows the House bill with three modifications—

(a) The period for filing floor stocks refund claims with respect to tires on which tax was reduced, but not repealed, by the Highway Revenue Act is extended for six months. Under the conference agreement, claims must be submitted to manufacturers by tire dealers before January 1, 1985; manufacturers must in turn submit claims to the Government before April 1, 1985.

(b) The provision under which taxpayers whose average daily production of crude oil is below a specified amount are permitted an additional five days in which to pay the gasoline excise tax if their payment is made by wire transfer is clarified to provide that the payment must be made by wire transfer to a Federal Reserve Bank.

(c) A clarification is made to the rules under which refunds or credits against the retail truck and trailer excise tax are available to ensure that refunds or credits for price readjustments will be available against the retail tax to the extent they were available when the tax was imposed as a manufacturers tax.

10. P.L. 98-258

The conference agreement makes the following modifications to P.L. 98-259, which forgives certain Federal income tax liabilities for U.S. military or civilian employees who die as a result of wounds or injuries sustained overseas either in certain military actions involving U.S. Armed Forces or in a terroristic activity directed against the U.S. or its allies (including a multinational force in which the U.S. participates).

(a) The effective date is changed from individuals wounded after December 31, 1979, to individuals wounded after November 17, 1978.

(b) The determination of whether terroristic action was directed against the U.S. or its allies is to be based on a preponderance of the evidence.

(c) The required relationship between the overseas wound or injury and the individ-

ual's death is clarified by providing that the individual must be a U.S. employee both at the date of incurring the wound and at the date of death.

(d) The definition of U.S. employees is modified so that the Director General of the Multinational Force and Observers in the Sinai who died February 15, 1984 is treated as a civilian employee of the United States while serving in that position.

11. Foreign currency contracts

The provision in the House bill relating to the election to treat certain foreign currency contracts as not marked-to-market is not contained in the conference agreement.

III. ENTERPRISE ZONES

Present law

No provision.

House bill

No provision.

Senate amendment

The Senate amendment provides for the designation of certain distressed areas as enterprise zones and provides tax incentives and regulatory relief designed to stimulate economic activity within the zones. Under these provisions, up to 75 enterprise zones are to be designated by the Secretary of the Department of Housing and Urban Development, beginning on January 1, 1985, over a period of 3 years, although no more than 25 designations may be made during each year. At least one-third of the designated zones will be in rural areas. Each enterprise zone is eligible for Federal tax and regulatory relief. The duration of each zone is 20 years, plus a 4-year phaseout period. Areas are to be nominated for enterprise zone designation by one or more local governments and the State in which the area is located. Areas nominated for such a designation have to meet certain criteria of economic distress, and designations are made through a competitive process weighing suggested plans for developing the area through tax and regulatory relief, improved services, and involvement of neighborhood and community organizations and private entities in development efforts.

Under the Senate amendment, the following Federal tax incentives are available in enterprise zones: An additional 3-percent or 5-percent investment tax credit for investments in personal property and a 10-percent credit for investments in new structures in the zone; a 10-percent credit to employers for increases in payroll to qualified zone employees and a credit for hiring disadvantaged workers for zone employment; a 5-percent credit to zone employees for wages received from zone employers; an exclusion from tax on capital gains attributable to zone property; allowance of full ACRS deductions for facilities in zones financed by industrial development bonds despite the limitation of such deductions for comparably financed facilities elsewhere, and the continued availability of the small issue exemption for industrial development bonds in zones after December 31, 1986, despite its termination on that date elsewhere.

Conference agreement

The conference agreement does not contain the Senate amendment.

IX. HIGHWAY REVENUE PROVISIONS

1. Reduction in heavy vehicle use tax and increase in diesel fuel tax

Present law

Use tax

In general, an annual excise tax is imposed on the use on the public highways of a highway motor vehicle whose taxable gross weight exceeds a prescribed minimum weight. The tax is paid by the person in whose name the vehicle is registered, and the taxable period begins on July 1. Amounts equivalent to highway use tax receipts are appropriated to the Highway Trust Fund. The tax expires on October 1, 1988.

Tax rate.—For uses occurring before July 1, 1984, the tax rate is $3 per 1,000 pounds of taxable gross weight or fraction thereof. Vehicles of 26,000 pounds or less are exempt.

The tax rate is scheduled to change to a graduated structure on July 1, 1984. Vehicles under 33,000 pounds are exempt. For vehicles between 33,000 and 55,000 pounds, the tax rate is $50, plus $25 for each 1,000 pounds or fraction thereof over 33,000 pounds. For vehicles of 55,000 pounds or more, the tax rate is $600, plus $40 (rising to $52 by 1988) for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 79,000 pounds, is $1,600 (rising to $1,900 by 1988).

Operating rules.—Two rules are generally effective as of July 1, 1984. First, a vehicle that travels fewer than 5,000 miles on the public highways during a taxable period is exempt, regardless of taxable gross weight. Second, a credit or refund is allowed pro rata, if a vehicle on which use tax has been paid is retired from service because of theft, accident or other casualty.

Small owner-operators.—Special rules apply in the case of a person (a small owner-operator) who owns and operates no more than 5 taxable vehicles during a taxable period. Beginning July 1, 1984, the tax rate applicable to small owner-operators in a taxable period is the tax rate generally applicable in the immediately preceding taxable year. In addition, the 5,000-mile exemption and proration for theft or accident are not effective for small owner-operators until July 1, 1985.

Diesel fuel tax

An excise tax of 9 cents a gallon is imposed on the sale of diesel fuel for use in a highway vehicle. The tax expires on October 1, 1988.

A number of complete exemptions are provided, including an exemption for diesel fuel sold to a State or local government or nonprofit educational organization for its exclusive use and a refund or credit for tax paid for diesel fuel used in an intercity, local or school bus. Certain other diesel fuel is exempt from only a portion of the tax.

Amounts equivalent to diesel fuel tax receipts are appropriated to the Highway Trust Fund. One-ninth of these amounts (currently, 1 cent per gallon) is designated for the Mass Transit Account in the fund.

House bill

Use tax

The House bill restructures and reduces the highway use tax rate generally, and revises the operating rules for small owner-operators, effective July 1, 1984.

Tax rate.—Vehicles under 55,000 pounds are exempt. For vehicles of 55,000 pounds or more, the tax rate is $150, plus $20 for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 72,000 pounds, is $500.

Small owner-operators.—For the taxable period beginning on July 1, 1984 only, the tax rate for small owner-operators is $3 per 1,000 pounds for vehicles of 55,000 pounds or more. However, if this special rule would produce a greater use tax on a small owner-operator's vehicle than does the general tax rate, then the general rate applies to that vehicle. Only the general tax rate applies to small owner-operators beginning July 1, 1985. Moreover, the 5,000-mile exemption and proration for theft or accident are made available to small owner-operators beginning July 1, 1984.

Study requirement.—The Secretary of Transportation is instructed to report to Congress within one year after the date of enactment whether trucks of 80,000 pounds or more bear their fair share of the costs of the highway system.

Diesel fuel tax

The House bill increases the excise tax on diesel fuel to 14.5 cents a gallon, effective July 1, 1984, to compensate for lower revenues from the reduced use tax provided by the bill. No modifications are made to the exemptions provided under present law; that is, complete exemptions remain complete, and partial exemptions remain at their present-law levels.

To offset the increase in fuel costs for light vehicles, the House bill provides an advanced rebate equal to the estimated extra tax to be paid over the expected life of the vehicle. A qualifying vehicle must have a gross vehicle weight of 10,000 pounds or less. The rebate is available only to (1) the original purchaser of a diesel-powered vehicle purchased after January 1, 1985, and before 1988 or (2) the holder as of January 1, 1985, of a vehicle purchased on or before that date. The rebate for a vehicle is claimed once, generally on the income tax return of (1) the original purchaser, in the taxable year of purchase, or (2) the holder, in the taxable year which includes December 31, 1984. The amount of the rebate is fixed at $96 for a new car ($180 for a new truck), and is reduced proportionally for older cars. No rebate is available if the model year is 1978 or earlier.

To maintain the currently effective designation of amounts to the Mass Transit Account, one cent per gallon (rather than one-ninth) of the diesel fuel tax is designated for that account.

Senate amendment

Use tax

Tax rate.—The Senate amendment restructures and reduces the tax rate, effective July 1, 1984. Vehicles under 55,000 pounds are exempt. For vehicles of 55,000 pounds or more, the tax rate is $75, plus $21 for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 79,000 pounds, is $600.

Logging vehicles.—Under a special rule, the tax rate is reduced by one-half for logging vehicles used exclusively to haul harvested forested products from the forested site and registered for that purpose.

Agricultural vehicles.—Under a special rule, the 5,000-mile exemption is increased to 7,500 miles for State-registered agricultural vehicles which haul farm commodities to or from the farm, effective as if included in sec. 513 of the Highway Revenue Act of 1982.

Small owner-operators.—The Senate amendment is the same as the House bill with respect to rules applicable to small owner-operators.

Study requirements.—The Secretary of Transportation is required to report to Congress within one year after the date of enactment on effects of the use tax on transborder trucking operations. In addition, the National Academy of Sciences is required to study weight-distance taxes and report to Congress within 18 months of the date of enactment.

Diesel fuel tax

The Senate amendment increases the excise tax on diesel fuel to 15 cents a gallon, effective July 1, 1984. Present law exemp

tions from the entire amount of tax, including the credit or refund for diesel fuel sold to a State or local government or nonprofit educational organization for its exclusive use, are generally increased to 15 cents a gallon. However, the credit or refund for diesel fuel used in intercity, local or school buses (which are not operated by or for a State or local government) is maintained at 9 cents a gallon, resulting in a 6-cents-a-gallon tax.

A rebate of the additional 6-cents-a-gallon tax is provided for taxable fuel used in vehicles which have a gross vehicle weight of 8,000 pounds or less. The rebate is generally claimed annually on the income tax form of the user who paid the additional tax.

One cent per gallon (rather than one-ninth) of the diesel fuel tax is designated for the Mass Transit Account of the Highway Trust Fund.

Conference agreement

Use tax

The conference agreement follows the Senate amendment, with the following modifications.

Tax rate.—The conference agreement restructures and reduces the tax rate, effective July 1, 1984. Vehicles under 55,000 pounds are exempt. For vehicles of 55,000 pounds or more, the tax rate is $100, plus $22 for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 75,000 pounds, is $550.

Logging vehicles.—The conference agreement provides that the tax rate is reduced by 25 percent for logging vehicles that are used exclusively to haul harvested forested products to and from the forested site and are required to be registered for that purpose.

Study requirements.—The conference agreement includes the study (relating to vehicles over 80,000 pounds) provided by the House bill. Also, it provides that the study relating to weight-distance taxes will be conducted by the Department of Transportation rather than the National Academy of Sciences. These studies and the study relating to trans-border trucking will be reported to Congress before October 1, 1987.

The conferees recognize that the Internal Revenue Service may need additional time to distribute use tax forms reflecting the new rate schedule, and that taxpayers should be allowed until September 30, 1984, to file the appropriate forms for the taxable period beginning July 1, 1984.

Diesel fuel tax

The conference agreement follows the House bill, with four modifications.

First, the excise tax on diesel fuel is increased by 6 cents a gallon to 15 cents a gallon.

Second, the credit or refund of tax paid on diesel fuel used in an intercity, local or school bus is generally increased to 12 cents a gallon, resulting in a 3-cents-a-gallon tax. However, this credit or refund is 15 cents a gallon in the case of a local bus while furnishing transportation, available to the general public along regularly scheduled routes, provided that the bus is operated under contract with a State or local government or that such government pays more than a nominal subsidy toward the operation of the bus.

Third, the effective date of provisions relating to the diesel fuel tax is August 1, 1984.

Fourth, the amount of the one-time rebate to purchasers and holders of qualifying vehicles is fixed (to reflect the 6-cents-a-gallon tax increase) at $102 for a new car and $198 for a new truck. As this rebate is designed to compensate the vehicle purchaser for the increase in the diesel fuel tax, the conferees intend that the rebate not be subject to those provisions of P.L. 95-355 that require separate appropriation for effecting payment of newly-enacted refundable tax credits.

2. One-year extension of refund of taxes on fuels used in qualified taxicabs

Present law

Present law provides a 4-cents-per-gallon exemption from the excise taxes on gasoline, diesel fuel, and special motor fuels when those fuels are used in certain taxicabs. The exemption is realized by means of a refund or credit rather than through exempt sales. Qualified taxicabs must be vehicles rated at above-average fuel economy and must not be precluded from offering ride-sharing. This exemption expires after September 30, 1984.

House bill

No provision.

Senate amendment

The Senate amendment extends the present 4-cents-per-gallon exemption for fuels used in qualified taxicabs through September 30, 1985.

The amendment also directs the Secretary of the Treasury to conduct a study of the effectiveness of the exemption and to report to Congress not later than January 1, 1985.

Conference agreement

The conference agreement includes the Senate amendment.

3. Increase in excise tax exemptions for alcohol fuels mixtures and alcohol fuels, income tax credit for qualified alcohol fuels, and duty on imported alcohol fuels

Present law

Excise tax exemptions

Alcohol fuels mixtures.—Present law provides a 5-cents-per-gallon exemption from the excise taxes on gasoline, diesel fuel, and special motor fuels for fuels consisting of mixtures of any of those fuels with at least 10 percent alcohol (i.e., "gasohol") (secs. 4041, 4081, and 6427). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal.

Alcohol fuels.—Present law provides a 9-cents-per-gallon exemption from the excise tax on special motor fuels for certain alcohol fuels comprised of at least 85 percent alcohol derived from a source other than petroleum or natural gas (sec. 4041).

Alcohol fuels credit

Present law allows a 50-cents-per-gallon income tax credit for alcohol used in mixtures with gasoline, diesel fuel, and special motor fuels where the alcohol comprises at least 10 percent of the mixture (sec. 44E). A like credit is allowed for alcohol used as a fuel, other than in a qualified fuels mixture. The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal.

Duty on imported alcohol fuels

Present law imposes a duty equal to 50-cent-per-gallon on alcohol imported into the United States for use as a fuel (19 U.S.C. sec. 1202).

House bill

No provision.

Senate amendment

Excise tax exemptions

Alcohol fuels mixtures.—The Senate amendment increases the excise tax exemptions for gasohol to 6.75 cents per gallon.

Alcohol fuels.—The Senate amendment provides a 4.5-cents-per-gallon exemption for alcohol fuels at least 85 percent pure if the alcohol is derived from natural gas.

Alcohol fuels credit

The Senate amendment increases the alcohol fuels mixture credit and the alcohol fuels credit to 67.5 cents per gallon.

Duty on imported alcohol fuels

The Senate amendment increases the duty on alcohol imported for use as a fuel to 67.5 cents per gallon.

Definition of certain qualified alcohol

The Senate amendment clarifies that alcohol derived from peat is considered to be derived from coal.

These provisions of the Senate amendment are effective on July 1, 1984. A floor stocks refund or credit is generally allowed to a manufacturer, producer or importer of articles for which the excise tax exemption is increased. The amount of the refund or credit equals the excess tax paid on such articles sold by the manufacturer, producer or importer before July 1, 1984, and held for sale in dealers' inventory on that date.

Conference agreement

The conference agreement includes the Senate amendment, with the following modifications. The conference agreement increases the excise tax exemption for gasohol to 6 cents per gallon, the alcohol fuels mixture credit and the alcohol fuels credit to 60 cents per gallon, and the duty on imported alcohol to 60 cents per gallon.

The provisions of the conference agreement are effective on January 1, 1985. The conference agreement does not include a floor stocks refund or credit provision.

4. Exemption from excise tax for piggyback trailers

Present law

A 12-percent excise tax is imposed on the first retail sale of truck trailer and semitrailer chassis and bodies which are suitable for use with a trailer or semitrailer which has a gross vehicle weight over 26,000 pounds. The tax generally applies to retail sales made after March 31, 1983. Under prior law, a 10-percent manufacturers excise tax applied to the sale of these trailers before April 1, 1983. The changes to a retail tax and higher rate of tax were enacted in the Highway Revenue Act of 1982, which also exempted rail trailers sold after December 2, 1982, from the prior-law and present-law sales tax on heavy trailers.

House bill

No provision.

Senate amendment

The Senate amendment exempts piggyback trailers and semitrailers (including parts or accessories) from the sales tax on heavy trailers. A piggyback trailer includes any trailer which is designed for use principally in connection with trailer-on-flatcar rail service and which the seller, according to regulations prescribed by the Secretary, certifies will be so used.

The conditions for exemption of a piggyback trailer continue to apply after the first retail sale. Thus, if the purchaser of an exempt piggyback trailer subsequently ceases to satisfy the conditions for exemption, the purchaser will be liable for the 12-percent excise tax (determined as if a taxable sale had occurred at that time). Similarly, if an exempt piggyback trailer is subsequently resold, the resale will be subject to the 12-percent tax and the reseller liable to pay the tax, unless the conditions for exemption apply to the resale.

The exemption is effective as if included in that provision of the Highway Revenue Act of 1982 which exempted rail trailers.

Refunds are provided for piggyback trailers sold to ultimate purchasers after December 2, 1982, and before the date of enactment.

Conference agreement

The conference agreement includes the Senate amendment, with modifications.

The conference agreement provides that the 12-percent excise tax on the sale of heavy trailers is reduced to 6 percent in the case of piggyback trailers and semitrailers. This reduced tax rate applies only to sales made during the one-year period beginning on the day of enactment, at the end of which period the tax rate returns to 12 percent. The conference agreement does not amend the treatment of piggyback trailers sold prior to the day after the date of enactment.

The conference agreement provides that the Secretary of Transportation is to report to Congress before May 1, 1985, on the appropriate application and level of the excise tax to piggyback trailers.

X. MISCELLANEOUS REVENUE PROVISIONS

A. Estate and Gift Tax Provisions

1. Qualification of certain holding company stock for installment payment of estate tax

Present law

Estate tax attributable to certain interests in closely held businesses may be paid in installments over up to 14 years (interest only for 4 years, followed by up to 10 annual installments of principal and interest). A special 4-percent interest rate is provided for certain amounts of deferred tax.

Qualifying closely held businesses may be conducted as proprietorships, partnerships, or corporations. Generally, only directly owned interests in active business operations are considered for purposes of the installment payment provision.

Present Treasury regulations take the position that the value of a trade or business carried on as a proprietorship includes only the value of those assets actually used in the trade or business. On the other hand, if the business is carried on as a partnership or a corporation, the value of the trade or business includes the value of all partnership or corporate assets, even though a portion of the partnership or corporate assets may be used for purposes other than carrying on a trade or business.

Unpaid tax (and interest thereon) is accelerated if cumulative withdrawals from or dispositions of the interest in the business exceed 50 percent of the value of the interest, if the estate has undistributed net income in certain circumstances, or if any installment is not paid within 6 months after the due date of that installment.

House bill

The House bill permits executors to elect to look through a passive holding corporation for purposes of determining whether the decedent owned an interest in a closely held business if 80 percent or more of the value of the holding corporation consists of the value of nonreadily tradeable stock in a single active business corporation.

Only the value of qualifying stock owned by the holding corporation which is attributable to the value of assets (including working capital) actually used in an active business operation is considered for purposes of the installment payment provision. If the election is made, the special 4-percent interest rate and 5-year deferral of principal payments are not available.

Conforming amendments are made to the acceleration provisions of present law providing that a disposition of an interest in or a withdrawal of property from the passive holding corporation as well as the active business may result in acceleration of unpaid tax. Likewise, dividends paid by the active business corporation to the holding corporation are treated as paid to the decedent's estate to the extent of the decedent's interest in the holding corporation.

This provision is effective for estates of individuals dying after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill except the Senate amendment also permits executors to elect to look through multiple tiers of passive holding corporations to determine whether the decedent owned an interest in a closely held business. The multiple tier look through is available only if at least 20 percent of the value of each corporation to be looked through is included (directly or indirectly) in the value of the decedent's gross estate. The Senate amendment also expands the House rule under which only the value of assets (including working capital) actually used in an active business are considered for purposes of the installment payment provision to provide that, in the case of all interests in partnerships and corporations (whether or not a passive holding corporation is present), only the value of assets directly related to the reasonable needs of the business are considered.

Conference agreement

The conference agreement follows the Senate amendment with technical modifications. Under the conference agreement, interests in active closely held corporations may be considered for purposes of the installment payment provision provided the indirectly owned interest would meet the requirements of that provision were it directly owned. Therefore, an indirectly owned interest in a single closely held corporation qualifies if the corporation has 15 or fewer shareholders or the decedent owned 20 percent or more of the corporation's voting stock. Also, the value of the business interest must exceed 35 percent of the value of the decedent's adjusted gross estate. As under present law, if a decedent owns interests in more than one closely held business, at least 20 percent of the value of each such business must be included in the decedent's estate if the businesses interests are to be aggregated for purposes of the installment payment provision.

The conference agreement retains the rules of the House bill and the Senate amendment pursuant to which the special 4-percent interest rate and the 5-year deferral of principal are not available to estates electing the special look-through provision.

Additionally, the conference agreement retains the rule that in the case of all corporations and partnerships, only active business assets are considered for purposes of the installment payment provision. The conference agreement does not apply to this rule, however, for purposes of the acceleration rules of section 6166(g).

Finally, the conference agreement includes an exception under which multiple wholly owned subsidiaries of a passive holding company may be treated as one subsidiary corporation if the holding company has fifteen or fewer shareholders on June 22, 1984, and at all times prior to the owners' death, and if at least some of the subsidiaries are carrying on a trade or business. In determining whether the subsidiary corporations are 100 percent owned, a de minimis amount of stock owned by the directors of a corporation, that under State law is treated as owned by the corporation is also treated as owned by the corporation for purposes of this rule.

2. Repeal of the generation-skipping transfer tax

Present law

A tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an interest in or power over the trust (for example, termination of a life income interest held by the grantor's child).

Basically, a generation-skipping trust is one which provides for a splitting of benefits between two or more generations younger than the generation of the grantor of the trust. The tax imposed on generation-skipping transfers is substantially equivalent to the the tax that would have been imposed if the property had been transferred outright to each successive generation (in which case, the gift or estate tax would have applied).

House bill

No provision.

Senate amendment

The Senate amendment repeals the generation-skipping transfer tax, effective with respect to such transfers occurring after June 11, 1976 (the date on which the tax was originally effective).

Conference agreement

The conference agreement follows the House bill.

3. Tax treatment of certain disclaimers of interests transferred before November 15, 1958

Present law

A disclaimer is a refusal to accept the ownership of property or of rights with respect to property. If a qualified disclaimer is made, the Federal gift, estate, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to a disclaimer is not treated as a taxable gift by the person making the disclaimer.

On November 15, 1958, the Treasury Department adopted regulations clarifying the requirement that a disclaimer, to be effective, must be made within a reasonable time after the transfer in which the property interest was created. These regulations applied to interests in property transferred before that date, as well as to such interests transferred after November 14, 1958. In 1976, Congress enacted statutory provisions similar to the 1958 regulations, applicable to disclaimers made after 1976 (Code sec. 2518).

On February 23, 1982, the Supreme Court upheld the applicability of the Treasury regulations to disclaimers of property interests transferred before November 15, 1958 (*Jewett* v. *Comm'r* (455 U.S. 305 (1982)).

House bill

No provision.

Senate amendment

The Senate amendment permits disclaimers of property interests created by transfers occurring before November 15, 1958, to be made within 90 days after the date of enactment in certain cases. To be qualified, these disclaimers must satisfy all requirements of the present statutory rules, except for the requirement that the disclaimer be made within nine months of the transfer creating the interest.

Conference agreement

The conference agreement follows the House bill.

4. Clarification that certain usufruct interests qualify for estate tax marital deduction

Present law

Present law generally permits an unlimited estate tax deduction for the value of interests in property passing from a decedent to his or her surviving spouse (Code sec. 2056). The election is available with respect to a "terminable interest" in property only if the executor makes a special election (i.e., makes a so-called "QTIP election"). If the election is made, the full value of the terminable interest in property is included in the estate of the surviving spouse. A terminable interest is an interest that terminates upon the lapse of time or the occurrence or failure of an event or other contingency.

Under the Louisiana Civil Code, if a surviving spouse receives a usufruct interest created by will, the interest generally is comparable to a common law life estate. Such a usufruct interest may be in consumable or nonconsumable property. It is unclear under present law whether a usufruct for life in consumable property is eligible for the QTIP election because Louisiana law does not trace the usufruct property to find if that property actually is included in the surviving spouse's estate.

House bill

No provision.

Senate amendment

The Senate amendment clarifies that a usufruct interest for life in both consumable and nonconsumable property is eligible for the QTIP election. The provision is effective for estates of individuals dying after 1981.

Conference agreement

The conference agreement follows the Senate amendment with certain clarifications as to the technical application of the provision. The conferees recognize that different results arguably might obtain in cases where a usufruct for life with respect to which a QTIP election is made is in consumable property (e.g., a certificate of deposit) as opposed to nonconsumable property. This difference could result from the fact that, unlike nonconsumable property, the consumable property is commingled with the spouse's own property and Louisiana law does not provide for tracing of the consumable property in the estate.

In the case of nonconsumable property, because the specific QTIP property can be identified, the entire value of that property is included in the estate of the second spouse to die exclusively under Code section 2044. Therefore, the value of the property is counted only one time in determining the value of the spouse's estate. Similarly, no deduction is allowed under section 2053 for any claim against a surviving spouse's estate by the naked owner of the nonconsumable usufruct property for which a QTIP election was made by the estate of the first spouse to die.

The conferees wish to reiterate that, as provided by the Senate amendment, these same results obtain in the case of a usufruct for life in consumable property with respect to which a QTIP election is made. A usufruct for life in consumable property for which a QTIP election is made is to be treated as exclusively included in the estate of the second spouse to die under section 2044 to the extent of the naked owner's claim against the spouse's estate with respect to the property, and as exclusively included under section 2033 to the extent of any excess value. Similarly, the claim of that spouse's estate for contribution from the naked owners of the property arising under section 2207A is to be limited to an amount of tax determined as if the value of the usufruct interest included in the spouse's estate were equal to the amount included in the estate under section 2044. Finally, no deduction is allowed under section 2053 for any claim against the surviving spouse's estate by the naked owners of the consumable usufruct property for which a QTIP election was made by the estate of the first spouse to die.

5. Special estate tax credits

Present law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.

House bill

No provision.

Senate amendment

The Senate amendment provides special estate tax credits for the estates of Neil J. Redfield and Elizabeth Schultz Rabe. The credits apply to the transfer, without reimbursement or payment, to the Secretary of Agriculture for addition to the Toiyabe National Forest of real property located within or adjacent to the boundaries of that national forest.

Conference agreement

The conference agreement follows the Senate amendment.

6. Perfection of estate tax current use valuation elections

Present law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use rather than its full fair market value (Code sec. 2032A). The election may be made only on the first estate tax return filed. Additionally, all persons with an interest in the property to be specially valued must enter into an agreement to the election, which agreement is binding under local law. Treasury regulations require that a notice of election and the required agreement must be filed with the estate's Federal estate tax return.

House bill

No provision.

Senate amendment

The Senate amendment directs the Treasury Department to develop procedures permitting perfection of notices within 90 days of a request from the Internal Revenue Service. Under the Senate amendment, the right to perfect a notice of election or agreement applies only where those items, as originally filed, substantially comply with the requirements of the regulations.

Conference agreement

The conference agreement follows the Senate amendment. The conferees wish to reiterate that, as under the Senate amendment, perfection of notices of election and of agreements to current use valuation elections is to be permitted only in cases where the estate tax return, as filed, evidences substantial compliance with the requirements of the Treasury regulations. For example, merely checking the applicable box on the Federal estate tax return that an election is being made is not sufficient action by the estate to secure the benefits of the current use valuation provision. Both a notice of election and an agreement that themselves evidence substantial compliance with the requirements of the regulations must be included with the estate tax return, as filed, if the estate is to be permitted to perfect its election.

Illustrations of the type of information that may be supplied after the initial filing of a notice of election are omitted social security numbers and addresses of qualified heirs and copies of written appraisals of the property to be specially valued. This provision does not, however, permit such appraisals to be obtained only after the estate tax return is made. Rather, the provision simply permits the submission of previously obtained appraisals. Likewise, a notice of election which does not provide a legal description of the property to be specially valued may not be perfected unless the notice, as initially filed with the estate tax return, described the property with reasonable clarity, even though the full legal description was not provided.

As stated above, an agreement to the current use valuation election may be perfected under this provision provided the agreement, as filed with the estate tax return, evidences substantial compliance with the requirements of the regulations. To be eligible for perfection, the agreement as originally filed must at a minimum be valid under State law and must include the signatures of all parties having a present interest or a remainder interest other than an interest having a relatively small value.[1] The right to perfect agreements is intended to be limited to cases where, for example, a parent of a minor remainderman, rather than a *guardian ad litem* as required under State law, signs the agreement. Similarly, failure to designate an agent in the agreement as filed may be corrected under this provision.

7. No gain recognized from net gifts made before March 4, 1981

Present law

Gift tax is the liability of the person making a gift. Satisfaction of a person's debt or other liability generally results in income to the person relieved of the liability. The Supreme Court, in *Diedrich* v. *Comm'r* (457 U.S. 191 (1982), held that a net gift (i.e., a gift in which the gift tax is paid by the donee of the transferred property) results in income to the donor to the extent that this gift tax exceeds the donor's basis in the transferred property.

House bill

The House bill provides that payment of gift tax by a donee does not result in income to the donor in the case of net gifts made before March 4, 1981. The effect of this provision is to reverse the Supreme Court decision in *Diedrich* v. *Comm'r* with respect to net gifts made before that date.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

8. Reformation of certain charitable split-interest trusts

Present law

Trusts having both charities and noncharities as beneficiaries generally must be

[1] The conferees are aware that the current use valuation provision requires that, when successive interests or concurrent interests are created in specially valued property, all parties with any interest in the property must be qualified heirs and all such parties must enter into the agreement to the election, regardless of the relative values of their interests. The de minimis rule established in this provision is intended to apply solely as a guideline in determining whether perfection of an agreement is to be permitted. The guideline is not intended to give rise to an inference that parties having an interest in specially valued property which has a relatively small value are not required to enter into the agreement or that such persons need not be qualified heirs.

structured as unitrusts or annuity trusts to qualify for a charitable deduction. These requirements were enacted by the Tax Reform Act of 1969.

Certain trusts created before December 31, 1978 (including trusts created in wills executed before that date) could be reformed (amended) to satisfy the unitrust, etc. requirements if (1) judicial or other proceedings were begun before January 1, 1982, and (2) the trust were amended within 30 days after completion of the proceedings (Code sec. 2055).

Present law includes no rule permitting reformation of defective charitable split-interest trusts created after December 31, 1978.

House bill

The House bill provides a permanent rule permitting reformation of charitable split-interest trusts if certain requirements are satisfied. Under this provision of the House bill, the relative values of the charity and the noncharity interests in the trust may not vary by more than 5 percent as a result of the reformation. Additionally, unless reformation proceedings are begun within 90 days after the due date of the Federal estate tax return (or the first trust income tax return if no estate tax return is due), the trust must, as executed, provide for an annuity trust or unitrust amount.

The provision is effective generally for reformations made after December 31, 1978.

Senate amendment

The Senate amendment is the same as the House bill, except the Senate amendment also provides that a reformation is deemed to occur to the extent that, pursuant to trust provisions, property passes directly to a charity before the due date of the estate tax return.

Conference agreement

The conference agreement follows the Senate amendment.

9. Alternate valuation date election

Present law

The value of property included in an individual's gross estate for Federal estate tax purposes generally is determined on the date of the individual's death. However, the executor of an estate may elect to value all property included in the gross estate as of the alternate valuation date, which generally is the date six months after the date of the decedent's death. The election to use the alternate valuation date must be made on a timely filed estate tax return (Code sec. 2032).

House bill

The House bill limits eligibility for the alternate valuation date election to estates where both the total value of the individual's gross estate and the amount of estate tax liability are reduced as a result of the election. The House bill also provides that the alternate valuation date election may be made on the first estate tax return filed (whether timely filed or late filed). Once an election is made, it is irrevocable.

The provision is effective for estates of individuals dying after the date of enactment.

Senate amendment

The Senate amendment is similar to the House bill with the following modifications:

(1) The total estate tax liability of the estate is not required to be reduced as a result of the election;

(2) The executor must determine in "good faith" that the value of assets in the gross estate for which no charitable or marital deduction is allowable is decreased (even though the value of the gross estate itself may not be decreased);

(3) A late-filed return on which a valid election is made may not be filed more than one year after the due date for the return and the principal purpose of the late filing may not be to make the election; and

(4) The provision is effective for estates of individuals who died before the date of enactment provided those estates satisfy the new requirements imposed by the amendment.

Conference agreement

The conference agreement follows the House bill with two modifications. First, as under the Senate amendment, an election may be made on a late-filed return only if the return is filed within one year of the due date. (As under the House bill, the election must be made on the first return filed, and is irrevocable, once made.)

Second, as under the Senate amendment, in addition to applying to estates of individuals dying after enactment, the conference agreement applies retroactively to estates that would qualify under the amended provision had the decedent died after the date of enactment. This retroactive effect is available, however, only if the period of limitations for assessment of estate tax remains open on the date of enactment, and if the estate makes a claim for refund within 90 days of enactment.

*** D. Excise Tax Provisions**

1. Excise tax on sport fishing equipment

Present law

Imposition of tax.—A 10-percent excise tax is imposed on the sale by a manufacturer, producer or importer of fishing rods, creels and reels, and artificial lures, baits and flies (including parts and accessories).

Time of payment.—Treasury regulations generally require monthly or semi-monthly payment of excise taxes. If excise tax liability is more than $2,000 in any month, then tax deposits must be made semi-monthly during the following quarter.

House bill

Imposition of tax.—There is no provision in H.R. 4170. However, in H.R. 2163 as passed by the House, the 10-percent tax is expanded to various additional articles of sport fishing equipment, and supplies and accessories, including tackle boxes. A special 3-percent tax is imposed on electric outboard motors. These changes are effective for articles sold after December 31, 1983.

H.R. 2163 continues imposition of the tax at the manufacturer's level, with a Committee Report statement to indicate that the IRS is to enforce actively the present-law constructive-sales price rules to insure that the incidence of the tax be equivalent for all manufacturers, producers and importers, regardless of form of business organization.

Time of payment.—H.R. 2163 changes the time of payment for the excise tax on sport fishing equipment to require payment on a quarterly basis: March 31, June 30, September 24, and a date to be prescribed by Treasury regulations, for the respective prior calendar quarter's tax liability.

Senate amendment

Imposition of tax.—The Senate amendment expands the 10-percent excise tax on sport fishing equipment to include the same additional articles as under the House bill except for tackle boxes which are taxed at a 3-percent rate. The Senate amendment also applies the 3-percent tax to electric outboard boat motors (as in the House bill) and certain fish finders (sonar devices suitable for finding fish, *except* graph recorders, digital type or meter readout devices, with a maximum tax of $30 per item). These changes generally are effective for articles sold after September 30, 1984, except that the tax on tackle boxes and fish finders is effective on October 1, 1985.

The Senate amendment replaces the manufacturers tax with a tax on the *last sale before retail* (generally the wholesale level except where an article sold directly from a manufacturer/producer or importer to a retailer). Under a special rule where the last sale before retail occurs before importation, the tax is imposed on the importer at the point of entry. This change in the level of the tax is effective for articles sold after September 30, 1984.

Time of payment.—The Senate amendment excuses small manufacturers (i.e., those having gross sales receipts of $100,000 or less for the preceding calendar year) from the present-law excise tax deposit requirements, thereby enabling these manufacturers to pay the tax on a quarterly basis with their regular Federal excise tax return. Other taxpayers must pay the tax as provided under present law.

Conference agreement

Imposition of tax.—The conference agreement follows the House bill with regard to the articles subject to tax at the 10-percent rate. As provided by the House bill and the Senate amendment, electric outboard boat motors will be subject to tax at a 3-percent rate, and as provided in the Senate amendment, certain sonar devices suitable for finding fish will be subject to tax (up to a maximum tax of $30).

The conference agreement generally follows the House bill with regard to the point at which tax is imposed. Therefore, the excise tax on sport fishing equipment will continue to be imposed at the manufacturer's (or importer's) level. However, the conference agreement provides that tax will be imposed a second time, on the sale of an article subject to tax by any wholesale distributor or retailer who (1) is a related party to the manufacturer or importer of the article sold, and (2) acquires the article from an unrelated party (i.e., from a party other than the manufacturer or importer). In cases where the tax is imposed a second time on any article, a credit for prior tax paid is available, provided the wholesale distributor or retailer can document the amount of tax that actually was paid previously. This documentation requirement generally will be considered as satisfied only through submission of copies of actual records of the party that previously paid the tax. For purposes of these rules, the term related party generally includes parties described in Code section 2670.

The conferees also are concerned that certain manufacturers and importers of taxable sport fishing equipment are engaged in arrangements that are not covered under the related party rules adopted above, but that do not represent true arm's-length dealings. Rather these transactions are in substance (if not form) dealings between related parties or are transactions conducted primarily to reduce Federal excise tax. Therefore, the conference agreement provides that, except as provided in Treasury regulations, certain sales are not to be treated as taxable first sales by a manufacturer or importer. Rather, the regulations will provide that tax is to be imposed on a later sale in such cases. The conferees intend that these regulations generally will provide that a sale by a manufacturer or importer is not to be treated as a taxable first sale for purposes of this tax unless the party selling the articles (1) conducts all manufacturing or importation transactions and related documentation in its own name; (2) assumes risks of late delivery and loss and pays freight, insurance costs, and customs duties

* Probably should read "B"

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(in the case of importers); (3) has on its payroll the employees who are engaged in the manufacturing process conducted by it or who are engaged in all aspects of the importation or other distribution of articles processed by it, including dealings with manufacturers with regard to quantity, quality control, design specifications and shipping; (4) finances the manufacture or purchase of previously manufactured articles on its own account; (5) maintains inventories of the articles in its own name; and (6) earns normal profits (determined by reference to industry standards) on its sales that are to treated as taxable first sales.

Finally, the conferees wish to state that they found persuasive arguments that inadequate State fisheries budgets have necessitated reductions in staff and programs. State fishery agencies have collectively indicated a pressing need for over $162 million per year in additional revenue to manage adequately the nation's recreational fishery resources. The conferees, in establishing this expanded funding source, intend that the new revenues be added to existing State fishery program funds available from traditional sources and not as a substitute therefor.

Time of payment.—The conference agreement generally follows the Senate amendment except all manufacturers and importers are excused from making deposit requirements in the case of the excise tax on sport fishing equipment. Under the conference agreement, the sport fishing equipment excise tax will be payable in full on the date established by the Treasury Department for filing of the quarterly return of that tax. The conferees have reached this decision because of the unique seasonal nature of the market for sport fishing equipment and intend that this action not be cited as precedent for excusing payers of other Federal excise taxes from deposit requirements.

Effective date.—The conference agreement is effective for sales occurring and for payments of tax due after September 30, 1984.

2. Aquatic Resources Trust Fund and Land and Water Conservation Fund

Present law

Financing of special funds.—Under present law, there is no special trust fund for sport fish restoration or for the Federal boating safety program. However, the sport fish restoration program is funded by an appropriation of amounts equivalent to the prior fiscal year revenues from the existing 10-percent excise tax on fishing equipment. The Federal boating safety program is financed through an appropriation to a special "fund" not having the status of a trust fund (the National Recreational Boating Safety and Facilities Improvement Fund). The appropriation is equivalent to revenues attributable to the 9-cents-per-gallon excise tax on motorboat fuels, up to $45 million per fiscal year for 1983-1988 (with a maximum fund balance at any time of $45 million). Any excess motorboat fuels tax revenues go to the Land and Water Conservation Fund, along with certain other, nontax monies (including general appropriations).

Fund expenditures.—The sport fish restoration program provides matching funds (up to 75 percent) for State fish restoration and management projects. A portion (8 percent) of the annual appropriation is available to the Secretary of the Interior for Departmental administrative expenses relating to the program. The balance of the appropriation is allocated to the States pursuant to a statutory formula. The Federal boating safety program provides financing for Federal-State recreational boat safety and facilities improvements projects. Currently monies are allocated one-third for boating safety programs and two-thirds for boating facilities improvement programs, and are allocated by formula among eligible States.

House bill

Financing of funds.—H.R. 2163, as passed by the House, establishes the Aquatic Resources Trust Fund. The new Trust Fund would include two separately financed accounts.

(1) *Sport Fish Restoration Account.*—This Account is to be financed from revenues attributable to (a) the expanded excise tax on sport fishing equipment; (b) motorboat fuels taxes, to the extent these revenues exceed the amounts transferred to the Boating Safety Account and Land and Water Conservation Fund (see below); and (c) import duties on sport fishing equipment and yachts and pleasure craft.

(2) *Boating Safety Account.*—This Account is to be financed by revenues attributable to the 9-cents-per-gallon motorboat fuels taxes, up to $45 million per fiscal year for 1983-1988 (with the present $45 million balance limit).

In addition, the Land and Water Conservation Fund will be limited to $1 million per fiscal year from the motorboat fuels tax revenues; the other financing sources for that Fund remain the same as under present law.

Fund expenditures.—H.R. 2163 also expands and redefines the purposes for which the new Aquatic Resources Trust Fund monies may be spent for the sport fish restoration and Federal boating safety programs. (No changes are made in the expenditure purposes for the Land and Water Conservation Fund.)

(1) *Sport fish restoration program.*—Monies must be allocated equitably between marine and freshwater sport fishing projects. Each State is required to allocate a minimum of 10 percent of its program monies to projects that improve public access to recreational boating waters. Also, States are authorized to use up to 10 percent of their allocation for aquatic resource education programs. Department of Interior administrative expenses are limited to 6 percent per year of the Account's monies.

(2) *Federal boating safety program.*—Monies will be reallocated so that (a) two-thirds (up to $30 million per year) are used for State boating safety programs and (b) one-third (up to $15 million per year) is made available to the U.S. Coast Guard to defray the costs of services provided by it for recreational boating safety. Amounts will no longer be available under this program for boating facilities improvements. (Amounts will be available for this purpose under the expanded sport fish restoration program.)

Effective date.—Trust fund monies may be expended for the period October 1, 1983 through March 31, 1989.

Senate amendment

Financing of funds.—The Senate amendment is generally the same as the provisions of H.R. 2163, except for the differences in tax rates on tackle boxes and fish finders (see above).

Fund expenditures.—The Senate amendment is the same as H.R. 2163 regarding the trust fund expenditure purposes.

Effective date.—Trust fund monies are available for expenditure for the period October 1, 1984 through March 31, 1989.

Conference agreement

The conference agreement follows the Senate amendment, including the provision that the popular name of the Aquatic Resources Trust Fund will be the Wallop-Breaux Fund.

3. Excise tax on certain arrows

Present law

An 11-percent manufacturers excise tax is imposed on the sale of any bow having a draw weight of 10 pounds or more and of any arrow measuring 18 inches overall or more in length. Revenues attributable to this tax are appropriated to the Federal Aid to Wildlife Program ("Pittman-Robertson" fund) for support of State wildlife programs.

House bill

The House bill contains no provision; however, H.R. 2163, as passed by the House, expands the tax on arrows to include those arrows fewer than 18 inches in length which are suitable for use with a taxable bow (i.e., crossbows). The expanded tax applies to sales of such arrows after December 31, 1983.

Senate amendment

The Senate amendment is the same as H.R. 2163, except that the expanded tax applies to sales after September 30, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

4. Exemption of certain helicopter operations from aviation excise taxes

Present law

Present law provides exemptions from the aircraft fuels and air transportation taxes for helicopters employed in hard mineral resource exploration and mining and in forestry operations provided the helicopters do not use Federally aided airports or Federal airway facilities.

House bill

No provision.

Senate amendment

The Senate amendment expands the present exemptions to include helicopters employed in the exploration and development of oil and gas. This provision is effective on April 1, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

5. Superfund excise tax corrections

Present law

Under present law, an excise tax is imposed on certain specified chemicals to fund the Hazardous Substance Response Trust Fund.

Proposed Treasury regulations would apply this tax to (1) light hydrocarbons added to motor fuels, and (2) metal compounds occurring temporarily during refining processes. Present law provides an exemption for fertilizer which is administered by using a certification procedure required by statute.

House bill

No provision.

Senate amendment

The Senate amendment makes three technical amendments to the Hazardous Substance Response Revenue Act of 1980. First, light hydrocarbons added to gasoline, diesel fuel, and aviation fuel are exempt from the tax. Second, cupric sulfate, cupric oxide, cuprous oxide, lead oxide, zinc chloride, zinc sulfate, and barium sulfide are exempt if they have only a transitory presence during smelting, refining, or extracting metal from ore. Third, the certification procedure for the fertilizer exemption is eliminated.

These provisions apply as if included in the Hazardous Substance Response Revenue Act of 1980.

Conference agreement

The conference agreement follows the Senate amendment with technical modifications.

C. Income Tax Credits

1. Residential renewable energy tax credits

Present law

Individuals are allowed a 40-percent energy tax credit on expenditures up to $10,000 for renewable energy property, which is defined as solar, wind or geothermal property. Qualified property must be installed in or on a taxpayer's principal residence. Expenditures may be made through 1985, and unused credits at the end of 1985 may be carried forward through 1987. The maximum amount of credits is $4,000.

House bill

No provision.

Senate amendment

Residential renewable energy credits are extended for two additional years, through 1987. Unused credits may be carried forward through 1989.

Conference agreement

The conference agreement follows the House bill.

2. Business energy tax credits

Present law

(a) *Solar, wind, geothermal and ocean thermal property.*—Qualified property is eligible for a 15-percent energy tax credit, which will expire at the end of 1985.

(b) *Rules for geothermal property.*—Qualified geothermal equipment is defined as being necessary to transmit or use energy from an underground reservoir. The energy consists of natural heat which is stored in rocks, liquid or vapor, and has a temperature exceeding 50 degrees Celsius (122 degrees Fahrenheit). This definition also applies to residential geothermal sources.

(c) *Dual purpose equipment.*—Under current regulations, equipment that serves both geothermal and nongeothermal functions does not qualify for the energy tax credit; however, emergency backup systems are not disqualified.

(d) *Biomass property.*—A 10-percent energy credit is available for qualified biomass property that is placed in service through 1985 and produces a qualified fuel from an alternate substance, i.e., neither oil, gas or one of their products.

(e) *Shale oil hydrogenation equipment.*—The 10-percent energy credit for shale oil equipment used through the retorting process and for equipment for hydrogenation or other processes subsequent to retorting in the vicinity of the extraction site expired after 1982, except for an affirmative commitment rule. Hydrogenation equipment is not eligible for the credit under the affirmative commitment rule.

(f) *Tar sands equipment.*—No provision.

(g) *Affirmative commitment.*—Energy credits which expired after 1982 remain available after their statutory expiration date for projects that require 2 or more years for completion, if (1) all engineering studies have been completed, and all necessary construction and environmental permits have been filed for, before 1983, (2) binding contracts for 50 percent of specially designed equipment have been entered into before 1986, and (3) the project is completed and placed in service before 1991.

(h) *Photovoltaics.*—Photovoltaic cells are eligible for the 15-percent solar credit through 1985.

House bill

No provision.

Senate amendment

(a) *Solar, wind, geothermal, and ocean thermal property.*—The credit is extended at the 15-percent rate for 3 years, through 1988.

(b) *Rules for geothermal property.*—The qualifying temperature threshold is reduced to 40 degrees Celsius (104 degrees Fahrenheit), as measured at the wellhead or at the intake to the distribution system. This change applies also to geothermal sources for residential renewable energy systems.

(c) *Dual purpose equipment.*—Equipment that serves dual functions will qualify for the credit in equal percentage to the geothermal use, if at least 50 percent of the use is for geothermal purposes.

Geothermal equipment also will qualify for the regular investment credit, if the equipment is used for geothermal purposes at least 50 percent of the time, and the remaining energy requirement is supplied by an alternate substance, i.e., neither oil, gas or one of their products. This rule does not change the present law rules relating to structural components.

(d) *Biomass property.*—The credit for qualified biomass property is extended for an additional 3 years, through 1988. Qualifying property also will include methane-containing gas for fuel or electricity which is produced by anaerobic digestion from nonfossil waste materials at farms or other agricultural facilities, and at facilities for the first processing of agricultural products.

The extension of the credit will not apply, however, to biomass property used in a trade or business that is included in the forest or paper products industries.

(e) *Shale oil hydrogenation equipment.*—Hydrogenation equipment that qualified for the energy credit before 1983 will continue to qualify under the extension of the affirmative commitment rules, (g) below.

(f) *Tar sands equipment.*—The 10-percent energy credit is made available for tar sands equipment, which includes mining, quarrying and extraction equipment through extraction of oil and other processing (including hydrogenation), but the credit will not be available for equipment used in refining. December 31, 1988, is the intended termination date for the credit, and the affirmative commitment rule will apply, as extended in (g) below.

(g) *Affirmative commitment rules.*—

(1) *Synthetic fuels projects.*—The rules requiring completion of certain actions by specific dates are deferred by several years for synthetic fuels projects that involve coal, shale oil and tar sands, if (1) required studies and filings for permits are completed before 1987, (2) binding contracts are entered into for 50 percent of specially designed equipment before 1990, and (3) the project is completed and placed in service before 1993.

(2) *Renewable energy sources.*—The expiration date of the energy credit for solar, wind, geothermal, and ocean thermal equipment is extended for one additional year, through 1989, if required studies and permit filings are completed before January 1, 1989, and (2) binding contracts are entered into for 50 percent of specially designed equipment before July 1, 1989.

(h) *Photovoltaic equipment.*—Photovoltaic property will become eligible for a 25-percent energy credit for 1985 and 1986, a 20-percent energy credit for 1987, and a 15-percent energy credit for 1988. These credits are available in lieu of the 15-percent renewable energy credit that is extended through 1988.

Qualified property includes equipment which is an integral part of a system that converts sunlight directly into electricity, and (2) structures that house or support eligible equipment. Photovoltaic equipment is not eligible for the solar and wind energy credits and does not include public utility property. The at-risk rules which apply to the investment credit will apply also to the energy credit for photovoltaic equipment.

The photovoltaic equipment energy credit will be available for property placed in service on or after January 1, 1985.

(i) *Effective date.*—The revisions in the provisions for business energy credits are effective on the date of enactment unless another date is specified.

Conference agreement

The conference agreement follows the House bill. The conferees understand that the House will hold hearings on the expiring credits so that informed decisions can be made in 1985 about whether to extend these credits.

3. Definition of new property for tax credit purposes

a. Energy property

Present law

Regular investment tax credits and energy property tax credits are allowed with respect to certain kinds of new property. In determining whether property is new property for purposes of the regular investment credit, property subject to a lease is treated as originally placed in service not earlier than the date the property is used under the lease, but only if the property is leased within 3 months of the date it is in fact placed in service. No similar rule applies in determining whether property is new for purposes of the energy property tax credit.

House bill

No provision.

Senate amendment

Under the Senate amendment, the 3-month rule, as amended by the bill, is applicable in determining whether property is new for regular investment credit purposes is applicable in determining whether property is new for energy property credits as well.

The provision is effective for property placed in service after April 11, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

It is clarified that the provision is effective for property in fact placed in service after April 11, 1984.

b. Investment credit property

Present law

Investment tax credits are allowed with respect to certain kinds of new property. In determining whether property is new property for this purpose, property subject to a lease is treated as originally placed in service not earlier than the date the property is used under the lease, but only if the property is leased within 3 months after such property is placed in service (sec. 48(b)).

House bill

No provision.

Senate amendment

For investment credit purposes, the 3-month rule is limited to sale-leasebacks. Thus, only in the case of property which is originally placed in service by a person and which is sold and leased back by such person within 3 months of the date such property was originally placed in service will such property be treated as originally being placed in service not earlier than the date it is used under the lease. The rule is also made applicable for purposes of the energy property tax credit.

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The provision is effective for property placed in service after April 11, 1984.

Conference agreement

The conference agreement generally follows the provision in the Senate amendment.

The conferees understand that taxpayers buying property from a manufacturer often take delivery of it and place it in service before they have their financing in place. Shortly after they place it in service, the property may be sold (or the purchase order assigned) by such taxpayer to another taxpayer who then leases it to the first taxpayer. The conferees intend the 3-month rule to be applicable in that case. Therefore, the conference agreement clarifies that the 3-month rule applies if the person who originally placed the property in service leases it within 3 months of having originally placed it in service.

It is clarified that the provision is effective for property in fact placed in service after April 11, 1984.

4. Extension of targeted jobs tax credit

Present law

The targeted jobs tax credit is available for wages paid to individuals who (1) begin work for an employer before January 1, 1985, and (2) are included in one of 9 categories of individuals who are economically disadvantaged or handicapped or who receive public assistance. The credit generally is 50 percent of the first $6,000 of wages paid in the first year of employment and 25 percent in the second year of employment.

An authorization of appropriations for funds to administer the certification of eligible individuals expires after fiscal year 1984.

To claim the targeted jobs credit for wages paid to a targeted group member, an employer must receive or request a certification that a new employee is a member of a targeted group on or before the day the individual begins work for the employer.

House bill

No provision.

Senate amendment

The Senate amendment extends the targeted jobs tax credit to apply to individuals who begin work for the employer before January 1, 1988, and extends the authorization for administrative funds through fiscal year 1987.

The Senate amendment extends the deadline for requesting certification to 5 days after the individual begins work for the employer, if the individual has received a "voucher" (i.e., a preliminary determination of targeted group eligibility) on or before the day the individual begins work for the employer.

Conference agreement

The conference agreement follows the Senate amendment, with modifications. First, the credit is extended for one year, to apply to individuals who begin work for the employer before January 1, 1986, and the authorization of administrative funds is extended through fiscal year 1985. Second, the credit is amended to treat a successor employer as if it were the predecessor for purposes of computing the amount of credit. Third, the conference agreement provides that the credit is allowed with respect to the remuneration of an employee who performs services for another person only if the payment by the other person to the employer exceeds the remuneration paid by the employer to the employee. This change is intended to prevent employers from lending or donating the services of individuals on their payroll to tax-exempt or other organizations which do not have sufficient tax liability to take advantage of the credit. Fourth, the credit is amended to provide that the age requirements of a summer youth employee are tested on the basis of the employee's age on May 1, if later than the hiring date. Fifth, the conference agreement deletes an obsolete provision dealing with the beginning of the 1-year credit eligibility period for vocational rehabilitation referrals.

5. Earned income tax credit

Present law

Certain individuals or couples with children are allowed a refundable tax credit equal to 10 percent of the first $5,000 of earned income, for a maximum credit of $500. The maximum credit is phased down to zero as income increases from $6,000 to $10,000.

House bill

No provision.

Senate amendment

The Senate amendment increases the rate of the credit to 10.5 percent and, thus, the maximum credit to $525, and raises the income level at which the credit is fully phased out to $11,000. The provision is effective for taxable years beginning after December 31, 1984.

Conference agreement

The conference agreement increases the rate of the credit to 11 percent and, thus, the maximum credit to $550, and raises the income range over which the credit is phased out to $6,500 to $11,000. The provision is effective for taxable years beginning after December 31, 1984.

The conference agreement also provides that the amount of credit allowed is reduced by the amount of a taxpayer's liability for alternative minimum tax.

6. Investment tax credit for soil and water conservation expenditures; increase in cost recovery period for single purpose agricultural structures

(a) Soil and water conservation credit

Present Law

A taxpayer may elect to deduct (i.e., expense) certain expenditures for the purpose of soil or water conservation that would otherwise be added to his or her basis in the land on which the conservation activity occurs (Code sec. 175). Deductible expenditures include amounts paid for items such as grading, terracing, and contour furrowing, the construction of drainage ditches, irrigation ditches, dams and ponds, and the planting of wind breaks. Also included assessments levied by a soil or water conservation drainage district are deductible under this provision to the extent those expenditures would constitute deductible expenditures if paid directly by the taxpayer.

The cost of acquiring or constructing machinery or facilities that is depreciable may not be expensed. In the case of depreciable items such as irrigation pumps, concrete dams, or concrete ditches, the taxpayer is allowed to recover his or her cost only through cost recovery allowances and only if he or she owns the asset. Certain depreciable assets also are eligible for the regular 10-percent investment credit.

Certain costs incurred in connection with soil and water conservation are deductible as trade or business expenses without regard to section 175. For example, interest expenses and property taxes are deductible as current expenses. Similarly, the cost of repairs to a complete soil or water conservation structure are deductible as current expenses. Certain other capital expenditures made primarily to produce an agricultural crop are deductible expenses (secs. 180 and 182), but are not treated as soil or conservation expenditures under section 175, because such expenditures only incidentally may conserve soil.

The deduction for soil and water conservation expenditures under section 175 is limited in any one year to 25 percent of the gross income derived by the taxpayer from farming. Any excess amount is carried forward to succeeding taxable years.

House bill

No provision.

Senate amendment

The Senate amendment provides a nonrefundable 10 percent investment credit for certain soil and water conservation expenditures. The credit is available with respect to (1) qualified expenditures otherwise chargeable to the basis of the land on which the conservation activity occurs, and (2) certain expenditures by district conservation authorities. The credit is available only to persons engaged in the business of farming the land on which the conservation improvements are made.

Types of qualified property

Qualified soil conservation improvements

Property that is eligible for the conservation credit consists of any improvements which are certified to the Secretary of the Treasury by the Soil Conservation Service of the Department of Agriculture as (1) consistent with state-of-the-art conservation practices and (2) making a major contribution to the conservation of soil or water on qualified land. A separate certification must be made with respect to each conservation project for which a credit is claimed.

Eligible soil conservation improvements include generally diversion, floodwater retarding, and multiple-purpose dams; fencing for protection of conservation cover; field windbreaks; filter strips, grade stabilization structures; grassed waterways or outlets; livestock water pipelines; sediment control ponds and basins; terracing; tree planting for erosion control and/or conservation cover; waste management systems; and any other improvements specified under Treasury Department regulations.

District conservation property

In addition to soil and water conservation property that is acquired directly by a taxpayer, the portion of assessments levied by a soil and water conservation district authority to finance qualified expenditures made by the authority is creditable by the person paying the assessment.

Qualified land

Expenditures are eligible for a soil conservation credit only if the expenditures are for otherwise qualifying improvements to land located in the United States which was owned entirely by a United States citizen and, as stated above, is used by the owner in the business of farming.

Coordination with certain expensing provisions

No credit is allowable with respect to any expenditure for which a deduction is claimed under present Code section 175 (soil and water conservation expenditures), section 180 (fertilizer, etc. costs), or section 182 (land clearing expenses). In addition, in applying the present limitations on the maximum amount of those deductions under section 175 and section 182 (e.g., 25 percent of gross farming income under sec. 175 and the lesser of 5 percent of taxable farming income or $5,000 under sec. 182), expenditures with respect to which a credit is claimed are treated as if the expenditures have been deducted. For example, if a taxpayer claims a credit with respect to $10,000 of soil conservation expenditures, the tax-

payer is treated as if the $10,000 has been deducted under section 175 in determining the taxpayer's maximum allowable deduction under that provision. The provision does not expand the types of expenditures for which a deduction presently is available under section 175, 180, or 182.

Other rules governing the credit

Certain highly erodible land

The credit is not available for expenditures made with respect to highly erodible land, as classified by the (Soil Conservation Service), if the expenditures are made in connection with conversion of that land from range land to crop land.

Maximum amount of credit

The soil conservation credit may not exceed 25 percent of a taxpayer's gross income derived from farming in any year. This limitation is in addition to the rule limiting investment credits generally to no more than 85 percent of tax liability in excess of $25,000.

Credit not allowed for expenditures financed with nontaxable grants

No credit is allowable with respect to conservation property financed with a grant from the Federal Government, or a State or local government, to the extent that the grant is not included in the taxpayer's gross income when received.

Carryover of unused credit and basis adjustment

The rules permitting carryforwards and carrybacks of investment credits generally apply to the credit for soil and water conservation expenditures. Additionally, an adjustment to the basis of the property equal to one-half of the credit amount is required.

Limitation on cost recovery deductions

Cost recovery deductions for any irrigation property with respect to which an investment credit is claimed must be computed using the straight-line method over the appropriate ACRS period rather than the accelerated method otherwise available.

Recapture of credit in certain circumstances

The soil and water conservation credit is recaptured if the taxpayer disposes of the land on which creditable improvements are made within 5 years after the conservation property is placed in service. In addition, the credit is recaptured if the taxpayer claiming the credit ceases to carry on the business of farming on the qualified land within 5 years after that date.

Effective Date

The provisions of the bill apply generally to taxable years beginning after December 31, 1984.

Conference agreement

The conference agreement follows the House bill.

(b) Single purpose agricultural and horticultural structures

Present law

Single purpose agricultural and horticultural structures qualify as 5 year property for ACRS purposes.

House bill

No provision.

Senate amendment

Single purpose agricultural and horticultural structures are treated as 15 year real property depreciable at a rate no more rapid than the 150 percent declining balance method.

This provision applies to property placed in service after date of enactment; however, a transitional rule exempts property where taxpayer had a binding contract to acquire or construct the property, or had commenced construction, before the date of enactment.

Conference agreement

The conference agreement follows the House bill.

7. Alternative test for definition of qualified rehabilitated building

Present law

A three-tier system of rehabilitation credits is provided for qualified expenditures incurred in connection with certain buildings. The credit is equal to 15 percent of qualified expenditures in the case of buildings at least 30 years old, but fewer than 40 years old. In the case of buildings at least 40 years old, the credit is equal to 20 percent of qualified expenditures, and in the case of certified historic structures, the credit is equal to 25 percent of qualified expenditures.

A building qualifies for the rehabilitation credits only if (among other requirements) at least 75 percent of the building's external walls are retained in place as external walls after completion of the rehabilitation.

House bill

No provision.

Senate amendment

The Senate amendment provides an alternative to the requirement that 75 percent of the building's external walls be retained in place as such. The alternative test requires that at least 50 percent of the building's external walls be retained in place as external walls, that at least 75 percent of the building's external walls be retained in place as either external walls or internal walls, and that at least 75 percent of the building's internal structural framework be retained in place.

The provision is effective for expenditures after December 31, 1983, in taxable years beginning after that date.

Conference agreement

The conference agreement follows the Senate amendment.

J. Provisions Relating to Research and Vocational Education

1. Incremental research tax credit

Present law

A 25-percent tax credit applies to the excess of qualified research expenditures incurred by a taxpayer during the year in carrying on a trade or business over the average of the taxpayer's research expenditures in a three-year base period (sec. 44F). The credit is scheduled to terminate after 1985.

The section 44F credit provision generally defines research by cross-reference to section 174, under which a current deduction is allowed for research and development costs in the experimental or laboratory sense. The amount of the section 174 deduction is not reduced by any amount of the section 44F credit.

Under present law, expenditures eligible for the credit consist of—

(1) "in-house" expenditures for research wages and supplies used in research, plus certain amounts paid for research use of computers, laboratory equipment, or other personal property;

(2) 65 percent of amounts paid by the taxpayer for contract research conducted on its behalf; and

(3) if the taxpayer is a corporation, 65 percent of its expenditures (including grants or contributions) for basic research to be performed by universities or certain scientific research organizations.

House bill

No provision.

Senate amendment

Under the Senate amendment, the 25-percent incremental research credit is made permanent.

The Senate amendment provides a statutory definition of credit-eligible research expenditures. The new definition is intended to target the credit to technological innovations developed through a process of experimentation relating to new or improved function or performance (rather than to style, taste, cosmetic, or seasonal design factors). The costs of computer software developed for the taxpayer's internal use are eligible for the credit only if the software is used in research or certain production processes, or in limited circumstances where meeting a high threshold of innovation as defined in Treasury regulations.

The Senate amendment also provides a new 25-percent nonincremental credit for the excess of (1) 65 percent of corporate contract expenditures or grants for basic research at universities or other qualified organizations over (2) the sum of the greater of two fixed maintenance-of-efforts floors (relating to 1981–83 research expenditures) plus an amount relating to university nonresearch contributions in a base period. Certain other modifications are made to the university basic research provision.

Under the Senate amendment, qualified research expenditures of startup corporations, of existing corporations for new trades or businesses, and of certain partnerships will become eligible for the credit in certain circumstances.

These provisions apply to taxable years beginning after 1984.

Conference agreement

The conference agreement does not include the Senate amendment.

2. Deduction for certain research equipment donations by corporations to universities

Present law

Corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to universities for research use in the physical or biological sciences (sec. 170(e)(4)). This increased deduction is generally for the sum of (1) the corporation's costs of producing the donated property (basis) plus (2) one-half of the difference between the property's fair market value and the donor's cost basis in the property, but cannot exceed twice the basis of the property.

House bill

No provision.

Senate amendment

Under the Senate amendment, the augmented charitable deduction provision for corporate donations of research equipment is expanded, for taxable years beginning after 1984—

(1) to cover donations of used (as well as new) equipment, replacement parts, and new computer software, and to cover technological (as well as scientific) equipment;

(2) to allow certain educational (as well as research) uses for donated equipment;

(3) to include as eligible donees a tax-exempt association of universities, and (by floor amendment by Sen. Kennedy, agreed to by voice vote) certain State-owned instrumentalities associated with universities; and

(4) to cover equipment produced or assembled (as well as equipment manufactured) by the donor.

Used property qualifies only if donated within three years after first used by the donor corporation, and only if worth more than $250. The augmented deduction for used property will equal 150 percent of the

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

donor's original basis, less accumulated depreciation (e.g., for fully depreciated equipment, 50 percent of the original basis), or fair market value if less.

Conference agreement

The conference agreement does not include the Senate amendment.

3. Payments and loan forgiveness received by graduate science students

Present law

Gross income generally does not include amounts received as a scholarship at a university or as a fellowship grant, other than as compensation (sec. 117). In general, income is realized when indebtedness is cancelled (sec. 61(a)(12)).

House bill

No provision.

Senate amendment

Under the Senate amendment, gross income will not include amounts received by graduate students in certain scientific fields as a scholarship, fellowship grant, or qualified student loan forgiveness, notwithstanding that the recipient is required to perform future teaching services for any of a broad class of universities, provided that such amounts are not received as compensation. This provision is effective for taxable years beginning after 1984.

Conference agreement

The conference agreement does not include the Senate amendment.

4. Deduction for vocational education equipment donations to certain donees

Present law

In general, the amount of charitable deduction for a donation of inventory property is limited to the donor's basis in the property (sec. 170(e)). The augmented deduction rule for corporation donations of newly manufactured scientific equipment to universities for research does not apply to donations of vocational education equipment.

House bill

No provision.

Senate amendment

The Senate amendment provides an augmented charitable deduction for corporate donations of newly manufactured technical and scientific equipment for certain vocational education uses, if the value of the donated item exceeds $250, and if certain other requirements are satisfied. (The augmented deduction is not available for donations of computer software, microcomputers, or certain other computers.) The eligible donees are public community colleges, public technical institutes, and certain area vocational education schools.

The augmented deduction under the Senate amendment is generally for the sum of (1) the corporation's costs of producing the donated property (basis) plus (2) one-half of the difference between the property's fair market value and the donor's cost basis in the property, but cannot exceed twice the basis of the property. This provision applies to contributions made after 1984.

Conference agreement

The conference agreement does not include the Senate amendment.

5. Vocational education instruction tax credit

Present law

There is no special tax credit relating to vocational education instruction.

House bill

No provision.

Senate amendment

Under the Senate amendment, a tax credit is allowed to a corporation for providing qualified teachers from its employees for postsecondary vocational education courses or for hiring qualified vocational education instructors on a temporary basis. The amount of the credit is $100 for each course taught by an employee (up to five courses), plus $100 for each instructor temporarily hired by the corporation, subject to an overall limitation of $20,000 per year.

This provision is effective for taxable years beginning after 1984.

Conference agreement

The conference agreement does not include the Senate amendment.

6. Extension of moratorium on application of research and experimental expense allocation regulation

Present law

The foreign tax credit is limited so that it cannot offset U.S. tax on U.S. source taxable income. In general, the Code requires allocation of all expenses between U.S. and foreign source gross income to determine U.S. and foreign source taxable income. A Treasury Regulation (sec. 1.861-8) rule generally requires taxpayers with foreign source income from products in an area in which the taxpayers do U.S. research to allocate part of their U.S. research and experimental expense against their foreign source income. In 1981, Congress suspended this rule for two years, so that research expenditures made for research conducted in the United States are allocated against U.S. source gross income only. The moratorium generally expires for taxable years following a taxpayer's second taxable year commencing after August 13, 1981.

House bill

No provision.

Senate amendment

The Senate amendment effectively extends for two years the moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8. For taxable years beginning on or before August 13, 1985, all of a taxpayer's research and experimental expenditures attributable to research activities conducted in the United States will be allocated to U.S. source gross income for purposes of computing U.S. source and foreign taxable income and taxable income from sources partly within and partly without the United States.

Conference agreement

The conference agreement follows the Senate amendment with a clarification of the effective date provision. The conference agreement provides that the extension of the moratorium on application of the Treasury's research and experimental expense allocation rule will generally apply to a taxpayer's taxable years beginning after August 13, 1983 and before August 1, 1985. However, in the event the taxpayer's third taxable year commencing after August 13, 1981 does not begin during this period, the extension of the moratorium applies to that taxable year also.

The moratorium applies only to the allocation of research expenses for the purpose of geographic sourcing of income. It does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier.

E. Capital Gains and Losses

1. Decrease in capital loss offset against ordinary income

Present law

Capital losses are deductible in full against capital gains. For individuals, the excess of capital losses over capital gains can be deducted against only $3,000 (or specially defined taxable income, if less) of ordinary income each year, with unlimited carryovers to future years.

Post-1969 long-term losses must be reduced by 50 percent when being deducted against ordinary income.

House bill

No provision.

Senate amendment

The Senate amendment decreases the amount of ordinary income against which capital losses may be deducted by individuals to $1,000. The amendment also treats pre-1970 loss carryovers under the rules for post-1969 losses.

The provision applies to taxable years beginning after December 31, 1984.

Conference agreement

The conference agreement does not reduce the $3,000 limit against which losses may be deducted. The agreement treats pre-1970 losses under the post-1969 loss rules for taxable years beginning after December 31, 1986.

2. Decrease in holding period for long-term capital gains

Present law

Gains or losses on capital assets held for more than one year are considered long-term capital gains or losses. For individuals, 60 percent of the net capital gain is excluded from income. Corporations have the option of paying an alternative tax of 28 percent on net long-term capital gain.

House bill

No provision.

Senate amendment

The Senate amendment decreases the holding period for long-term capital gains from one year to six months.

The provision applies to assets acquired after February 29, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment. However, the six-month holding period will apply to assets acquired after June 22, 1984, and before January 1, 1988.

F. Miscellaneous Housing Provisions

1. Disaster loss deduction for condemned residences

Present law

Nonbusiness casualty losses over $100 are allowed as itemized deductions to the extent the total amount of such losses exceeds 10 percent of the taxpayer's adjusted gross income. Generally, the deduction is available only when the casualty (e.g., storm, flood, or earthquake) causes actual physical damage to the taxpayer's property.

House bill

The House bill provides that certain taxpayers whose residences are located in a Federally declared disaster area, and who are ordered by a State or local government to demolish or relocate their residences, may deduct any loss attributable to the disaster as a casualty loss. The provision applies to taxpayers whose residences have been rendered unsafe for use as a residence as a proximate result of the disaster. At the taxpayer's election, these losses may be deducted for the year preceding the year in which the demolition or relocation order was made.

This provision applies to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill.

2. Cooperative housing corporations

a. Pass-through of interest and tax deductions to tenant-stockholders

Present law

Qualification for pass-through treatment

Tenant-stockholders in cooperative housing corporations may deduct their proportionate share of mortgage interest and real estate taxes paid by the cooperative. To qualify for this pass-through treatment, 80 percent of the cooperative's gross income must be derived from tenant-stockholders. In addition, a tenant-stockholder must have the right to occupy a house or apartment solely by reason of owning cooperative stock.

Generally, only individuals qualify as tenant-stockholders. However, certain original sellers of property to a cooperative (including corporations, partnerships, and other entities) may qualify as tenant-stockholders for up to three years after acquiring stock in the cooperative. This treatment applies even if the cooperative reserves the right to approve occupancy by any nominee of such entity. Additionally, a bank or other lending institution obtaining cooperative stock by foreclosure is treated as a tenant-stockholder for up to three years, even if the cooperative retains the right to approve occupancy by the bank or its nominee.

Allowance for depreciable property

A tenant-stockholder using depreciable cooperative property in a trade or business is allowed a special deduction with respect to his cooperative stock. This deduction is generally limited to that portion of the taxpayer's adjusted basis for his stock which is allocable to the depreciable property, with no carryover of excess deductions.

House bill

No provision.

Senate amendment

Extension of pass-through treatment to non-individual entities

The Senate amendment expands the definition of tenant-stockholder to include non-individual entities (including corporations, trusts, estates, partnerships, associations, or companies) which otherwise meet the requirements applicable to tenant-stockholders. These entities may therefore qualify for a pass-through of interest and tax deductions. This treatment applies even if, by agreement with the cooperative, a nominee of such entity may not occupy a house or apartment without prior approval of the cooperative.

The special rules regarding original sellers and foreclosures by lending institutions are made unnecessary by this change and are therefore repealed. However, under the Senate amendment, a cooperative's right to approve any occupant does not affect the tenant-stockholder status of certain original sellers of property (including an individual or a non-individual entity) to the cooperative. Additionally, where any person (including an individual or a non-individual entity) acquires stock in a cooperative by operation of law (e.g., by inheritance or foreclosure), the cooperative's right to approve any occupant does not affect the tenant-stockholder status of such person.

This provision is effective on the date of enactment.

Treatment of depreciable property

The Senate amendment allows deductions exceeding the taxpayer's allocable basis for his stock to be carried over to succeeding taxable years. However, the Senate amendment further provides that no deduction may be allowed for any amount paid or accrued to the cooperative (in excess of proportionate interest and real estate taxes) to the extent that, under Treasury regulations, such amount is properly allocable to amounts chargeable to the cooperative's capital account. This rule generally prevents a tenant-stockholder from obtaining deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit outright.

This provision is effective on the date of enactment.

Conference agreement

The conference agreement does not include the Senate provision.

b. Allocation of certain property taxes

Present law

A tenant-stockholder's proportionate share of rent or property taxes, for deduction purposes, is equivalent to the portion of cooperative stock owned by the tenant-stockholder. This rule applies even where special property taxes (e.g., certain California property taxes) are imposed on certain tenant-stockholders out of proportion to the value of their stock.

House bill

No provision.

Senate amendment

The Senate amendment provides that where a State or locality imposes tax based on a separate appraisal for some or all of the units in a house or apartment building, each tenant-stockholder's proportionate share of such taxes is to be the amount allocated to his unit under the applicable tax law. Thus, deductions are allocated among the tenant-stockholders according to the actual amount of such taxes each tenant-stockholder is required to pay.

This provision is effective for State tax years ending in 1984 or later years.

Conference agreement

The conference agreement does not include the Senate provision.

3. Sale-leasebacks of principal residences by taxpayers 55 or older

Present law

Qualification of a transaction involving a principal residence as a valid sale-leaseback is sometimes uncertain. Recognition of a transaction as a sale-leaseback may entitle the purchaser to certain tax benefits associated with ownership of property (e.g., cost recovery allowances). The seller may be entitled to claim the one-time exclusion for gain on the sale of a residence (sec. 121) and other tax benefits.

House bill

No provision.

Senate amendment

The Senate amendment provides a safe harbor and certain tax benefits for qualified sale-leasebacks of principal residences by taxpayers 55 or older. A sale-leaseback qualifies for this special treatment if the seller has attained the age of 55 before the date of the transaction and has owned and used the property as his or her principal residence for at least three of the five immediately preceding years. Such property must never have been depreciable property in the seller's hands. The sale price must be a fair market value amount, taking into account the burden of the lease on the property. The seller-lessee must retain occupancy rights in the property pursuant to a written lease requiring the payment of a fair rental. Finally, the purchaser-lessor must be a person who is entitled to the benefits, and contractually responsible for the risks and burdens, of ownership after the date of the transaction.

A qualified sale-leaseback does not include a sale-leaseback involving related parties or in which the purchaser-lessor is a tax shelter. For this purpose, a tax shelter is any partnership or other enterprise in which interests have been publicly offered or which is described in section 6661(b) of the Code.

The seller in a qualified sale-leaseback may elect to exclude gain from the sale to the extent provided in section 121. The seller's gain will not include the excess of the fair market value of any occupancy rights retained by the seller over the rent payable under the lease. Furthermore, any discount in the purchase price attributable to the leaseback by the seller is excluded from the gross income of the purchaser.

If the purchaser-lessor in a qualified sale-leaseback purchases an annuity for the seller-lessee as part of the consideration for the property, the cost of the annuity is deemed to be received by the seller in the year of the sale. This amount is treated as an investment by the seller-lessee in the annuity contract for purposes of section 72.

Although the purchaser-lessor will be entitled to claim depreciation on the property as the sole owner, such depreciation must be computed using the straight-line method and a 40-year useful life.

Any sale-leaseback transaction covered by the bill will, for purposes of section 183, be presumed to be one engaged in for profit unless the Secretary of the Treasury establishes to the contrary.

These provisions are effective for sales or exchanges after the date of enactment but prior to December 31, 1988.

Conference agreement

The conference agreement does not include the Senate provision.

4. Deductibility of mortgage interest and taxes paid out of tax-free allowances for military personnel and ministers

Present law

Deductions are disallowed for expenses allocable to tax-exempt income (Code sec. 265(1)). In January 1983, the IRS ruled that a minister may not take deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers under section 107 (Rev. Rul. 83-3, 1983-1 C.B. 72). This disallowance rule generally applies beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule will not apply until January 1, 1985, with respect to such home (IRS Ann. 83-100).

In December 1983, the IRS announced that it was studying whether members of the Armed Forces are entitled to deduct interest and property taxes to the extent they receive tax-free housing allowances from the Federal Government. The IRS stated that any determination on the issue that would adversely affect military personnel would not be applied to amounts paid before 1985 (IR 83-161).

House bill

No provision.

Senate amendment

The Senate amendment precludes application of the deduction disallowance rule under Code section 265(1) to mortgage interest and real estate taxes paid or incurred before January 1, 1986, by a minister or member of the Armed Forces.

Conference agreement

The conference agreement generally follows the Senate amendment, with modifications, as applied to ministers. The conference agreement does not include the language of the Senate amendment (or any other provision) applicable to members of the Armed Forces.

In the case of ministers, the conference agreement extends until January 1, 1986 the transitional rule date applicable to certain ministers in the circumstances defined in IRS Ann. 83-100, i.e., to a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date). In the case of mortgage interest deductions, the provision in the conference agreement only applies to a mortgage existing on that date (or in connection with a contract to purchase a home before that date). The conference agreement does not make any change in the general effective date of July 1, 1983 for Rev. Rul. 83-3, or in any aspect of that ruling not relating to ministers.

5. Rollover of gain on sale of residence for military personnel stationed overseas

Present law

No gain is recognized on sale of a personal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period of time, generally ending two years after the sale of the old residence. Under present law, this period is extended for up to four years where the taxpayer serves on extended active duty with the Armed Forces (Code sec. 1034(h)).

House bill

No provision.

Senate amendment

The Senate amendment provides that, in the case of a member of the Armed Forces who is stationed outside the United States or who is required to reside in government quarters at a remote site, the normal nonrecognition period will not expire until the end of four years after the sale of the old principal residence or one year after the member is no longer stationed outside the United States or no longer required to reside in such government quarters, whichever is later, but not to exceed eight years. This provision applies to sales of residences after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

6. Nonimposition of interest and penalties on tax liability with respect to home won as prize and designed for handicapped foster child of the taxpayer

Present law

Under present law, gross income generally includes amounts received as prizes, such as cash or property won in a lottery, sweepstakes, or other contest (Code sec. 74(a)).

House bill

The House bill provides that no interest or penalties are payable on the Federal income tax liability attributable to receipt of a residence won as a prize, and specially designed for a handicapped foster child of the taxpayer, where certain conditions apply, but only if the tax liability is paid not later than one year after the date of enactment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

7. Condominium conversions

Present law

Under present law, gain on the sale of condominium units by a building owner generally does not qualify for capital gain treatment. However, an owner generally may secure capital gain treatment by selling the property to an unrelated person, who then converts the property to condominiums.

House bill

The House bill allows a property-by-property election to treat a portion of gain on the sale or exchange of condominium units by the building owner as capital gain. This election applies to residential or commercial property used by the taxpayer in a trade or business at all times during the five-year period ending on the determination date (as described below).

Under the House bill, capital gain treatment applies to the excess (if any) of the fair market value of the property on the determination date (excluding improvements made in anticipation of conversion) over the adjusted basis of the property to the owner, reduced by depreciation recapture. The determination date is the earliest of dates on which (1) the taxpayer adopts the plan to convert the building to condominiums, (2) substantial improvements are begun in anticipation of conversion, or (3) the form of ownership of the property changes into condominium units. If more than two years elapse between the sale of the first and second, the date of the second sale is substituted for (1) and (3) above. The amount eligible for capital gain treatment is allocated among individual units according to their fair market value on the determination date and realized in part on the sale of each unit (together with any ordinary income gain).

Where property is overvalued (whether or not such overvaluation is intentional), the amount eligible for capital gain treatment is reduced by 20 percent for each full percentage point by which the property is overvalued in excess of 15 percent. The amount of this reduction is treated as ordinary income.

This provision applies to property the form of ownership of which is changed into condominium units after the date of enactment, in taxable years ending after such date.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision.

G. Extensions of Existing Provisions and Miscellaneous Transition Rules

1. Investment income from S corporations

Present law

Investment interest deductions are generally limited to investment income plus $10,000. The treatment of income with regard to S corporations is not entirely clear under prior law. One case held that subchapter S income under prior law was investment income (*William H. Crook*, 80 T.C. 27 (1983)).

House bill

The House bill provides that for taxable years beginning in 1983 and 1984, a taxpayer may elect to treat income (other than personal service income) from an S corporation as investment income.

Senate amendment

No provision.

Conference agreement

The conference agreement generally follows the House bill. The agreement provides an election for 1983 and 1984 to characterize income from an S corporation, for purposes of section 163(d), under the law in effect prior to the enactment of the Subchapter S Revision Act of 1982. No inference is intended as to the proper interpretation of prior law.

2. Extension of the Payment-in-Kind Tax Treatment Act of 1983

Present law

The Payment-in-Kind Tax Treatment Act of 1983 generally treats commodities received under a 1983 PIK program as if they were grown on the land withdrawn from production under the PIK program; the Act also provides that estates are not disqualified from certain special estate tax provisions solely by reason of participation in a PIK program.

USDA determined that the $50,000 limit applicable to crop diversion payments did not apply to 1983 PIK payments; USDA has applied the limit to the 1984 wheat PIK program.

House bill

The House bill extends the PIK tax provisions to property withdrawn from production under the 1984 wheat PIK program. The bill also directs the Comptroller General to bring a declaratory judgment action to determine if the $50,000 payment limit applies to 1984 wheat PIK payments.

Senate amendment

The Senate amendment is the same as the House bill, except it does not mandate the Comptroller General to bring a declaratory judgment action with respect to application of the $50,000 payment limitation in the case of payments in kind (as opposed to payments in cash).

Conference agreement

The conference agreement follows the Senate amendment. The conferees wish to state, however, that their reason for not adopting the House bill's requirement that the Comptroller General bring a declaratory judgment action with respect to the application of the $50,000 payment limitation was that the Secretary of Agriculture has applied that limitation to the 1984 wheat PIK program.

3. Transitional rule for safe-harbor leasing of coal gasification facilities

Present law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally reduced the tax benefits of safe-harbor leasing between July 1, 1982, and January 1, 1984, and repealed safe-harbor leasing for agreements entered into after December 31, 1983. However, these modifications do not apply to transitional safe-harbor lease property, which generally is property placed in service before January 1, 1983, provided that certain additional requirements are met.

House bill

No provision.

Senate amendment

The Senate amendment generally provides that transitional safe-harbor lease property includes certain coal gasification facilities that would meet the requirements of the general transitional rule in TEFRA if July 1, 1984, were substituted for the January 1, 1983, placed-in-service date. The provision applies only to the lease of an undivided interest in the facility in an amount which does not exceed the lesser of $67.5 million or 50 percent of the cost basis of the entire facility.

Conference agreement

The conference agreement includes the Senate amendment. The conferees intend that under the agreement, a coal gasifica-

tion facility placed in service prior to July 1, 1984, may be leased in a safe harbor lease transaction within three months after it is placed in service by the lessee without losing its status as transitional safe harbor lease property.

4. Provisions of Indian Tribal Governmental Tax Status Act of 1982 made permanent

Present law

For years 1983 and 1984 only, Indian tribal governments are treated as State governments for most purposes of the Internal Revenue Code.

Special restrictions apply to this treatment in certain cases. For example, Indian tribal governments are permitted to issue tax-exempt bonds only to finance traditional public activities (e.g., schools, streets, and sewers). Additionally, the proceeds of these bonds must be used in an "essential governmental function." Tribal governments are not permitted to issue private activity bonds (i.e., industrial development bonds, student loan bonds, and mortgage subsidy bonds).

Additionally, exemptions from Federal excise taxes provided for State governments apply to articles sold to the Indian tribal governments only if the articles are sold for the tribal government's exclusive use in carrying out an essential governmental function.

House bill

No provision.

Senate amendment

The Senate amendment makes permanent the present law provisions that are scheduled to expire at the end of 1984.

Conference agreement

The conference agreement follows the Senate amendment with three modifications. These modifications permit Indian tribal governments to be treated as State governments for the following purposes in addition to the purposes for which such treatment is available under present law:

(1). Treatment of payments under certain State accident and health plans;

(2). Deductibility of certain costs associated with appearances before the State legislatures; and

(3). Rules relating to treatment of original issue discount on certain State obligations.

5. Amortization of low-income housing rehabilitation expenditures

Present law

Present law includes no special provision regarding cost recovery deductions for low-income housing rehabilitation expenditures. Before January 1, 1984, however, a taxpayer could elect (in lieu of any other cost recovery method) to amortize up to $20,000 generally of rehabilitation expenditures with respect to a unit of low-income housing over a 60-month period.

House bill

No provision.

Senate amendment

The Senate amendment reenacts the provision of prior law that permitted amortization over a 60-month period of certain expenditures for rehabilitation of low-income housing. The reenacted provision is effective for 3 years, through December 31, 1986.

Conference agreement

The conference agreement follows the Senate amendment.

6. Disallowance of deduction for costs of demolishing structures

Present law

Costs and other losses incurred in connection with the demolition of buildings generally may be claimed as a current deduction unless the building and the property on which it is located are purchased with an intent to demolish the building. If so purchased, costs and other losses are added to the basis of the land.

Before 1984, costs and other losses incurred in connection with the demolition of certified historic structures were required to be added to the basis of the land on which the structure was located in all cases. A certified historic structure is a building that is certified by the Secretary of the Interior as having historic significance and that meets certain other requirements.

House bill

No provision.

Senate amendment

The Senate amendment provides a general rule under costs and other losses incurred in connection with the demolition of all buildings, including certified historic structures, must be added to the basis of the land on which the demolished building were located, rather than claimed as a current deduction.

The provision generally is effective for demolition beginning after December 31, 1983.

Conference agreement

The conference agreement follows the Senate amendment. The conferees expect that this additional extension of the moratorium will allow the Treasury Department and the industry adequate time to resolve this issue and that no further extensions of this moratorium will be requested.

7. Reinstatement of deduction for elimination of certain barriers to the handicapped and the elderly

Prior law

Under prior law, Code section 190 provided a special tax deduction for up to $25,000 of expenses incurred during a taxable year in removing architectural or transportation barriers to the handicapped and the elderly. This provision was effective for taxable years beginning before 1983. Thus, for taxable years beginning after 1982, no special deduction for such expenses is provided.

Section 190 applied to expenses incurred to make more accessible to, and usable by, the handicapped and elderly facilities or public transportation vehicles owned or leased by the taxpayer for use in the taxpayer's trade or business. To be entitled to the deduction, the taxpayer had to establish that the barrier removal met standards set by the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board. Under section 190, the definition of an elderly person was a person age 65 or over, and handicapped individuals included the blind and the deaf.

The maximum deduction allowed under prior law to a taxpayer (including a controlled group of corporations filing a consolidated return) for any taxable year was $25,000.

House bill

No provision.

Senate amendment

Under the Senate amendment, section 190 is reinstated and made applicable to expenses incurred in taxable years beginning after December 31, 1983, and before January 1, 1986. (Thus, the special deduction provided by section does not apply to expenses incurred in taxable years beginning in 1983.) The maximum deduction allowed to a taxpayer (including a controlled group of corporations) is increased to $35,000.

This provision is effective on the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment.

H. Additional Items

1. Employee tips

Present law

A large food or beverage establishment must allocate to employees as tips the excess of 8 percent of gross receipts over tips reported by the employees to the employer. The IRS can reduce the percentage up to which allocations must be made to as low as 5 percent.

House bill

No provision.

Senate amendment

A majority of the employees or the employer can petition the Internal Revenue Service for a reduction in the percentage of gross receipts required to be allocated. The minimum percentage required to be allocated is reduced from 5 to 2 percent. The provision is effective on the date of enactment. The Secretary is required to prescribe regulations within one year of the date of enactment that describe the applicable record-keeping requirements for tipped employees.

Conference agreement

The conference agreement follows the Senate bill, with a modification clarifying that a person owning 50 percent or more of the value of a corporation that operates the food or beverage establishment is not considered employees, only for purposes of determining whether the establishment normally employed more than 10 employees. The conferees anticipate that an establishment will ordinarily not be able to prove down to the 2-percent rate.

2. FUTA treatment of tips

Present law

Tip income is considered wages for purposes of the Federal Unemployment Tax Act (FUTA) only to the extent paid directly to the employee by the patron, reported by the employee to the employer, and used by the employer to satisfy the minimum wage requirement of the Fair Labor Standards Act.

House bill

The House bill provides that all tip income reported by the employee to the employer is considered wages for FUTA purposes. The provision generally is effective on January 1, 1985. However, in the case of any State the legislature of which (1) did not meet in a regular session which begins during 1984 and after the date of enactment, and (2) did not meet in a session which began on the date of enactment and remained in session for at least 25 calendar days after the date of enactment, the provision is effective on January 1, 1986.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill, except that the effective dates are one year later than under the House bill.

3. FUTA treatment of certain fishing activities

Present law

Remuneration paid to fishing boat crew members is generally subject to FUTA if the services performed are related to catching halibut or salmon for commercial purposes or if the services are performed on a vessel of more than 10 net tons.

Under a provision which expired on December 31, 1982, remuneration paid to fishing boat crew members was exempt from FUTA if the remuneration depends on the boat's catch and the crew normally consists of fewer than 10 members.

Published 1984 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

House bill

No provision.

Senate amendment

The Senate amendment extends the exemption through December 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment.

4. Taxation of unemployment compensation for pre-1978 periods

Present law

The Revenue Act of 1978 provides that the unemployment compensation taxation provisions apply to payments of unemployment compensation made after 1978, in taxable years ending after 1978. Thus, benefits paid in 1979 and later years may be subject to income tax even if attributable to periods of unemployment before 1979.

House bill

The House bill amends the Revenue Act of 1978 to provide that the provisions of that statute which make includible in income a portion of unemployment compensation benefits apply to payments of unemployment compensation made after 1978 except payments for weeks of unemployment ending before December 1, 1978. The bill also extends until one year after enactment the period for claiming any credit or refund attributable to this amendment.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement follows the House bill and the Senate amendment.

5. Tax refunds relating to traveling expenses incurred in 1970–74 for employment at North Dakota ABM site

Present law

No deduction is allowed for commuting costs. However, traveling expenses (transportation, meals, and lodging) incurred by a taxpayer away from home in connection with temporary employment are deductible as business expenses (Code sec. 162). Court decisions generally hold that temporary employment means employment which can reasonably be expected to last only for a short period of time.

The U.S. Court of Appeals for the Eighth Circuit has allowed deduction of transportation expenses incurred by a carpenter while employed during 1970–73 at an antiballistic missile (ABM) site in Nekoma, North Dakota. However, other workers at the site are barred by the period of limitations from filing refund claims on the basis of that decision.

House bill

The House bill allows deductions for traveling expenses incurred between 1970 and 1974 in employment at the Nekoma, North Dakota, ABM site, if such expenses were claimed as deductions on the individual's tax returns. For a taxpayer who is precluded by the period of limitations from filing a refund claim with respect to such deductions, the bill allows a refund claim to be filed within one year after the date of enactment.

This provision applies to taxable years ending after 1969, with respect to expenses incurred after 1969 and before 1974.

Senate amendment

No provision.

Conference agreement

The conference agreement does not include the House provision.

6. Shore-based fishery processing facilities

Present law

Certain tax benefits are provided U.S. taxpayers owning or leasing vessels operating in the foreign or domestic commerce of the U.S. or in U.S. fisheries. Such taxpayers are entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to certain agreements. Earnings from the investment or reinvestment of amounts in such a fund are excluded from income. Furthermore, withdrawals from the fund, made in accordance with the applicable agreement, for the acquisition, construction, or reconstruction of certain vessels, or for the payment of principal on certain indebtedness, are not taxable, although the taxpayer's basis in the property involved is reduced by the amount of the withdrawal. Finally, for investment credit purposes only, the taxpayer's basis in the property is not reduced by more than 50 percent of the withdrawal.

House bill

No provision.

Senate amendment

The tax benefits available under present law are also made available to U.S. citizens (and certain other persons) owning or leasing a fishery facility in the U.S. In addition, deposits into, and withdrawals from a capital construction fund (made in accordance with the applicable agreement) which are used for the acquisition, construction, or reconstruction (not including routine minor repair and maintenance) of certain fishery facilities, are entitled to the tax treatment indicated above. For this purpose, a fishery facility includes land, structures, and equipment used for the unloading and receiving from vessels, the processing, the holding, and the distribution of fish from fisheries.

The provision is effective upon enactment.

Conference agreement

The conference agreement does not contain the provision in the Senate amendment.

7. Tax exemption for the National Credit Union Central Liquidity Facility

Present law

The National Credit Union Central Liquidity Facility ("Central Liquidity Facility") was created by Congress in 1978[1] to meet the liquidity needs of credit unions, including the need for short-term adjustment credit, seasonal credit, and protracted adjustment credit in the event of unusual or emergency circumstances. Under present law, the Central Liquidity Facility is not explicitly exempt from Federal, State or local taxes.

House bill

No provision.

Senate amendment

The Senate amendment provides that the Central Liquidity Facility is exempt from Federal income taxes under the Internal Revenue Code. Additionally, the Central Liquidity Facility is exempt from State or local taxes, other than taxes on real property (to the extent that similar property held by other persons is taxed). The Senate amendment also clarifies that the Central Liquidity Facility is to be an instrumentality of the United States for all purposes under Federal law.

Under the Senate amendment, notes, bonds, and other obligations issued on behalf of the Central Liquidity Facility, and the income from such obligations, are exempt from State and local taxation, other than gift, estate, inheritance, or other wealth transfer taxes. However, such obligations (and the income therefrom) are subject to Federal tax.

These provisions are effective on and after October 1, 1979, i.e., the effective date of the legislation creating the Central Liquidity Facility.

Conference agreement

The conference agreement follows the Senate amendment. The conference agreement further specifies that future tax exemptions for instrumentalities of the United States must be provided in the Internal Revenue Code.

8. Exclusion from gross income for cancellation of certain student loans

Present law

Gross income generally includes income from the discharge of indebtedness (Sec. 61(a)(12)).

Under a provision enacted in the 1976 Tax Reform Act, and later extended through 1982, an individual does not realize gross income from cancellation of student loans made by government agencies where the individual in return works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers.

House bill

No provision.

Senate amendment

The Senate amendment provides a permanent exclusion from income for amounts realized by reason of cancellation of certain student loans where the recipient performs certain professional services for any of a broad class of employers.

This provision is effective for discharges of indebtedness on or after January 1, 1983.

Conference agreement

The conference agreement follows the Senate amendment.

9. Duck stamps

Present law

Duck stamps and postage stamps are considered a type of Federal obligation, and reproduction of them is forbidden under Federal anticounterfeiting laws. Limited reproduction in black and white is permitted for philatelic, numismatic, education, historical or newsworthy purposes, and color reproductions of postage stamps is permitted under carefully prescribed conditions.

House bill

No provision.

Senate amendment

The Secretary of the Interior, with the concurrence of the Secretary of the Treasury, is authorized to license color, as well as black and white, reproductions of duck stamps. The reproductions would have to be less than three-fourths, or more than one and one-half, of the size of the original stamp. The proceeds from such licensed reproductions would be deposited in the Migratory Bird Conservation Fund. Reproductions may be made for commercial purposes which may include facsimiles on such products as placemats and shotguns.

Conference agreement

The conference report follows the Senate amendment, with a technical amendment which specifies that any proceeds from reproductions of duck stamps will be paid into the Migratory Bird Conservation Fund and with an amendment that permits the color reproduction of duck stamps in philatelic (or stamp-collecting) advertising designed to encourage collectors to purchase duck stamps. The conferees understand that duck

[1] Pub. L. 95-630, 95th Cong., 2d Sess., November 10, 1978 (12 U.S.C. sec. 1795 *et seq.*).

stamp reproductions used in philatelic advertising will not be subject to the licensing requirements of the Senate amendment, but they would have to otherwise conform to the requirements imposed under anticounterfeiting provisions.

10. Boundary Waters Canoe Act payments

Present law

Equity grants have been provided to resort and recreational activities operators in the Boundary Waters Canoe Area to assist them in converting their business operations to conform with more restrictive rules governing activities in the area since it was designated as a wilderness area.

Because of the wilderness designation, resort operators have experienced an economic effect similar to an involuntary conversion, in which event the basis of property received is reduced by the amount of funds received but not spent, as provided by law.

House bill

No provision.

Senate amendment

The Senate amendment permits resort and recreational activities operators to make tax-free investments of equity-grants in depreciated property for use in activities within the Boundary Water Canoe Wilderness Area. The property to which taxpayers allocate equity grants must be placed in service before the later of two years after the date of enactment or two years after the payment is received. The basis for each item of property will be reduced by the amount of the equity grant and will be increased by the amount repaid on sale of property. No credit or ACRS deduction may be taken for the portion of any property funded by an equity grant.

Conference agreement

The conference agreement follows the Senate amendment.

11. Physicians' and surgeons' mutual protection associations

Present law

In general, the gross income of a mutual insurance company (other than a life insurance company) includes gross premiums and other consideration, gross investment income, and gain from the sale or other disposition of property. Gross income, generally, does not include any contribution to capital. Present law provides a specific deduction for dividends and similar distributions paid to policyholders in their capacity as such.

Under present law, premiums for liability insurance in carrying on any trade or business are deductible in the year they are paid or incurred. However, no deduction is allowed as an expense paid or incurred during the taxable year for a contribution to capital.

House bill

No provision.

Senate amendment

The Senate amendment provides special rules for the tax treatment of certain physicians' and surgeons' mutual protection and indemnity associations. The gross income of such associations will not include any payment made by a member as an initial payment (or capital contribution) upon joining the association, if the payment does not release the member from obligations to pay current or future dues, assessments or premiums, and if the initial payment is a condition precedent to receiving benefits of membership. Any repayment of an amount so excluded will not be deductible (as a policyholder dividend or otherwise) by the association.

The initial payments of capital will not be excluded from the income of the association to the extent the member makes an election to treat the initial payment as a trade or business expense. Generally, a member making the election (upon joining the association) will be able to deduct the initial payment of capital (or portion thereof) during each of the first 6 years of membership, to the extent the annual premium that would be payable to an independent insurance company for similar coverage exceeds the dues, assessments, or premiums paid during the taxable year to the association.

The provision applies only to those organizations that were operating and providing medical malpractice liability protection under State laws prior to January 1, 1984, and only with respect to payments made to, receipts of, and refunds of payments by such associations, after the date of enactment.

Conference agreement

The conference agreement follows the House bill.

12. Tax treatment of regulated investment companies

Present law

Regulated investment companies.—Under present law a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders. Thus, no corporate level tax is payable on earnings of a RIC distributed (or deemed distributed) to its shareholders.

Accounting for certain obligations.—Issue discount on certain short-term government obligations issued at a discount and redeemable at maturity without interest is deemed to accrue at the earlier of the date the obligation is paid, or the date it is sold or otherwise disposed of.

House bill

Regulated investment companies.—The House bill repeals the prohibition of present law which denies eligibility for RIC status to a personal holding company (PHC), and provides that the undistributed investment company taxable income of any RIC which is a PHC will be subject to tax at the highest rate (presently 46 percent). In addition, the bill provides, in effect, that corporations with accumulated earnings and profits attributable to a non-RIC year will be ineligible to elect RIC status without a distribution of those earnings.

Accounting for short-term government obligations.—The House bill provides that the issue discount accruing with respect to any short-term government obligation will be taxable to the RIC as it accrues, if the company so elects in a manner prescribed by the Internal Revenue Service.

Senate amendment

The Senate amendment is the same as the House bill.

Conference agreement

The conference agreement is the same as the House bill and the Senate amendment. However, a transitional rule is added under which a corporation with earnings attributable to a non-RIC year will be eligible to elect RIC status without distributing such earnings if it completed all the economic steps required to elect RIC status during the period beginning on January 1, 1982 and ending on November 7, 1983, and elects or has elected RIC status for its first taxable year beginning after November 8, 1983.

13. Increased payments for presidential nominating conventions

Present Law

Congress has authorized the payment from the Presidential Election Campaign Fund of up to $3 million for presidential nominating conventions of major parties; lesser amounts may be made available to minor parties. The base amount is adjusted for inflation. The payments are to be used only to defray expenses incurred with respect to a presidential nominating convention.

House bill

No provision.

Senate amendment

The Senate amendment authorizes an increase in the limitation to $4 million. The additional amount is intended to defray the expenses for security arrangements at the two presidential nominating conventions.

Conference agreement

The conference agreement follows the House bill.

XI. STUDIES

1. Study of alternative tax systems

Present law

There is no specific provision.

House bill

The House bill provides that the Secretary of the Treasury is to submit to the Congress a study of a simplified gross income tax (covering both individual and corporate income taxes). The report is to be submitted within 6 months of enactment.

Senate amendment

The Senate amendment provides that the Secretary of the Treasury is to submit to the Congress a study of alternative tax systems (covering both the individual and corporate income taxes), including a simplified gross income tax, a consumption-based tax, a value-added tax, a national sales tax, and broadening of the current income tax base combined with lowering of tax rates. The report is to be submitted within 6 months of enactment.

Conference agreement

The conference agreement generally follows the Senate amendment; except that the report is to be submitted to the Congress by December 31, 1984, and that the report is to include a study of tax shelters.

2. Treasury study on foreign taxation of certain U.S. services

Present law

The foreign tax credit cannot offset U.S. tax on U.S. source income. The United States considers income for services performed in the United States for use in foreign countries to be U.S. source income; some foreign countries consider the same income to be local income. Double taxation may arise.

House bill

No provision.

Senate amendment

The Senate amendment directs the Treasury Department to study the practices of foreign countries that impose taxes on the basis of services that are performed in the United States, including the status of treaty negotiations with such countries, and options to alleviate the resulting double tax burden on U.S. taxpayers. The Treasury Department is to report on the results of its study to the Senate Committee on Finance and the House Committee on Ways and Means no later than August 31, 1984.

Conference agreement

The conference agreement follows the Senate amendment, except that the Treasury study will be due on December 31, 1984.

H. Con. Res. 328
Correcting Technical Errors in the Enrollment of HR. 4170, Tax Reform Act of 1983
Vol. 130 Cong. Rec. H. 7524 (June 29, 1984)

CORRECTING TECHNICAL ERRORS IN THE ENROLLMENT OF H.R. 4170, TAX REFORM ACT OF 1983

Mr. GIBBONS. Mr. Speaker, I ask unanimous consent to take from the Speaker's table the concurrent resolution (H. Con. Res. 328) entitled "Concurrent resolution to correct technical errors in the enrollment of the bill H.R. 4170," with a Senate amendment thereto, and concur in the Senate amendment.

The Clerk read the title of the concurrent resolution.

The Clerk read the Senate amendment, as follows:

Strike out all after the resolving clause and insert: That, in the enrollment of the bill (H.R. 4170) to provide for tax reform, and for other purposes, the Clerk of the House of Representatives shall make the following corrections:

DIVISION A—TAX REFORM ACT OF 1984

(1) In section 168(j) of the Code (as added by section 31(a) of the bill) strike out "15" and insert in lieu thereof "18" in each of the following provisions of section 168(j):

(A) Subclause (III) of paragraph (1)(B).

(B) Clause (i) of paragraph (2)(B) (including the heading thereof).

(C) Clause (ii) of paragraph (2)(B) (including the heading thereof).

(D) Paragraph (2)(D).

(E) Paragraph (3)(A) (including the heading thereof).

(F) The heading of paragraph (3)(B).

(G) Clause (i) of paragraph (3)(B).

(H) Clause (ii) of paragraph (3)(C).

(I) Paragraph (6)(C) (including the heading thereof).

(2) In clause (ii) of section 168(j)(2)(B) of the Code (as added by section 31(a) of the bill) insert "(using a mid-month convention)" after "months".

(3) In section 168(j)(2) of the Code (as added by section 31(a) of the bill) strike out subparagraph (F) and insert:

"(F) 18-year real property.—For purposes of this subsection, the term '18-year property' includes—

"(i) low-income housing, and

"(ii) any property which was treated as 15-year real property under this section (as in effect before the amendments made by the Tax Reform Act of 1984).

(4) In subclause (II) of section 168(j)(4)(E)(ii) of the Code (as added by section 31(a) of the bill), insert "under the lease" after "placed in service".

(5) In subclause (I) of section 48(a)(5)(B)(ii) of the Code (as added by section 31(b) of the bill), strike out "and" at the end thereof and insert in lieu thereof "or".

(6) In subclause (I) of section 48(a)(5)B)(iii) (as added by section 31(b) of the bill), strike out "to which section 47(a)(7) applies" and insert in lieu thereof "used under a qualifying lease (as defined in section 47(a)(7)(C))".

(7) In subclause (II) of section 48(A)(5)(B)(iii) of the Code (as added by section 31(b) of the bill), strike out "the lease" and insert in lieu thereof "a lease".

(8) In section 7701(e)(3) of the Code (as added by section 31(e) of the bill), strike out the matter following subparagraph (B) thereof and preceding subparagraph (C) thereof.

(9) In each of subparagraphs (C), (D), and (E) of section 7701(e)(3) of the Code (as added by section 31(e) of the bill), strike out "The" and insert in lieu thereof "For purposes of subparagraph (A), the".

(10) In subparagraph (A) of section 7701(e)(4) of the Code (as added by section 31(e) of the bill), insert ", cogeneration facility, alternative energy facility, or water treatment works facility" after "qualified solid waste disposal facility" in the matter preceding clause (i).

(11) In paragraph (5) of section 7701(e) of the Code (as added by section 31(e) of the bill), strike out "section 168" and insert in lieu thereof "section 168(c)(2)(F)".

(12) In subparagraph (A) of section 31(g)(8) of the bill, insert at the end thereof "For purposes of the preceding sentence, the term '15-year real property' includes 18-year real property."

(13) In clause (i) of section 31(g)(11)(B) of the bill, strike out "maximum of units" and insert in lieu thereof "maximum number of units".

(14) In clause (i) of section 31(g)(15)(A) of the bill, insert "by the taxpayer" after "placed in service".

(15) In paragraph (17) of section 31(g) of the bill, strike out "section 168(c)(1)(D)" in the matter preceding subparagraph (A) and insert in lieu thereof "section 168(c)(2)(D)".

(16) In clause (ii) of section 31(g)(17)(J) of the bill, insert "written" before "commitment".

(17) In clause (ii) of section 31(g)(17)(L) of the bill—

(A) strike out "Internal Revenue Code" and insert in lieu thereof "Internal Revenue Code of 1954", and

(B) strike out "in existence".

(18) In subparagraph (M) of section 31(g)(17) of the bill, insert "and" after "center,".

(19) In subparagraph (D) of section 31(g)(20) of the bill—

(A) insert "to a tax-exempt entity" after "sublease", and

(B) insert ", 168(j)(8)(A)," after "section 168(j)(6)(A)".

(20) In section 1274(c)(2) of the Code (as added by section 41(a) of the bill), strike out "is less than" and insert in lieu thereof "is less than or equal to".

(21) In the subpart heading for subpart B of part V of subchapter P of chapter 1 of the Code (as added by section 41(a) of the bill), strike out "on Bonds".

(22) In section 163(e)(2) of the Code (as added by section 42(a) of the bill), strike out subparagraph (C).

Strike out paragraph (23) of the corrections to DIVISION A—TAX REFORM ACAT OF 1984 and insert the following new paragraph:

(23) in section 483 of the Code (as added by section 41 (b) of the bill), redesignate subsection (e), (f), and (g) as subsection (f), (g), and (h), respectively, and insert after subsection (d) the following new subsection:

"(e) Interest Rates in Case of Sales of Principal Residences or Farm Lands.—

"(1) In general.—In the case of any debt instrument arising from a sale or exchange to which this subsection applies, subsections (b) and (c)(1)(B) shall be applied by using, in lieu of the discount rates determined under such subsections, discount rates determined under subsections (b) and (c)(1), respectively, of this section as it was in effect before the amendments made by the Tax Reform Act of 1984.

"(2) Sales or exchanges to which subsection applies.—This subsection shall apply—

"(A) to any sale or exchange by an individual of his principal residence (within the meaning of section 1034), and

"(B) to any sale or exchange by a person of land used by such person as a farm (within the meaning of section 6420(c)(2)).

(3) Limitation.—Paragraph (1) shall apply to any sale or exchange by an individual of his principal residence (within the meaning of section 1034), only to the extend the purchase price of such residence does not exceed $250,000.

(24) In paragraph (1) os section 53(b) of the bill, strike out "section 246(c)" and insert in lieu thereof "section 246".

(25) In section 301(e)(2) of the Code (as added by section 54(b) of the bill), strike out "section 1248(f)(2)" and insert in lieu thereof "section 1248".

For purposes of the preceding sentence, the purchase price of a residence shall be determined without regard to this section.

(26) In the section heading for section 59 of the bill, strike out "EXCEPTIONS" and insert in lieu thereof "EXCEPTION" and

amend the table of contents of the bill accordingly.

(27) Strike out paragraph (2) of section 87(e) of the bill and insert in lieu thereof the following:

(2) Special rule for contract amendments.—Any contract entered into before June 15, 1984, which is amended after June 14, 1984, in any significant relevant aspect shall be treated as a contract entered into after June 14, 1984.

(28) In section 291(A)(4) of the Code (as amended by section 88(b) of the bill), strike out subparagraphs (A) and (B) and insert the following:

"(A) '30 percent' for '32 percent' in paragraph (2), and

"(B) '15/23' for '16/23' in paragraph (3).

(29) Strike out subparagraphs (C) and (D) of section 706(d)(2) of the Code (as added by section 72(a) of the bill) and insert in lieu thereof the following:

"(C) Items attributable to periods not within taxable year.—If any portion of any allocable cash basis item is attributable to—

"(i) any period before the beginning of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the first day of such taxable year, or

"(ii) any period after the close of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the last day of taxable year.

"(D) Treatment of deductible items attributable to prior periods.—If any portion of a deductible cash basis item is assigned under subparagraph (C)(i) to the first day of any taxable year—

"(i) such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and

"(ii) any amount allocated under clause (i) to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in section 755.

(30) In paragraph (5) of section 77(b) of the bill, insert "and which was executed on or before March 31, 1984," after "March 29, 1984,".

(31) In section 77(b)(5) of the bill, strike out "on, or before" and insert in lieu thereof "on or before".

(32) In section 91(g) of the bill, strike out paragraphs (1) and (2) and insert the following:

(1) In general.—Except as provided in this subsection and subsections (h) and (i), the amendments made by this section shall apply to amounts with respect to which a deduction would be allowable under chapter 1 of the Internal Revenue Code of 1954 (determined without regard to such amendments) after—

(A) in the case of amounts to which section 461(h) of such Code (as added by such amendments) applies, the date of the enactment of this Act, and

(B) in the case of amounts to which section 461(i) of such Code (as so added) applies, after March 31, 1984.

(2) Taxpayer may elect earlier application.—

(A) In general.—In the case of amounts described in paragraph (1)(A), a taxpayer may elect to have the amendments made by this section apply to amounts which—

(i) are incurred before the date of the enactment of this Act (determined without regard to such amendments), and

(ii) are incurred on or after the date of the enactment of this Act (determined with regard to such amendments).

(B) Election treated as change in the method of accounting.—For purposes of section 481 of the Internal Revenue Code of 1954, if an election is made under subparagraph (A) with respect to any amount, the application of the amendments made by this section shall be treated as a change in method of accounting—

(i) initiated by the taxpayer,

(ii) made with the consent of the Secretary of the Treasury, and

(iii) with respect to which section 481 of such Code shall be applied by substituting a 3-year adjustment period for a 10-year adjustment period.

(33) In the table contained in section 467(e)(3)(A) of the Code (as added by section 92(a)), after the item relating to "10-year property", insert the following new item:

"Low-income housing..... 15 years."

(34) In clause (ii) of section 92(c)(2)(C) of the bill insert "(for purposes of this clause)" after "assuming" in the matter preceding subclause (I).

(35) Strike out the last two sentences of section 92(c)(2) of the bill and insert:

Paragraph (3)(B)(ii)(II) shall apply for purposes of clauses (ii) and (iii) of subparagraph (C), as if, as of the beginning of the last stage, the separate agreements were treated as 1 single agreement relating to all property covered by the agreements, including any property placed in service before the property to which the agreement for the last stage relates. If the lessor under the agreement described in subparagraph (C) leases the property from another person, this exception shall also apply to any agreement between the lessor and such person which is integrally related to, and entered into at the same time as, such agreement, and which calls for comparable payments of rent over the primary term of the agreement.

(36) In paragraph (2) of section 195(b) of the Code (as added by section 94(a)), insert "attributable to such trade or business" after "deferred expenses".

(37) In paragraph (2) of section 1092(f) of the Code (as added by section 101(c) of the bill), strike out "The holding period" and insert in lieu thereof "Except for purposes of section 851(b)(3), the holding period".

(38) Strike out subparagraph (C) of section 1265(g)(4) of the Code (as amended by section 102(a) of the bill) and insert in lieu thereof the following:

"(C) is listed on the qualified board or exchange on which such options dealer is registered.

(39) In subparagraph (A) of section 211(h)(1) of the Social Security Act, as added by section 102(c)(2) of the bill, insert "activity of " before "dealing in or trading".

(40) In subsection (d) of section 102 of the bill, strike out paragraph (3) and insert in lieu thereof the following:

(3) Subchapter S election—If a commodities dealer or an options dealer—

(A) becomes a small business corporation (as defined in section 1361(b) of the Internal Revenue Code of 1954) at any time before the close of the 75th day after the date of the enactment of this Act, and

(B) makes the election under section 1362(a) of such Code before the close of such 75th day,

then such dealer shall be treated as having received approval for and adopted a taxable year beginning on the first day during 1984 on which it was a small business corporation (as so defined) and ending on the date determined under section 1378 of such Code and such election shall be effective for such taxable year.

(41) In the subsection heading to subsection (b) of section 106 of the bill, strike out "Business" and insert in lieu thereof "Dealer".

(42) In paragraph (2) of section 105(a) of the bill, strike out "such Act" and insert in lieu thereof "the Economic Recovery Tax Act of 1981".

(43) Strike out subsection (d) of section 111 of the bill and insert in lieu thereof the following:

(d) Use of Mid-Month Convention.—Subparagraphs (A) and (B) of section 168(b)(2) are each amended by inserting "(using a mid-month convention)" after "months".

(44) In paragraph (2) of section 111(g) of the bill, strike out "but only if property is not" and insert in lieu thereof "but only if the property is not".

(45) In subparagraph (B) of section 111(g)(3) of the bill, strike out "March 1984" and insert in lieu thereof "March 16, 1984".

(46) In paragraph (1) of section 48(r) of the Code (as added by section 113(a)(1) of the bill), strike out "commences with taxpayer" and insert in lieu thereof "commences with the taxpayer".

(47) In paragraph (1) of section 113(b) of the bill, strike out "Film" and insert in lieu thereof "Films".

(48) Strike out subsection (c) of section 113 of the bill and insert in lieu thereof the following:

(c) Effective date.—

(1) Sound recordings.—The amendments made by subsection (a) shall apply to property placed in service after March 15, 1984, in taxable years ending after such date.

(2) Films and other property.—

(A) The amendment made by paragraph (1) of subsection (b) shall apply to any motion picture film or video tape placed in service before, on, or after the date of the enactment of this Act, except that such amendment shall not apply to—

(i) any qualified film placed in service by the taxpayer before March 15, 1984, if the taxpayer treated such film as recovery property for purposes of section 168 of the Internal Revenue Code of 1954 on a return of tax under chapter 1 of such Code filed before March 16, 1984, or

(ii) any qualified film placed in service by the taxpayer before January 1, 1985, if—

(I) 20 percent or more of the production costs of such film were incurred before March 16, 1984, and

(II) the taxpayer treats such film as recovery property for purposes of section 168 of such Code.

No credit shall be allowable under section 38 of such Code with respect to any qualified film described in clause (ii), except to the extent provided in section 48(k), of such Code.

(B) The amendments made by paragraphs (2) and (3) of subsection (b) shall apply as if included in the amendments made by sections 201(a), 211(a)(1), and 211(f)(1) of the Economic Recovery Tax Act of 1981.

(C) The amendment made by paragraph (4) of subsection (b) shall take effect as if included in the amendments made by section 205(a)(1) of the Tax Equity and Fiscal Responsibility Act of 1982.

(D) For purposes of this paragraph, the terms "qualified film" and "production costs" have the same respective meanings as when used in section 48(k) of the Internal Revenue Code of 1954.

(49) In pargraph (1) of section 121(b) of the bill, strike out "a taxable year of any United States-owned foreign corporation in which occurs" and insert in lieu thereof "any taxable year of any United States-owned foreign corporation ending after".

(50) In subparagraph (D) of section 121(b)(2) of the bill, strike out "and the holding of short-term" and insert in lieu thereof "or the holding of short-term".

(51) In paragraph (5) of section 121(b) of the bill, strike out "paragraphs (2) or (3)" and insert in lieu thereof "paragraph (2) or (3)".

(52) In paragraph (6) of section 121(b) of the bill—

(A) strike out "issued obligations on" and insert in lieu thereof "issued certificates with respect to obligations on", and

(B) strike out "income received or accrued on such obligations" and insert in lieu thereof "the proceeds from relending such obligations or related capital".

(53) In clause (ii) of section 904(d)(3)(E) of the Code (as added by section 122(a) of the bill), strike out "the taxpayer" and insert in lieu thereof "a United States person".

(54) In subparagraph (J) of section 904(d)(3) of the Code (as added by section 122(a) of the bill), strike out "under such interest" and insert in lieu thereof "unless such interest".

(55) In subparagraph (B) of section 122(b)(2) of the bill, strike out "designated payor" each place it appears and insert in lieu thereof "designated payor corporation".

(56) In paragraph (3) of section 122(b) of the bill—

(A) strike out "corporations which are not" in the heading and insert in lieu thereof "corporation which is not", and

(B) strike out "section 131(b)(2)(D)" and insert in lieu thereof "section 121(b)(2)(D)".

(57) In paragraph (6) of section 864(d) of the Code (as added by section 123(a) of the bill)—

(A) strike out "other than a related person", and

(B) strike out "such related person" in subparagraphs (A) and (B) and insert in lieu thereof "a related person".

(58) In paragraph (2) of section 123(c) of the bill—

(A) strike out "March 1, 1984" the second place it appears and insert in lieu thereof "March 1, 1994",

(B) strike out "investment in United States property of such corporation" and insert in lieu thereof " amount includible in gross income by reason of section 956 of the Internal Revenue Code of 1954 with respect to such corporation", and

(C) strike out "investment on or before March 1, 1984" and insert in lieu thereof "adjusted basis on March 1, 1984".

(59) In paragraph (1) of section 127(a) of the bill, strike out "by redesignating subsection (i) as subsection (j) and by adding at the end thereof the following new subsection" and insert "by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection".

(60) Subsection (i) of section 871 of the Code (as added by section 127(a)) is redesignated as subsection (h).

(61) In subsection (h) of section 871 of the Code (as redesignated by the preceding paragraph and as added by section 127(a) of the bill)—

(A) strike out "who is, or would otherwise be," in paragraph (2)(B)(ii) and insert "who would otherwise be", and

(B) strike out "owner" in paragraph (3)(C)(ii) and insert "owning".

(62) In subsection (c) of section 881 of the Code (as added by section 127(b) of the bill)—

(A) Strike out "paragraph (1) of subsection (a)" in paragraph (1) and insert in lieu thereof "paragraph (1) or (3) of subsection (a)".

(B) Strike out "section 871(i)(2)(A)" in paragraph (2)(A) and insert in lieu thereof "section 871(h)(2)(A)".

(C) Strike out "who is, or would otherwise be," in paragraph (2)(B) and insert in lieu thereof "who would otherwise be".

(D) Strike out "section 871(i)(4)" in paragraph (2)(B) and insert in lieu thereof "section 871(h)(4)".

(E) Strike out "or" at the end of paragraph (3)(A).

(F) Strike out subparagraph (B) of paragraph (3) and insert in lieu thereof the following:

"(B) is received by a 10-percent shareholder (within the meaning of section 871(h)(3)(B)), or

"(C) is received by a controlled foreign corporation from a related person (within the meaning of section 864(d)(4)).

(G) Strike out "not found or avoided" in paragraph (4)(A)(ii) and insert in lieu thereof "not formed or availed".

(H) Strike out subparagraphs (B) and (C) of paragraph (4) and insert in lieu thereof the following:

"(B) Controlled foreign corporation.—For purposes of this subsection, the term 'controlled foreign corporation' has the meaning given to such term by section 957(a)."

(I) Strike out "section 871(i)(5)" each place it appears in paragraph (5) and insert in lieu thereof "section 871(h)(5)".

(63) In subsection (c) of section 127 of the bill, strike out "section 871(i)" and insert in lieu thereof "section 871(h),".

(64) In section 2105(b) of the Code (as added by section 127(d) of the bill)—

(A) strike out "section 871(i)(4)" and insert in lieu thereof "section 871(h)(4)", and

(B) strike out "section 871(i)(1)" and insert in lieu thereof "section 871(h)(1)".

(65) In paragraph (9) of section 1441(c) of the Code (as added by section 127(e) of the bill)—

(A) strike out "section 871(i)(2)" and insert in lieu thereof "section 871(h)(2)", and

(B) strike out "section 871(i)(3)" and insert in lieu thereof "section 871(h)(3)".

(66) Strike out paragraph (2) of section 127(e) of the bill and insert the following:

(2) FOREIGN CORPORATIONS.—The last sentence of section 1442(a) is amended—

(A) by striking out "and" after "section 881(a)(4)," and

(B) by inserting before the period at the end thereof the following: ", and the references in section 1449(c)(9) to sections 871(h)(2) and 871(h)(3) shall be treated as referring to sections 881(c)(2) and 881(c)(3)".

(67) In paragraph (3)(A) of section 127(g) of the bill, strike out "application" and insert in lieu thereof "applicable".

(68) In subparagraph (C) of section 127(g)(3) of the bill—

(A) strike out "131(b)(2)(D)" and insert in lieu thereof "121(b)(2)(D)", and

(B) strike out "section 131(b)(2)(F)" and insert in lieu thereof "section 121(b)(2)(F)".

(69) In section 1445(b)(2) of the Code (as added by section 129(a) of the bill), strike out "penalty or perjury" and insert in lieu thereof "penalty of perjury".

(70) Strike out subparagraph (B) of section 1445(d)(1) of the Code (as added by section 129(a) of the bill) and insert in lieu thereof the following:

"(B) in the case of—

"(i) any transferor's agent, the transferor is a foreign corporation or such agent has actual knowledge that such affidavit is false, or

"(ii) any transferee's agent, such agent has actual knowledge that such affidavit is false,

(71) In clause (ii) of section 367(a)(3)(B) of the Code (as added by section 131(a) of the bill), strike out "installment obligation" and insert in lieu thereof "installment obligations".

(72) In clause (i) of section 136(c)(7)(A) of the bill, strike out "before April 15, 1984" and insert in lieu thereof "on April 5, 1984".

(73) In section 879(a) of the Code (as amended by section 139(8) of the bill), strike out "community" and insert in lieu thereof "community income".

(74) In subsection (c) of section 111 of the Code (as added by section 171 of the bill), insert "or adjustment" after "the recovery".

(75) At the end of subparagraph (B) of section 179(d)(1) of the bill, add the following new sentence:

For purposes of the preceding sentence, the term "15-year real property" includes 18-year real property.

(76) In paragraph (6) of section 809(g) of the Code (as added by section 211 of the bill) insert "of a subsidiary" after "tax reserves".

(77) In paragraph (1) of section 817(h) of the Code (as added by section 211 of the bill) strike out "For purposes of the preceding sentence" and insert in lieu thereof "For purposes of this paragraph and paragraph (2)".

(78) In section 219 of the bill—

(A) strike out "APPLICATION OF SECTION 6001" and insert in lieu thereof "AUTHORITY TO REQUIRE CERTAIN INFORMATION", and

(B) strike out "exercising his authority under section 6001 of the Internal Revenue Code of 1954 to require" and insert in lieu thereof "requiring".

(79) In the table of contents of the bill after the item relating to section 218, insert the following new item:

Sec. 219. Clarification of authority to require certain information.

(80) In subclause (II) of section 465(c)(7)(D)(ii) of the Code (as added by section 432(a) of the bill), strike out "20 percent" and insert in lieu thereof "10 percent".

(81) In section 419(a)(2) of the Code (as added by section 511 of the bill), strike out "they testify" and insert in lieu thereof "they satisfy".

(82) In section 419(c)(3)(A) of the Code (as added by section 511 of the bill), strike out "the aggregate amount" and insert in lieu thereof "the aggregate amount (including administrative expenses)".

(83) In paragraph (4) of section 419A(a) of the Code (as added by section 511 of the bill), strike out "life insurance benefit" and insert in lieu thereof "life insurance benefits".

(84) Strike out paragraph (2) of section 419A(c) of the Code (as added by section 511 of the bill) and insert in lieu thereof the following:

"(2) Additional reserve for post-retirement medical and life insurance benefits.—The account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for—

"(A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or

"(B) post-retirement life insurance benefits to be provided to covered employees.

(85) Strike out subparagraph (A) of section 419A(c)(3) of the Code (as added by section 511 of the bill) and insert the following:

"(A) IN GENERAL.—The account limit for any taxable year with respect to SUB or severance pay benefits is 75 percent of the average annual qualified direct costs for SUB or severance pay benefits for any 2 of the immediately preceding 7 taxable years (as selected by the fund)..

(86) Strike out clauses (i) and (ii) of section 419A(c)(5)(B) and insert in lieu thereof the following:

"(i) SHORT-TERM DISABILITY BENEFITS.—In the case of short-term disability benefits, the safe harbor limit for any taxable year is 17.5 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year with respect to such benefits.

"(ii) MEDICAL BENEFITS.—In the case of medical benefits, the safe harbor limit for any taxable year is 35 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year with respect to medical benefits.

(87) In paragraph (1) of section 419A(e) of the Code (as added by section 511 of the bill), strike out "medical benefits or life insurance benefits provided to retired employees" and insert in lieu thereof "post-retirement medical benefits or life insurance benefits to be provided to covered employees".

(88) In paragraph (2) of section 419A(g) of the Code (as added by section 511 of the bill), strike out "referred to in paragraph (1)".

(89) Strike out paragraph (5) of section 511(e) of the bill and insert in lieu thereof the following:

(5) BINDING CONTRACT EXCEPTIONS TO PARAGRAPH (4).—Paragraph (4) shall not apply to any facility placed in service before January 1, 1987—

(A) which is acquired by the fund (or contributed to the fund) pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or

(B) the construction of which by or for the fund began before June 22, 1984.

(90) In clause (i) of section 512(a)(3)(E) of the Code (as added by section 511(b)(2) of the bill), strike out "any reserve for medical benefits provided to retired employees" and insert in lieu thereof "any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits".

(91) Strike out clause (iii) of section 512(a)(3)(E) of the Code (as added by section 511(b)(2) of the bill) and insert the following:

"(iii) TREATMENT OF EXISTING RESERVES FOR POST-RETIREMENT MEDICAL OR LIFE INSURANCE BENEFITS—

"(I) Clause (i) shall not apply to any income attributable to a existing reserve for post-retirement medical or life insurance benefits.

"(II) For purposes of subclause (I), the term 'existing reserve or post-retirement medical or life insurance benefit' means the amount of assets set aside as of the close of the last plan year ending before the date of the enactment of the Tax Reform Act of 1984 for purposes of post-retirement medical benefits or life insurance benefits to be provided to covered employees.

"(III) All payments during plan years ending on or after the date of the enactment of the Tax Reform Act of 1984 of post-retirement medical benefits or life insurance benefits shall be charged against the reserve referred to in subclause (II). Except to the extent provided in regulations prescribed by the Secretary, all plans of an employer shall be treated as 1 plan for purposes of the preceding sentence."

(92) Strike out paragraph (2) of section 4976(b) of the Code (as added by section 511(c)(1) of the bill) and insert the following:

"(2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of section 505(b)(1) with respect to such benefit, and"

(93) In the item added by section 511(c)(2) of the bill, strike out "4977" and insert in lieu thereof "4976".

(94) In paragraph (4) of section 511(e) of the bill, strike out "to be used to acquire" and insert in lieu thereof "to be used to acquire or improve".

(95) In paragraph (5) of section 511(e) of the bill, strike out "acquired pursuant to" and insert in lieu thereof "acquired or improved pursuant to".

(96) In the subsection heading for subsection (a) of section 505 of the Code (as added by section 513(a) of the bill), strike out "(9), (17), OR (20)" and insert in lieu thereof "(9) OR (20)"

(97) Redesignate paragraph (3) of section 505(a) of the Code (as added by section 513 of the bill) as paragraph (2).

(98) In subparagraph (B) of section 505(b)(1) of the Code (as added by section 513(a) of the bill), strike out "benefits for not discriminate" and insert in lieu thereof "benefits do not discriminate".

(99) At the end of subtitle E of title V of the bill, insert the following new section:

SEC. 561. LIMITATION ON ACCRUAL OF VACATION PAY.

(a) GENERAL RULE.—Paragraph (1) of section 463(a) (relating to accrual of vacation pay) is amended by striking out "and payable during" and inserting in lieu thereof "and expected to be paid during".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after March 31, 1984.

(100) In the table of contents of the bill, insert after the item relating to section 560 the following new item:

Sec. 561. Limitation on accrual of vacation pay.

(101) In section 403(b)(8)(B) of the Code (as added by section 522(d)(10) of the bill), strike out clause (iii) and insert closing quotation marks at the end of clause (ii).

(102) In paragraph (1) of section 219(f), as amended by section 529 of the bill, strike out "paragraph (1)" and all that follows and insert in lieu thereof "section 71 with respect to a divorce or separation instrument described in subparagraph (A) of section 71(b)(2)."

(103) In paragraph (1) of section 125(h) of the Code (as added by section 531(b)(4)(A) of the bill), strike out "taxable" each place it appears.

(104) In section 4977 of the Code (as added by section 531(e)(1) of the bill), strike out subsection (e) and insert in lieu thereof the following new subsection:

"(e) TREATMENT OF CONTROLLED GROUPS.—All employees treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section."

(105) In subparagraph (A) of section 103A(j)(3) of the Code (as added by section 611(b)(1) of the bill), strike out "a statement concerning" and insert in lieu thereof "(or such later time as the Secretary may prescribe with respect to any portion of the statement) a statement concerning".

(106) In subparagraph (A) of section 103A(j)(4) of the Code (as added by section 611(b)(1) of the bill), strike out "certifies that" and insert in lieu thereof "certifies in the manner prescribed by regulations that".

(107) In subparagraph (B) of section 103A(j)(4) of the Code (as added by section 611(b)(1) of the bill), strike out "paragraph (3)" and insert in lieu thereof "paragraph (3) or such other time as the Secretary may prescribe".

(108) In subparagraph (C) of section 103A(j)(4) of the Code (as added by section 611(b)(1) of the bill), strike out "constitutional home rule cities" and insert in lieu thereof "any constitutional home rule city".

(109) In subparagraph (B) of section 103A(j)(5) of the Code (as added by section 611(b)(1) of the bill)—

(A) strike out clause (i) and insert in lieu thereof the following:

"(i) a statement of the policies with respect to housing, development, and low-income housing assistance which such governmental unit is to follow in issuing qualified mortgage bonds and mortgage credit certificates, and

(B) strike out "great extent feasible" in clause (ii)(II) and insert in lieu thereof "greatest extent feasible".

(110) Strike out subparagraph (B) of section 103A(o)(3) of the Code (as added by section 611(c)(2) of the bill) and insert in lieu thereof the following:

"(B) STATE VETERANS LIMIT.—A State veterans limit for any calendar year is the amount equal to—

"(i) the aggregate amount of qualified veterans bonds issued by such State during the period beginning on January 1, 1979, and ending on June 22, 1984 (not including the amount of any qualified veterans bond issued by such State during the calendar year (or portion thereof) in such period for which the amount of such bonds so issued was the lowest), divided by

"(ii) the number (not to exceed 5) of calendar years after 1979 and before 1985 during which the State issued qualified veterans bonds (determined by only taking into account bonds issued on or before June 22, 1984).

(111) In subparagraph (C) of section 611(d)(3) of the bill—

(A) strike out "section 103(o)(3)" and insert in lieu thereof "section 103A(o)(3)", and

(B) strike out "such bond is authorized" and insert in lieu thereof "such bond was authorized".

(112) In paragraph (7) of section 611(d) of the bill—

(A) strike our "Annual report" in the paragraph heading and insert in lieu thereof "Report", and

(B) strike out "shall submit an annual report" and insert in lieu thereof "shall, not later than January 1, 1987, submit a report".

(113) In section 25(d)(2)(A) of the Code (as added by section 612(a) of the bill), strike out "or, if lesser, the aggregate amount of certified indebtedness referred to in clause (i)".

(114) At the end of subsection (d) of section 25 of the Code (as added by section 612(a) of the bill), insert the following:

"(3) ADDITIONAL LIMIT IN CERTAIN CASES.—In the case of a qualified mortgage credit certificate program in a State which—

"(A) has a State ceiling (as defined in section 103A(g)(4)) for the year an election is made that exceeds 20 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single family owner-occupied residences located within the jurisdiction of such State, or

"(B) issued qualifies mortgage bonds in an aggregate amount less than $150,000,000 for calendar year 1983,

the certificate credit rate for any mortgage credit certificate shall not exceed 20 percent unless the issuing authority submits a plan to the Secretary to ensure that the weighted average of the certificate credit rates in such mortgage credit certificate program does not exceed 20 percent and the Secretary approves such plan.

(115) In paragraph (2) of section 25(e) of the Code (as added by section 612(a) of the bill), strike out "(g) and (j) of section 103A" and insert in lieu thereof "and (j) of section

103A and clauses (iv), (v), and (vii) of subsection (c)(2)(A)".

(116) Strike out paragraph (4) of section 25(e) of the Code (as added by section 612(a) of the bill) and insert in lieu thereof the following:

"(4) REISSUANCE OF MORTGAGE CREDIT CERTIFICATES.—The Secretary may prescribe regulations which allow the administrator of a mortgage credit certificate program to reissue a mortgage credit certificate specifying a certified mortgage indebtedness that replaces the outstanding balance of the certified mortgage indebtedness specified on the original certificate to any taxpayer to whom the original certificate was issued, under such terms and conditions as the Secretary determines are necessary to ensure that the amount of the credit allowable under subsection (a) with respect to such reissued certificate is equal to or less than the amount of credit which would be allowable under subsection (a) with respect to the original certificate for any taxable year ending after such reissuance."

(117) In paragraph (1) of section 25(f) of the Code (as added by section 612(a) of the bill), strike out the first sentence and insert in lieu thereof the following: "If for any calendar year any mortgage credit certificate program which satisfies procedural requirements with respect to volume limitations prescribed by the Secretary fails to meet the requirements of paragraph (2) of subsection (d), such requirements shall be treated as satisfied with respect to any certified indebtedness of such program, but the applicable State ceiling under paragraph (4) of section 103A(g) for the State in which such program operates shall be reduced by 1.25 times the correction amount with respect to such failure."

(118) Strike out subparagraph (A) of section 25(f)(2) of the Code (as added by section 612(a) of the bill) and insert the following:

"(A) IN GENERAL.—For purposes of paragraph (1) the term 'correction amount' means an amount equal to the excess credit amount divided by 0.20."

(119) In subsection (h) of section 25 of the Code (as added by section 612(a) of the bill), strike out "1978" and insert in lieu thereof "1987".

(120) In paragraph (1) of section 6708(a) of the Code (as added by section 612(d) of the bill), strike out "a misstatement" and insert in lieu thereof "a material misstatement".

(121) Add at the end of subsection (c) of section 6708 of the Code (as added by section 612(d) of the bill) the following new sentence: "In the case of any report required under the second sentence of section 25(g), the aggregate amount of the penalty imposed by the preceding sentence shall not exceed $2,000."

(122) In the heading of subparagraph (C) of section 103(n)(4) of the Code (as added by section 621 of the bill) strike out "termination" and insert in lieu thereof "partial termination".

(123) In clause (i) of section 103(n)(7)(C) of the Code (as added by section 621 of the bill), strike out "section 103(b)(4)" and insert in lieu thereof "subsection (b)(4)".

(124) Strike out clause (ii) of section 103(n)(7)(C) of the Code (as added by section 621 of the bill) and insert in lieu thereof the following:

"(ii) EXCEPTION NOT TO APPLY TO CERTAIN PARKING FACILITIES.—For purposes of clause (i), subparagraph (D) of subsection (b)(4) shall be applied as if it did not contain the phrase 'parking facilities'."

(125) In section 622 of the bill, strike out "certain obligations must not be" and insert in lieu thereof "certain obligations which must not be".

(126) In clause (iv) of section 103(h)(3)(A) of the Code (as amended by section 622 of the bill), strike out "of 1984" and insert in lieu thereof "of 1984 with respect to any obligation issued before July 1, 1989".

(127) In clause (ii) of section 103(b)(15)(B) of the Code (as added by section 623 of the bill), strike out "for the later issue" and insert in lieu thereof "of the later issue".

(128) Strike out subparagraph (C) of section 103(b)(15) of the Code (as added by section 623 of the bill) and insert in lieu thereof the following:

"(C) ALLOCATION OF FACE AMOUNT OF AN ISSUE.—

"(i) IN GENERAL.—Except as otherwise provided in regulations, the portion of the face amount of an issue allocated to any test-period beneficiary of a facility financed by the proceeds of such issue (other than an owner of such facility) is an amount which bears the same relationship to the entire face amount of such issue as the portion of such facility used by such beneficiary bears to the entire facility.

"(ii) OWNERS.—Except as otherwise provided in regulations, the portion of the face amount of an issue allocated to any test-period beneficiary who is an owner of a facility financed by the proceeds of such issue is an amount which bears the same relationship to the entire face amount of such issue as the portion of such facility owned by such beneficiary bears to the entire facility."

(129) In subparagraph (D) of section 103(b)(15) of the Code (as added by section 623 of the bill), strike out "principal user of" and insert in lieu thereof "a principal user of".

(130) In clause (ii) of section 103(c)(6)(F) of the Code (as added by section 624 of the bill)—

(A) strike out "Notwithstanding subparagraphs (D)" and insert in lieu thereof "Under regulations prescribed by the Secretary", and

(B) strike out "this paragraph only" and insert in lieu thereof "this clause only".

(131) In the heading of section 625 of the bill, strike out "BOND" and insert in lieu thereof "BONDS" and amend the table of contents accordingly.

(131a) In section 625(a)(3)(C) of the bill, strike out "section 625(c)(5)" and insert in lieu thereof "section 626(b)(4)".

(132) In the paragraph heading of paragraph (3) of section 103(o) of the Code (as added by section 626(a) of the bill), strike out "student loans" and insert in lieu thereof "student loan bonds".

(133) In subsection (b) of section 626 of the bill, redesignate paragraphs (4), (5), (6), and (7) as paragraphs (3), (4), (5), and (6), respectively.

(134) In section 626(b)(5) of the bill (as redesignated by their resolution), strike out "amounts made" and insert in lieu thereof "amendments made".

(135) In subparagraph (C) of section 103(b)(16) of the Code (as added by section 627(a) of the bill), strike out "port development project" and insert in lieu thereof "port development project which consists of facilities described in paragraph (4)(D)".

(136) In paragraph (17) of section 103(b) of the Code (as added by section 627(b) of the bill), strike out the quotation marks at the end of subparagraph (C)(iii) and add at the end thereof the following new subparagraph:

"(D) SPECIAL RULE FOR CERTAIN PROJECTS.—In the case of a project involving 2 or more buildings, this paragraph shall be applied on a project basis."

(137) Strike out paragraphs (2) and (3) of section 628(a) of the bill and insert in lieu thereof the following:

(2) Subparagraph (B) of section 103(m)(2) is amended to read as follows:

"(B) is exempt from tax under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act."

(3) Subsection (m) of section 103 is amended by adding at the end thereof the following new paragraph:

"(3) EXCEPTIONS.—The following obligations shall be treated as obligations described in paragraph (1) (without regard to the second sentence thereof):

"(A) Any obligation issued pursuant to the Northwest Power Act (16 U.S.C. 839d) as in effect on the date of the enactment of the Tax Reform Act of 1984.

"(B) Any obligation issued pursuant to section 608(6)(A) of Public Law 97-468.

"(C) Any obligation issued before June 19, 1984, under section 11(b) of the United States Housing Act of 1937."

(138) At the end of section 628 of the bill, add the following new subsection:

(h) SMALL ISSUE LIMIT IN CASE OF CERTAIN URBAN DEVELOPMENT ACTION GRANTS.—In the case of any obligation issued on December 11, 1981, section 103(b)(6)(I) of the Internal Revenue Code of 1954 shall be applied by substituting "$15,000,000" for "$10,000,000" if—

(1) such obligation is part of an issue,

(2) substantially all of the proceeds of such issue are used to provide facilities with respect to which an urban development action grant under section 119 of the Housing and Community Development Act of 1974 was preliminarily approved by the Secretary of Housing and Urban Development on January 10, 1980, and

(3) the Secretary of Housing and Urban Development determines, at the time such grant is approved, that the amount of such grant will equal or exceed 5 percent of the total capital expenditures incurred with respect to such facilities.

(139) In paragraph (1) of section 631(c) of the bill, strike out "this section" and insert in lieu thereof "this subtitle".

(140) In clause (ii) of section 631(c)(3)(A) of the bill, strike out "significant expenditure" and insert in lieu thereof "significant expenditures".

(141) In section 631(c)(4) of the bill, strike out "section 628(j)" and insert in lieu thereof "section 628(g)".

(142) Strike out paragraphs (1) and (2) of section 631(d) of the bill and insert in lieu thereof the following:

(1) Any property described in paragraph (5), (6), or (7) of section 31(g) of this Act.

(2) Any property described in paragraph (4), (8), or (17) of section 31(g) of this Act but only if the obligation is issued before January 1, 1985, and only if before June 19, 1984, the issuer had evidenced an intent to issue obligations exempt from taxation under the Internal Revenue Code of 1954 in connection with such property.

(143) In subsection (f) of section 631 of the bill—

(A) strike out "June 1, 1984" and insert in lieu thereof "June 19, 1984", and

(B) strike out "such issues" and insert in lieu thereof "such issue".

(144) In subsection (a) of section 632 of the bill, strike out "title" each place it appears and insert in lieu therof "subtitle".

(145) In paragraph (6) of section 632(a) of the bill, strike out "November 23, 1983" and insert in lieu thereof "November 3, 1983".

(146) In paragraph (6) of section 632(a) of the bill, strike out "issued pursuant to" and

insert in lieu thereof "issued in connection with".

(147) In section (d) of section 632 of the bill—

(A) strike out "were issued with respect to" and insert in lieu thereof "are issued with respect to", and

(B) strike out "or any facility related to such facility".

(148) In subsection (b) of section 644 of the bill, strike out "take into account in 1984" and insert in lieu thereof "use in 1984".

(149) In subsection (a) of section 646 of the bill, strike out "a hearing and".

(150) In section 647 of the bill, strike out "any other provision of law" and insert in lieu thereof "any other provision of law, in the case of obligations issued before July 1, 1987".

(151) In paragraph (3) of section 712(k) of the bill, strike out subparagraph (B) and insert in lieu thereof the following:

(B) by inserting "or" at the end of subparagraph (C), and

(152) In paragraph (2) of section 1362(e) of the Code, as amended by section 721(g)(2) of the bill, strike out "paragraphs (3) and (6)(C)" and insert in lieu thereof "paragraph (3) and subparagraphs (C) and (D) of paragraph (6)".

(153) In subsection (a) of section 518 of the Highway Revenue Act of 1982, as amended by section 734(l) of the bill, insert ", except as provided in regulations prescribed by the Secretary of the Treasury or his delegate," before "any Federal Reserve Bank".

(154) In paragraph (2) of section 921(d) of the Code (as added by section 801 of the bill), insert "or accured" after "received".

(155) In paragraph (3) of section 921(d) of the Code (as added by section 801(a) of the bill), insert "or accured" after "received".

(156) In section 921(d) of the Code (as added by section 801(a)) strike out "the conduct of" in the matter following paragraph (3).

(157) In clause (i) of section 922(a)(1)(D) (as added by section 801(a) of the bill), insert before the comma at the end thereof "or in any possession of the United States".

(158) In the last sentence of section 924(a) of the Code (as added by section 801(a) of the bill), insert "derived" before "from activities".

(159) In paragraph (3) of section 927(e) of the Code (as added by section 801(a) of the bill) strike out "credited or organized" and insert in lieu thereof "created or organized".

(160) In section 927(e) of the Code (as added by section 801(a) of the bill), strike out paragraph (5) and insert:

"(5) Exemption from certain other taxes.—No tax shall be imposed by any jurisdiction described in subsection (d)(5) on any foreign trade income derived before January 1, 1987.

(161) In section 801(d) of the bill, add at the end thereof the following new paragraphs:

(11) Section 936(f) (relating to DISC or former DISC ineligible for credit) is amended to read as follows:

"(F) LIMITATION ON CREDIT FOR DISCs AND FSCs.—NO CREDIT SHALL BE ALLOWED UNDER THIS SECTION TO A CORPORATION FOR ANY TAXABLE YEAR—

"(1) for which it is a DISC or former DISC, or

"(2) In which it owns at any time stock is a—

"(A) DISC or former DISC, or

"(B) FSC or former FSC."

(12) Section 6011(c) (relating to returns of DISCs and former DISCs) in amended—

(A) by inserting "or a FSC of former FSC" after "former DISC" in paragraph (1), and

(B) by inserting "and FSCs and Former FSCs" after "Former DISCs" in the heading thereof.

(13) Section 6072(e) (relating to returns by nonresident alien individuals and foreign corporations) is amended by inserting "or a FSC or former FSC" after "United States".

(14) Section 6501 (g)(3) (relating to income tax returns of DISCs) is amended by striking out "section 6011(e)(2)" and inserting in lieu thereof "section 6011(c)(2)".

(15)(A) Section 6686 (relating to failure of DISC to file returns) is amended—

(i) by striking out "section 6011(e)" and inserting in lieu thereof "section 6011(c)", and

(ii) by striking out the heading thereof and inserting in lieu thereof the following:

"SEC. 6686. FAILURE TO FILE RETURNS OR SUPPLY INFORMATION BY DISC OR FSC."

(B) The table of sections for subchapter B of chapter 68 is amended by striking out the item relating to section 6686 and inserting in lieu thereof the following new item:

"SEC. 6686. FAILURE TO FILE RETURNS OR SUPPLY INFORMATION BY DISC OR FSC."

(162) Section 995(f)(B) (as added by section 802(a)(3)) is amended by striking out "and carrybacks of losses and credits".

(163) In section 805(b)(2)(A) of the bill, insert "with respect to which there had previously been a deemed distribution to which section 996(e)(1) of such Code applied" immediately before the period at the end thereof.

(164) In paragraph (2) of section 4051(d) of the Code, as amended by section 921 of the bill, strike out subparagraph (B) and insert in lieu thereof the following:

"(B)(i) both the seller and the purchaser of which are registered in a manner similar to registration under section 4222, and

"(ii) with respect to which the purchaser certifies (at such time and in such form and manner as the Secretary prescribes by regulations) to the seller that such trailer or semitrailer—

"(I) will be used, or resold for use, principally in connection with such service, or

"(II) will be incorporated into an article which will be so used or resold."

(165) Strike out section 1020 of the bill.

(166) Strike out the item relating to section 1020 in the table of contents of the bill.

(167) In clause (iii) of section 6166(b)(9)(B) of the Code, as added by section 1021 of the bill, insert before the period at the end of the first sentence "for purposes of clause (ii)".

(168) In clause (i) of section 1034(c)(2)(B) of the bill, strike out "account of interest" and insert in lieu thereof "number of units".

(169) In clause (iii) of section 1034(c)(2)(B) of the bill, strike out "amount of interests" and insert in lieu thereof "number of units".

(170) In subsection (j) of section 51 of the Code, as added by subsection (c) of section 1041 of the bill—

(A) strike out "allowable under section 44B" in paragraph (1) thereof and insert in lieu thereof "under this section", and

(B) strike out "allowed under section 44B" in paragraph (2) thereof and insert in lieu thereof "determined under this section".

(171) In paragraph (1) of section 1072(c) of the bill, strike out "section 6056(c)" and insert in lieu thereof "section 6053(c)".

(172) In section 1079 of the bill, strike out all that follows the parenthetical material and insert in lieu thereof ", as amended by section 2813 of the bill, is amended by striking out subparagraph (A) thereof and inserting in lieu thereof the following:

"(A) is exempt from Federal income taxes—

"(i) under such Act as amended and supplemented before the date of the enactment of the Tax Reform Act of 1984, or

"(ii) under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act, or

(173) Section 217 of the bill is amended by adding at the end thereof the following new subsection:

(n) SPECIAL RULE FOR COMPANIES USING NET LEVEL RESERVE METHOD FOR NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—A company shall be treated as meeting the requirement of section 807(d)(3)(A)(iii) of the Internal Revenue Code of 1954, as amended by this Act, with respect to any noncancellable accident and health insurance contract for any taxable year if such company—

(1) uses the net level reserve method to compute its tax reserves under section 807 of such Code on such contracts for such taxable year,

(2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and

(3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

(174) In section 521 of the bill redesignate subsection (d) as subsection (e) and insert after subsection (c) the following new subsection:

(d) CERTAIN DISTRIBUTION REQUIREMENTS TO APPLY TO 5-PERCENT OWNERS RATHER THAN KEY EMPLOYEES.—Section 72(m)(5) (relating to penalties applicable to certain amounts received by owner-employees) is amended—

(1) by striking out "key employee" each place it appears in subparagraph (A) and inserting in lieu thereof "5-percent owner";

(2) by striking out "in a top-heavy plan" in clause (i) of subparagraph (A), and

(3) by striking out "the terms 'key employee' and 'top-heavy plan'" in subparagraph (C) and inserting in lieu thereof "the term '5-percent owner'".

(175) In section 168(b)(4)(A) of the Code (as added by section 111(b)(1) of the bill), insert "(without regard to the mid-month convention)" after "paragraph (2)" in the matter preceding clause (i).

(176) In paragraphs (2) and (3)(C) of section 1042(b) of the Code (as added by section 541(a) of the bill), strike out "qualified securities" and insert "employer securities (within the meaning of section 409(1)".

(177) In section 4978 of the Code (as added by section 545(a))—

(A) strike out "qualified securities" in paragraph (1) of subsection (a) and insert "employer securities",

(B) strike out "qualified securities" the second place it appears in paragraph (2) of subsection (a) and insert "employer securities".

(C) amend subsection (e)(1) to read as follows:

"(1) EMPLOYEE STOCK OWNERSHIP PLAN.—The term 'employee stock ownership plan' has the meaning given to such term by section 4975 (e)(7).",

(D) strike out the closing quotation marks at the end of subsection (e)(4), and

(E) insert at the end of subsection (e) the following:

"(5) EMPLOYER SECURITIES.—The term 'employer securities' has the meaning given to such term by section 409 (1).".

(178) In section 1276(a)(2)(A) of the Code (as added by section 41(a) of the bill), insert "(determined without regard to paragraph (2) thereof)" after "section 1272(a)".

(179) In section 48(a)(5)(B)(ii)(II) of the Code (as amended by section 31(b) of the bill), strike out "section 48(a)(2)(B)(vi)" and insert "section 48(a)(2)(B)(v)".

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(180) In section 112(b)(2) of the bill, strike out "act" and insert "section".

(181) In subparagraph (D) of section 31(g)(15) of the bill, strike out "passenger" in the matter preceding clause (i).

(182) In section 111(g) of the bill, insert the following new paragraph at the end thereof:

(5) SPECIAL RULE FOR MID-MONTH CONVENTION.—In the case of the amendment made by subsection (d)—

(A) paragraph (1) shall be applied by substituting "June 22, 1984" for "March 15, 1984", and

(B) paragraph (2) shall be applied by substituting "June 23, 1984" for "March 16, 1984" each place it appears.

(183) In paragraph (3) of section 523(b) of the Highway Revenue Act of 1982 (as amended by section 734(a)(2)(A) of the bill) strike out "solely by reason of the parenthetical matter in paragraph (1)" and insert in lieu thereof "solely by reason of the amendment made by subsection (a)(1) or (d) of section 734 of the Tax Reform Act of 1984".

(184) Insert at the end of section 112(b), the following new paragraph:

(3) SPECIAL RULE FOR CERTAIN DISPOSITIONS BEFORE OCTOBER 1, 1984.—The amendments made by this section shall not apply to any disposition before October 1, 1984, of all or substantially all of the personal property of a cable television business pursuant to a written offer delivered by the seller on June 20, 1984, but only if the last payment under the installment contract is due no later than October 1, 1989.

SEC. 2. TRANSITIONAL RULE FOR PURPOSES OF IMPUTED INTEREST RULES.

Subsection (b) of section 44 of the Tax Reform Act of 1984 (relating to effective date for treatment of debt instruments received in exchange for property) is amended by adding at the end thereof the following new paragraphs:

"(4) SPECIAL RULES FOR SALES BEFORE JULY 1, 1985.—

"(A) IN GENERAL.—In the case of any sale or exchange before July 1, 1985, of property other than new section 38 property—

"(i) sections 483(c)(1)(B) and 1274(c)(3) of the Internal Revenue Code of 1954 shall be applied by substituting the testing rate determined under subparagraph (B) for 110 percent of the applicable Federal rate determined under section 1274(d) of such Code, and

"(ii) sections 483(b) and 1274(b) of such Code shall be applied by substituting the imputation rate determined under subparagraph (C) for 120 percent of the applicable Federal rate determined under section 1273(d) of such Code.

"(B) TESTING RATE.—For purposes of this paragraph—

"(i) IN GENERAL.—The testing rate determined under this subparagraph is the sum of—

"(I) 9 percent, plus

"(II) if the borrowed amount exceeds $2,000,000, the excess determined under clause (ii) multiplied by a fraction the numerator of which is the borrowed amount to the extent it exceeds $2,000,000, and the denominator of which is the borrowed amount.

"(ii) EXCESSES.—For purposes of clause (i), the excess determined under this clause is the excess of 110 percent of the applicable Federal rate determined under section 1278(d) of such Code over 9 percent.

"(C) IMPUTATION RATE.—For purposes of this paragraph—

"(i) IN GENERAL.—The imputation rate determined under this subparagraph is the sum of—

"(I) 10 percent, plus

"(II) if the borrowed amount exceeds $2,000,000, the excess determined under clause (ii) multiplied by a fraction the numerator of which is the borrowed amount to the extent it exceeds $2,000,000, and the denominator of which is the borrowed amount.

"(ii) EXCESS.—For purposes of clause (i), the excess determined under this clause is the excess of 120 percent of the applicable Federal rate determined under section 1274(d) of such Code over 10 percent.

"(D) BORROWED AMOUNT.—For purposes of this paragraph, the term 'borrowed amount' means the stated principal amount.

"(E) AGGREGATION RULES.—For purposes of this paragraph—

"(i) all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange, and

"(ii) all debt instruments arising from the same transaction (or a series of related transactions) shall be treated as one debt instrument.

"(F) CASH METHOD OF ACCOUNTING.—In the case of any sale or exchange before July 1, 1985, of property (other than new section 38 property) the active business of farming and in which the borrowed amount does not exceed $2,000,000—

(i) section 1274 of the Internal Revenue Code of 1954 shall not apply; and

(ii) interest on the obligation issued in connection with such sale or exchange shall be taken into account by both buyer and seller on the cash receipts and disbursements method of accounting.

The Secretary may by regulation prescribe rules to prevent the mismatching of interest income and interest deductions in connection with obligations on which interest is computed on the cash receipts and disbursements method of accounting.

"(5) GENERAL RULE FOR ASSUMPTIONS OF LOANS.—Except as provided in paragraphs (6) and (7), if any person—

"(A) assumes, in connection with the sale or exchange of property, any debt obligation, or

"(B) acquires any property subject to any debt obligations,

sections 1274 and 483 of the Internal Revenue Code of 1954 shall apply to such debt obligation by reason of such assumption (or such acquisition).

"(6) EXCEPTION FOR ASSUMPTIONS OF LOANS MADE ON OR BEFORE OCTOBER 15, 1984.—

"(A) IN GENERAL.—If any person—

"(i) assumes, in connection with the sale or exchange of property, any debt obligation described in subparagraph (B) and issued on or before October 15, 1984, or

"(ii) acquire any property subject to any such debt obligation issued on or before October 15, 1984,

sections 1274 and 483 of the Internal Revenue Code of 1954 shall not be applied to such debt obligation by reason of such assumption (or such acquisition) unless the terms and conditions of such debt obligation are modified in connection with the assumption (or acquisition).

"(B) OBLIGATIONS DESCRIBED IN THIS SUBPARAGRAPH.—A debt obligation is described in this subparagraph if such obligation—

"(i) was issued on before October 15, 1984, and

"(ii) was assumed (or property was taken subject to such obligation) in connection with the sale or exchange of property (including a deemed sale under section 338(a)) the sales price of which is greater than $100,000,000.

"(C) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to effect the purpose of this paragraph and paragraph (5), including regulations relating to tax-exempt obligations, government subsidized loans, or other instruments.

"(D) CERTAIN EXEMPT TRANSACTIONS.—The Secretary shall prescribe regulations under which any transaction shall be exempt from the application of this paragraph if such exemption is not likely to significantly reduce the tax liability of the purchaser by reason of the overstatement of the adjusted basis of the acquired asset.

"(7) EXCEPTION FOR ASSUMPTIONS OF LOANS WITH RESPECT TO CERTAIN PROPERTY.—

"(A) IN GENERAL.—If any person—

"(1) assumes, in connection with the sale or exchange of property described in subparagraph (B), any debt obligation, or

"(ii) acquires any such property subject to any such debt obligation.

sections 1274 and 483 of the Internal Revenue Code of 1954 shall not be applied to such debt obligation by reason of such assumption (or such acquisition) unless the terms and conditions of such debt obligation are modified in connection with the assumption (or acquisition).

"(B) SALES OR EXCHANGES TO WHICH THIS PARAGRAPH APPLIES.—This paragraph shall apply to any of the following sales or exchanges:

"(i) RESIDENCE.—Any sale or exchanges of a residence by an individual, an estate, or a testamentary trust, but only if—

"(I) either—

"(aa) such residence on the date of such sale or exchange (or in the case of an estate or testamentary trust, on the date of death of the decedent) was the principal residence (within the meaning of section 1034) of the individual or decedent, or

"(bb) during the 2-year period ending on such date, no substantial portion of such residence was of a character subject to an allowance under this title for depreciation (or amortization in lieu therof) in the hands of such individual or decedent, and

"(I) such residence was not at any time, in the hands of such individual, estate, testamentary trust, or decedent, described in section 1221 (1) (relating to inventory, etc.).

"(II FARMS.—Any sale or exchange by a qualified person of—

"(I) real property which was used as a farm (within the meaning of section 6420 (c)(2)) at all times during the 3-year period ending on the date of such sale or exchange, or

"(II) tangible personal property which was used in the active conduct of the trade or business of farming on such farm and is sold in connection with the sale of such farm,

but only if such property is sold or exchanged for use in the active conduct of the trade or business of farming by the transferee of such property.

"(iii) TRADES OR BUSINESSES.—

"(I) IN GENERAL.—Any sale or exchange by a qualified person of any trade or business.

"(II) APPLICATION WITH SUBPARAGRAPH (B).—This subparagraph shall not apply to any sale or exchange of any property described in subparagraph (B).

"(III) NEW SECTION 38 PROPERTY.—This subparagraph shall not apply to the sale or exchange of any property which, in the hands of the transferee, is new section 38 property.

"(iv) SALE OF BUSINESS REAL ESTATE.—Any sale or exchange of any real property used in an active trade or business by a person who would be a qualified person if he disposed of his entire interest.

This subparagraph shall not apply to any transaction described in the last sentence of paragraph (6)(B) (relating to transaction in excess of $100,000,000).

"(C) DEFINITIONS.—For purposes of this paragraph—

"(i) QUALIFIED PERSON DEFINED.—The term 'qualified person' means—

"(I) a person who—

"(aa) is an individual, estate, or testamentary trust,

"(bb) is a corporation which immediately prior to the date of the sale or exchange has 35 or fewer shareholders, or

"(cc) is a partnership which immediately prior to the date of sale or exchange has 35 or fewer partners,

"(II) is a 10-percent owner of a farm or a trade or business,

"(III) pursuant to a plan, disposes of—

"(aa) an interest in a farm or farm property, or

"(bb) his entire interest in a trade or business and all substantially similar trades or businesses, and

"(IV) the ownership interest of whom may be readily established by reason of qualified allocations (of the type described in section 168(j)(9)(B), one class of stock, or the like).

"(ii) 10-PERCENT OWNER DEFINED.—The term '10-percent owner' means a person having at least a 10-percent ownership interest, applying the attribution rules of section 318 (other than subsection (a)(4)).

"(iii) TRADE OR BUSINESS DEFINED.—

"(I) IN GENERAL.—The term 'trade or business' means any trade or business, including any line of business, qualifying as an active trade or business within the meaning of section 355.

"(II) RENTAL OF REAL PROPERTY.—For purposes of this clause, the holding of real property for rental shall not be treated as an active trade or business.

PARTIAL TEXT OF AN OCTOBER 12, 1984 PRESS RELEASE BY SENATOR BOB DOLE (R.,KANS.)

The highlights of the temporary solution approved by the Congress Thursday are:

1. For sales of real property and used personal property before July 1, 1985, involving seller financing of $2 million of principal or less, no interest will be imputed if the parties state at least 9 percent compound interest. If the parties fail to state adequate interest, it will be imputed at a 10 percent compound rate.

2. Transactions involving seller financing of more than $2 million will be subject to a blended interest rate, based on a weighted average between 9 and 10 percent, and the higher rates applicable under the Deficit Reduction Act (110 percent and 120 percent of the Treasury borrowing rate).

3. Assumptions of loans in connection with sales of principal residences, vacation homes, farms and ranches, and small business property will be permanently exempt from the new provisions applying imputed interest rules to assumptions.

   In addition, assumptions of loans made before October 16, 1984, will be permanently exempt from the new assumption rules, except for assumptions in connection with transactions involving a purchase price of $100 million or more.

4. For sales before July 1, 1985, of real property and used personal property used in the active business of farming or ranching, with seller financing of $2 million or less of principal, interest income and deductions will be accounted for by both the buyer and seller on the cash method.

5. Under the permanent rules of the Deficit Reduction Act, sales of all principal residences, and farms or ranches costing $1 million or less, will be permanently exempt from the OID rules. Sales of principal residences (to the extent they cost under $250,000) and sales of land in connection with the sale of a farm or ranch costing $1 million or less, will be permanently exempt from the requirement to state interest at 110 percent of the Treasury borrowing rate. These transactions will be subject to the interest rates established by regulations, currently 9 percent and 10 percent.

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46(c)	113, 431	B-141, B-189	B-331, B-362		14, 15, 40
46(e)	31(f)	B-107	B-265		14, 15, 18
47(a)	474(o)(8)	B-199	B-364		15, 40
47(d)	431	B-189	B-362		14, 15
47(e)	421(a), (b)(7)	B-186	B-361		14, 15
48(a)	31(b)	B-108	B-265	(5), (6), (7), (179); B-407, B-412	6, 14, 15, 18, 40
48(b)	114(a)	B-142	none		6, 15, 18
48(c)	11	B-105	B-263		14
48(d)	431(c)	B-190	B-362		14
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51	1041	B-256	B-398		14, 17
51(c)	1041(a)	B-256	B-398		14, 17
51(d)	712(n), 1041(c)	B-232, B-257	B-390, B-398		14, 17
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53	474(p)(8), 713(c)(1)	B-247, B-232	B-364		14, 17
55	711(a)(1)	B-228	B-389		6, 41
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71	422(a)	B-187	B-361		13
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72(q)	222	B-181	B-350		1
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87	474(r)(3)	B-199	B-364		41
88 (new)	91	B-134	B-295		3, 20
103(b)	623, 627, 629, 630	B-222 to B-226	B-386 to B-388	(127), (128), (129), (135), (136); B-411	6, 20
103(c)	624	B-222	B-385	(130); B-411	20
103(h)	622	B-222	B-385	(126); B-411	20
103(m)	628	B-225	B-384		20
103(n)	621	B-221	B-382	(122), (123), (124); B-411	20
103(o)	626	B-224	B-385	(131); B-411	20
103A(c)	611	B-217	B-380		20
103A(g)	612	B-220	B-382		20
103A(j)	611(b)	B-217	B-380	(105), (106), (107), (108), (109); B-410	20
103A(o)	611	B-217	B-380	(110); B-410	20
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129	474(r)(6)	B-199	B-264		46
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133	543	B-214	B-379		5, 48
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152(e)	423	B-188	B-361		13
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163(d)	56	B-124	B-278		3, 8, 11, 22, 41
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165(k)	1051	B-257	B-401		11
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168(b)	111	B-140	B-330	(175); B-412	6, 15, 40
168(e)	113(b)	B-142	B-331		6, 15, 19, 20
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179(b)	13	B-105	B-264		6, 26
189(d)	93	B-136	B-298		11
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274(h)	801(c)	B-243	B-320		64
280F (new)	179(a)	B-163	B-335		6, 15, 19, 40
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306(c)	712(l)	B-232	B-390		31, 32
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312(h)	63	B-127	B-284		31, 32
312(k)	61(b)	B-126	B-281		31, 32
312(n)	61(a)	B-126	B-281		31, 32
312(o)	61(c)	B-126	B-281		31, 32
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368(c)	64	B-127	B-284		32, 65
381(c)	474(r)(23)-(30)	B-201	B-364		32
382(b)	62(a)	B-127	B-283		32, 33
386 (new)	75	B-130	B-289		32
401(a)	521(a), 524(d)	B-207, B-209	B-365		49, 50
401(e)	713(d)	B-233	none		50
401(h)	528	B-210	B-369		50
401(k)	527(a), (b)	B-210	B-369		50
402(a)	522, 713(c)(3)	B-208, B-232	B-366		49, 50
403(b)	521(c), 522(b)	B-207, B-208	B-366	(101); B-410	49
404(a)	713(d)	B-233	none		47, 50
404(b)	512	B-206	B-371		47
404(k)	542	B-214	B-379		48
405(d)	491	B-202	B-364, B-365		50
408(a)	521(b)	B-207	B-366		49
408(k)	713(f), (j)	B-233	none		50
414(m)	526(a)	B-209	B-368		47, 50
414(n)	526(b), 713(i)	B-209, B-233	B-368		47, 50
414(o)	526(d)	B-210	B-368		50
415(c)	713(d), (k)	B-233	none		47, 50
415(d)	15	B-105	B-369		50
416(c)	524(c)	B-209	B-365		50
416(d)	713(f)	B-233	none		50
416(g)	524(a), 713(f)	B-209, B-233	B-365		50
416(i)	524(a), 713(f)	B-209, B-233	B-365		46, 47, 50

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419(c)	511(a)	B-204	B-371	(82); B-409	47
419A (new)	511	B-204	B-368		47
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419A(c)	511	B-204	B-368	(84), (85), (86); B-409, B-410	47
419A(e)	511	B-204	B-368	(87); B-410	47
419A(g)	511	B-204	B-368	(88); B-410	47
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425(h)	555	B-216	B-378		46
441(h)	803	B-244	B-320		64
446	161	B-159	B-329		23, 43
453(i)	112	B-141	B-331		26
453B(d)	492	B-204	B-364		21
461(h)	91(a), (g)	B-131, B-134	B-291, B-295		21, 23, 38, 43, 47
461(i)	91(a), (g)	B-131, B-134	B-291, B-295		23, 38, 43
463 (new)	561	none	none	(99); B-410	23
465(a)	721(x)(2)	B-237	B-391		12, 15, 24
465(b)	432(c)	B-192	B-362		12, 15, 24
465(c)	432(a)	B-191	B-362	(80); B-409	12, 15, 24
467 (new)	92(a)	B-134	B-297	(33); B-408	22, 42, 43
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468A (new)	91	B-133	B-293		23
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507(d)	313	B-184	B-355		59
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514(c)	174, 1034	B-162, B-256	B-384		60
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535(b)	58(b)	B-124	B-279		33
535(d)	125	B-145	B-280		69
551(f)	132(b)	B-150	B-316		67
552(c)	132(c)	B-150	B-316		67, 71
554(c)	132(a)	B-150	B-316		67, 71
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643(d)	81	B-131	B-291		56
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704(c)	71(a)	B-128	B-287		36
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804 (new)	211(a)	B-166	none		79
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811(c)	714(a)	B-233	none		79
812 (new)	211(a)	B-171	B-347		79
813 (new)	211(a)	B-172	B-348		79
814 (new)	211(a)	B-172	B-348		79
815 (new)	211(a)	B-173	B-342		79
816 (new)	211(a)	B-173	B-340		79
817 (new)	211	B-174	B-344		79
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818 (new)	211(a)	B-175	B-348		79
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845 (new)	212	B-176	none		79
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852	1071(a)	B-259	B-406		34
852(b)	55(a), 1071(a)	B-124, B-259	B-278, B-406		31, 34
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857(b)	55(b)	B-124	B-278		31
863(c)	124(a)	B-144	B-310		66, 67
864(c)	127(c)	B-146	B-310		61, 62
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871(i)	127(a)	B-145	B-310	(60), (61); B-409	62
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921 (new)	801(a)	B-240	B-320	(154), (155), (156); B-412	64
922 (new)	801(a)	B-241	B-320	(157); B-412	64
923 (new)	801(a)	B-241	B-320		64
924 (new)	801(a)	B-241	B-320	(158); B-412	64
925 (new)	801(a)	B-242	B-320		64
926 (new)	801(a)	B-242	B-320		64
927 (new)	801(a)	B-242	B-320	(159); B-412	64
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954(h)	712(f)	B-230	B-305		77
956(b)	801(d)(8)	B-244	B-320		64, 66, 71
959(e)	133(b)	B-151	B-317		68, 71
992(a)	802(c)	B-244	B-320		64
993(a)	802(c)	B-244	B-320		64
995(b)	802(b)	B-244	B-320		33, 64
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1042(b)	541	B-213	B-379	(176); B-412	30, 48
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1091(a)	106(b)	B-140	B-304		10, 27
1091(e)	106(a)	B-140	B-304		27
1092(b)	103	B-139	B-303		27
1092(c)	108(e)	B-140	B-304		10, 27, 69
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1212(b)	1002(a)	B-248	B-401		28
1212(c)	102(e)(3)	B-138	B-302		27
1222	1001	B-247	B-401		18
1231(a)	711(c)(2)(A)	B-229	B-389		12, 42
1231(c)	176(a)	B-162	B-338		42
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1233	103(c), 1001(b)(17)	B-139, B-248	B-401		10, 27
1234(b)	1001(b)(18)	B-248	B-401		27, 33
1234(c)	105(a)	B-140	B-304		27
1234A	102(e)(9)	B-138	B-302		27
1239	421(b)(6)	B-186	B-338, B-361		28
1239(b)	175	B-162	B-338		28
1239(d)	557	B-216	B-375		28
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